REPUBLIC OF KENYA
IN THE TAX APPEALS TRIBUNAL
APPEAL NO. 347 OF 2018

AFRICA OIL KENYA BV.....APPELLANT

-VERSUS-

COMMISSIONER OF DOMESTIC TAXES.....RESPONDENT

JUDGEMENT

INTRODUCTION

1. The Appellant is a limited liability company incorporated in The Netherlands and carries on its business in the oil and gas industry. In Kenya, it operates through a branch registered in Kenya. The principal business of the Appellant is the production and exploration of petroleum. It has other revenue streams like revenue raised from farmouts of some of their interest in the blocks.

2. The Appellant has held interests in various oil and gas exploration blocks in Kenya. The blocks are more particularly described and known as; **Block 9**, **Block 12A** and **Block 13T**. It farmed-out its interests in blocks 9, 12A and 13T during the period 2011 - 2015. The Appellant currently only retains an interest in Block 13T, following unsuccessful exploration activities on the other blocks.

3. The Respondent, Commissioner of Domestic Taxes is a statutory entity established under the Kenya Revenue Authority Act (Cap 469), Laws of Kenya, for assessment, collection and accounting for government revenue and taxes.

BACKGROUND

4. In 2017, the Respondent carried out an audit in respect of the Appellant's tax affairs for the years of income 2011 to 2017. The audit related to Corporation Income Tax Valued Added Tax, pay as you earn tax and withholding tax. The audit included a review of the farm-out transactions by the Appellant, during the same period, 2012 to 2017.

5. By a letter dated 29th June 2018, the Respondent issued the formal assessments on the corporate Income Tax and VAT subsequent to which the Appellant filed a Notice of Objection dated 27th July 2018 Subsequent to the Appellant's

Notice of Objection. The Appellant confirmed its formal assessments by way of its letter dated 24th September 2018 stating that the Appellant was liable to pay;

a. **Kes.1,324,213,123/=** being income in respect of the Appellant's assignment of its 50% interest in Block 9 to Marathon International Oil Company, in 2012;

b. **Kes. 617,721,941/=** being Income Tax in respect of the Appellant's assignment of its 30% interest in Block 12A to Marathon International Oil Company (15%) and Tullow Kenya BV (15%) in 2012;

c. **Kes.433,142,567/=** being Income Tax in respect of the Appellant's assignment of its 25% interest in Block 13T to Total E&P International K3 Limited in 2016; and

d. **Kes.2,293,334,065.44** being VAT on farm-out transactions for 2011, 2012 and 2016

6. In addition, The Respondent also disallowed CIT expenditure of;

a. **Kes.489,784,237/=** overhead uplift under a Product Sharing Contract and Joint Operating Agreement; and

b. **Kes.67,085,060**/=common costs in respect of operated and non-operated licenses.

7. Being aggrieved by the Respondent's decision, the Appellant proffered this appeal.

GROUNDS OF APPEAL

8. The grounds upon which the Appellant preferred this appeal were set out on the Memorandum of Appeal dated and filed on 5th November 2018 and were:

a. THAT the Respondent erred in law and in fact by confirming, in its Objection decision, that CIT on the gross consideration received in respect of the assignment of 50% interest in Block 9 and 30% interest in Block 12A in the year 2012 on the basis that gains from farm-out transactions are a specified source of income for tax purposes

b. THAT the Respondent erred in law and in fact by failing to take into account the full value of tax losses brought forward and thereby confirming CIT in respect of the assignment of 25% interest in Block 13T in the year 2015

c. THAT the Respondent erred in law and in fact by disallowing expenditure for CIT purposes wholly and exclusively incurred by the Appellant in the production of income and more specifically, overhead uplift costs in respect of Joint Operations Agreement, and Production Sharing Contracts;

d. THAT the Respondent erred in disallowing common costs for CIT purposes

e. THAT the Respondent erred in its assessment of VAT;

f. THAT the Respondent erred its interpretation of the exclusions from registration of; and

g. THAT the Respondent erred in assessing the Appellant for CIT and VAT for the years 2011 and 2012 as this is outside the statutory period of limitation.

APPELLANT'S CASE

9. The Appellant submitted that farm-out transactions do not result in the farmor granting any proprietary interests as envisaged under Sections 3(2)(a)(iii) and 15(7)(e)(i), as such transactions merely transfer an existing interest under a Production Sharing Contract ("**PSC**"). The Government of Kenya remains the sole grantor of such interests.

10. Further, the assignment of an interest in a license is an assignment of a right (granted by the Government of Kenya) to carry out exploration, production and related activities in respect of the license. It involves the sale of an already existing intangible asset and is therefore not a grant of a right for use or occupation of property as envisaged under Sections 3(2) (a) (iii) and 15(7) (e) (i) of the ITA.

11. The Appellant submitted that its correct reading of the legislation is as follows;

i. Gains from farm-out transactions are a "gains or profits from a business" under Section 3(2)(a)(i); Section 3(2)(a)(iii) is not applicable as there has been no "grant" of a right – see above; 'Business is defined as 'any

trade, profession or vocation, and every manufacture, adventure and concern in the nature of trade, but does not include employment;

ii. Section 4(f) then provides that any such gains or profits which arise to a PSC contractor (such as the Appellant) are calculated under the Ninth Schedule;

iii. At the time of the relevant farm-outs, Paragraph 7(1) of the Ninth Schedule provided that the consideration for the assignment of a PSC right "*shall be treated as a receipt of a petroleum company, and tax shall be charged accordingly*" (this was subsequently repealed effective 1 January 2015, but remains applicable to these farm-outs);

iv. The effect of Paragraph 7(1) is therefore to treat the consideration for the farm-outs as ordinary business income (rather than capital gains as provided under the Eighth Schedule);

12. The Appellant further submitted that in computing the tax due on farm-out transactions, it had included the value of work obligation which is expressly excluded from being taken into account when determining the value of consideration for Income Tax purposes under Paragraph 7(4) of the repealed Ninth Schedule. Paragraph 7(4) states that;

"...where part of the consideration consists of the undertaking by the assignee of a work obligation, no amount in respect thereof shall be taken into account under this paragraph."

13. The Appellant further submitted that the entire value designated as exploration carry- on costs and discretionary amounts in the farm-out agreements had subsequently been paid for by the farmee towards exploration activities in the relevant licenses, that is, the Appellant has been carried to the extent agreed.

14. The Appellant submitted that The Respondent confirmed CIT of **Kes.433,142,567/=** in respect of the Appellant's transfer of 25% interest in Block 13T in 2015 arguing, *inter alia,* that the ring-fencing by license which was introduced effective 1st January 2015 pursuant to the Finance Act, 2014, applies to the losses incurred by the Appellant before 31 December 2014.

15. It submitted that there is no statutory basis upon which the Respondent can claim as it has done, that the ring-fencing provisions apply to the Appellant's tax losses of **USD 166,881,895** (approximately **Kes.16,918,486,515.10**).

16. The Appellant relies on the **Interpretation and General Provisions Act (Cap 2), Laws of Kenya which provides under Section 23 (3) (b) and (c)** as follows;

> (3) ***Where a written law repeals in whole or in part another written law, then, unless a contrary intention appears the repeal shall not—.***
> ***(b) Affect the previous operation of a written law so repealed or anything duly done or suffered under a written law so repealed; or***
> ***(c) Affect a right, privilege, obligation or liability acquired, accrued or incurred under a written law so repealed;***

17. The Appellant found support for its position in the Court of Appeal decision in **Civil APPEAL No.29 of 2005 COMMISSIONER OF INCOME TAX V PAN AFRICAN PAPER MILLS (E.A.) LIMITED [2018] eKLR**, in which case the Court of Appeal reiterated that unless a statute expressly provided for retrospective application, it can only apply prospectively. It also cited **YEW BON TEW V KENDERAAN BAS MARA [1982] ALL ER 833** where the court held that;

> ***"Apart from the provisions of the interpretation statutes, there is at common law a prima facie rule of construction that a statute should not be interpreted retrospectively so as to impair an existing right or obligation unless that result is unavoidable on the language used. A statute is retrospective if it takes away or impairs a vested right acquired under existing laws, or creates a new obligation, or imposes a new duty, or attaches a new disability in regard to events already past".***

18. The Appellant further asserted that it is trite that the provisions only apply prospectively from 1st January 2015 and cannot apply to tax losses generated by the entity before that date. This means that tax losses until 31 December 2014 are carried forward in a tax losses pool and may be utilized across all licences by the entity as at 31 December 2014, until exhausted.

19. The Respondent disallowed overhead uplift costs of **KEes.489,784,237/=** arising from Joint Operations Agreement ("**JOA**") and PSC and in so doing, failed to deduct these costs for the purposes of CIT. The Respondent's position is that the costs are not deductible as they were not incurred wholly and exclusively in the generation of income of the Appellant and that the PSC and JOA are irrelevant for the purposes of assessing tax.

20. It submitted that these costs are allowable deductions, pursuant to Section 15(1) of the ITA and Paragraph 9 of the Ninth Schedule as expenditure incurred in the production of income of the Appellant. The expenses clearly have a direct nexus with the income-earning activities of the Appellant and are not private in nature. The Tribunal was referred to the Expert Witness

Statement in which the nature of overhead uplift costs is explained and the fact that such costs are incurred wholly and exclusively for the production of income.

21. The Appellant submitted that the Respondent had failed to provide any cogent or statutory basis upon which overhead uplift costs should be disallowed and that the Appellant's approach is not only consistent with the law but adheres to international best practice and accounting standards.

22. The Respondent has disallowed shared costs of **Kes.1,220,509,394/=** incurred across both operated and non-operated licences and which are not wholly attributable to the Appellant for tax purposes to the extent to which the costs relate to other related entities.

23. The Appellant agreed that such costs should be allocated across the licences, but rejected the Respondent's assertion that the allocation must be on a proportionate basis regardless of the level of activity in the licence. The Respondent's approach fails to adopt a reasonable basis for allocation of costs which takes into account the actual activities carried on in respect of the relevant licences.

24. The Appellant summarized its rationale and basis for its apportionment as set out in the table below.

Entity	**Africa Oil Kenya BV**		**Africa Oil Turkana Ltd**	**Centric Energy**
Contract area	Block 9	Block 13T	Block 10BB	Block 10BA
Proposed allocation to December 2016	75%	10%	10%	5%
CCP costs to Dec 2017 (USD)	3,244,007	432,534	432,534	216,267
Exchange rate @(KES) 102				
Allocated amounts	330,888,714	44,118,468	44,118,468	22,059,234

25. The Appellant submitted that the Respondent has purported to issue a VAT assessment of **Kes.2,778,163,730.42** on the basis that the Appellant ought to have registered and accounted for VAT because the Appellant's farm-outs were taxable supplies which surpassed the Kes 5 million turnover threshold in the years 2011, 2012 and 2015.

26. The Appellant submits that a transfer of a PSC interest is a taxable supply of a capital asset and is therefore excluded in determining whether a person exceeds the Kes 5 million turnover threshold (by virtue of Section 34(2)(a) of the VAT Act, 2013).

27. The Tribunal was referred to the expert testimony of Mr. Page at **para 13 - 22 of the Expert Witness Statement** which explains that the Appellant's PSC rights formed a critical component of its fixed capital and business structure, and that the PSC rights did not constitute the stock in trade of the Appellant.

28. The Appellant's position it submitted, was supported by a substantial body of case law. In particular, **Hughes (H M Inspector of Taxes) v The British Burmah Petroleum Co, Ltd 17 TC 286**, where the Court held that a payment for the acquisition of interests in oil wells was of a capital nature. In reaching this conclusion, the court noted that

> ***"[t]he principle is quite clear: If you have an expenditure of that sort, an expenditure to buy an asset of the nature of a mine or an oil well or anything of that sort, that is capital expenditure and cannot be deducted."***

29. The Tribunal was referred to **ANGLO-PERSIAN OIL COMPANY, LIMITED V THE COMMISSIONERS OF INLAND REVENUE 16 TC 253**, where the Court held that

> ***"[t]he Company's oil concessions in Persia are part of the Company's fixed capital, and if a sum were paid for the cancellation of such a concession on the ground that it was onerous that would, no doubt, be a capital expenditure..."***

30. The authorities echo the fact that the PSC interests farmed out by the Appellant were clearly items of fixed capital that were integral to the profit-making structure of its business. They gave the Appellant the right to drill for and extract oil from the relevant blocks (which is the Appellant's circulating capital) and were therefore held for the "enduring benefit" of the Appellant's trade (a clear hallmark of a capital asset, per **BRITISH INSULATED AND HELSBY CABLED COMPANY V ATHERTON, [1926] A.C. 205, AT PAGE 213**).

31. In addition, the consideration paid under the farm-out agreements was a large, one-off, lump sum payment, which is consistent with a capital outlay. The Appellant therefore submits that the farm-outs clearly constituted supplies of capital assets and were correctly excluded in determining whether the

Appellant exceeded the VAT registration threshold under paragraph 34(2) of the VAT Act.

32. By reason of the foregoing, the Appellant submits that a farm-out transaction constitutes a taxable supply made solely as a consequence of the person selling the whole or a part of the person's business or permanently ceasing to carry on the person's business and is therefore also excluded under Section 34 (2)(b).

33. The Appellant noted that the Respondent's key argument in concluding that farm-outs are not a sale of a person's business is that the Appellant continued in the same business. It noted that the exclusion under Section 34(2) (b) applies whether a person sells the whole of, or only part of a person's business and, for reasons outlined above, the PSC interests formed a critical part of the Appellant's business. It was therefore proper for the Appellant to exclude the farm-out in the computation of VAT, pursuant to the express provisions of the VAT Act; case law and international best practice.

34. The Appellant submitted that the Respondent was precluded, by Sections 29(5) and 31(4) (b) of the Tax Procedures Act, 2015 ("**TPA**"), from raising tax assessments for the years 2011 and 2012 as they fell outside the 5year statutory limitation. This means that the Respondent had no power to raise tax assessments for **Kes.1,941,934,616/=** in Income Tax and **Kes.484,829,665/=** for VAT in respect of the years 2011 and 2012. The sum of **Kes.2,426,764,281/=** is therefore ultra vires the TPA and the Respondent had no power to make the tax assessments of the Appellant's taxes, under Sections 29(6) and 31(4) of the as alleged, or at all.

35. In regards to the CIT self-assessment, Section 31(4) provides the KRA may amend an assessment "within 5 years of" the date the self-assessment was submitted. The Appellant submitted and Respondent received the relevant CIT self-assessments on 27 June 2013 as evidenced by the acknowledged 2012 self-assessment return attached as Section I. The Respondent only issued a notice of assessment on 29 June 2018, which is two days after the applicable time limit. The Respondent was therefore out of time under Section 31(4).

36. In regards of VAT assessment of **Kes.484,829,665/=** for VAT in respect of the years 2011 and 2012, Section 29(5) provides that an assessment shall not be made after five years immediately following the 'last date of the reporting period' to which the assessment relates. VAT is reported on a monthly basis by the 20th of the next following month after the date of the transaction.

37. In this case, the relevant transactions are dated 12 October 2011 (Block 9, Marathon), 12 October 2012 (Block 12A, Marathon), and 9 July 2012 (Block 12A, Tullow) (Deeds of Assignment attached as Section II). It follows that the last date of reporting period are 31 January 2011, 31 July 2012 and 30 April 2012 respectively. The Respondent issued a notice of assessment on 29 June 2018, which is significantly beyond the applicable time limit and therefore out of time under Section 29 (5).

38. The Court of Appeal IN **CIVIL APPEAL NO. 34 OF 2008 - KENYA REVENUE AUTHORITY V HABIMANA SUED HEMED & ANOTHER [2015] eKLR** held that **A regulator exercising statutory powers must keep within the limits of the authority and discretion committed to it, and that it must also act reasonably, and in good faith** (emphasis added).

    By failing to uphold the statutory time limitations set out for further amendments of tax computation, the Respondent failed to honor its responsibility to uphold the principle of certainty of law and by extension, its responsibility to uphold the rule of law.

39. The Respondent also claims that it has power, under Section 31(4) of the TPA, to amend any assessment at any time, in the event of "gross neglect". This is the provision it seeks to rely on for its VAT assessment and to counter the Appellant's Objection in respect of the CIT assessment.

40. The Appellant noted that gross negligence is "*something more fundamental than failure to exercise proper skill and/or care constituting negligence*" (**RED SEA TANKERS LTD v PAPACHRISTIDIS [1997] 2 LLOYD'S REP 547)** and that the burden of proving that this high threshold has been met rests with the Respondent (**Income Tax Appeal No.7 of 2014 NATIONAL SOCIAL SECURITY FUND BOARD OF TRUSTEES V COMMISSIONER OF DOMESTIC TAXES, KENYA REVENUE AUTHORITY [2016] eKLR).**

41. The Respondent has failed to prove the alleged gross negligence of the Appellant. It is not enough for the Respondent to merely seek to invoke the provision, rather, it must demonstrate the manner in which it is alleged the Appellant was grossly negligent. This it has failed to do.

APPELLANT'S PRAYERS

42. For the reasons set out above the Appellant prays that this Appeal be allowed with costs.

RESPONDENT'S SUBMISSIONS

43. **As regards Block 9** the Appellant undertook some farm-outs of their interests in the block. For this block, CNOOC signed a contract with the Ministry of Energy for full exploration rights on the block in the year 2006. CNOOC then assigned 30% of the interests to AOKBV in year 2008. By year 2011, CNOOC had ceded all their rights in block 9 to AOKBV.

44. In year 2012, AOK B.V assigned 50% of the rights in Block 9 to Marathon Oil for a consideration of their past exploration costs and future carry costs. The breakdown of acquisition costs considered are provided as USD 23,000,000 for the prior period to June 2012 and an additional cost of USD 767,307 considered for the period July to October 2012 when the completion of the farm out was done. The total amount of USD 23,767,307 was paid to Africa Oil Corporation (Canada) bank account.

45. The exploration carry amount of USD 15M was then paid through Cash calls to Marathon Oil paid on behalf of AOKBV for costs incurred from the effective date. An additional discretionary amount of USD 3.5M was also agreed as part of the consideration as per the farm-out agreement.

46. With respect to **Block 12A,** the audit established that Appellant did some farm-outs of their interests in this block. For the block, AOKBV assigned rights to Tullow Oil in January 2011 and April 2012 respectively and also to Marathon Oil in October 2012.

The table below shows the consideration as indicated in the Farm-out agreements:

	2012
Acquisition Costs for the assignment of rights to Tullow Oil	759,000
Acquisition Costs for the assignment of rights to Marathon Oil	9,000,000
Exploration Carry Costs - Tullow farm-in	3,100,000
Exploration Carry Costs - Marathon Oil farm-in	4,500,000
Discretionary amount - Tullow farm-in	-
Discretionary amount - Marathon Oil farm-in	2,000,000
Total Consideration for assignment of rights to Marathon Oil	**19,359,000**

47. Regarding **Block 13T, in** the year 2015, AOKBV farmed-out 25% of their interests in this block to Maersk Oil. In this farm-out, the Block 13T Farmor (AOKBV) was holding a fifty percent (50%) Participating Interest in the Block 13T PSC and sold to the Block 13T Farmee (Maersk Oil) who purchased the Block 13T Transferred Interest. The effective date of the Farm-Out was 31st March 2015 and the Completion date was 31st December 2015.

48. **Section 15 (7) (e)** of the Income Tax Act provides that notwithstanding anything contained in the Act, the gains or profits of a person derived from one of the seven sources of income respectively shall be computed separately from the gains or profits of the person derived from other of the specified source and separate from any other income of that person.

The specified sources of income are –

(i) rights granted to other persons for the use or occupation of immovable property;
(ii) ....
(iii)....
(v) ***Other sources of income chargeable to tax under Section 3(2) (a), not falling within subparagraph (i), (ii), (iii) or (iv) of this paragraph***

49. It therefore follows that the rights to the PSC agreement Blocks constitute rights to immovable property and thus the transfer/granting rights to the agreement constitutes granting rights to the use of immovable property.

50. The two revenue streams for a petroleum company are further spelled out clearly by the Ninth Schedule of the Income Tax Act identifies that the companies have two incomes chargeable to tax. Paragraph 2 which deals with taxation of licensees identifies one source of income to be production income determined by the value of production entitled under a petroleum agreement. Paragraph 7 of the same schedule which deals with taxation of contractors also recognizes that income from assignment of a right under the petroleum agreement gives rise to a receipt chargeable to tax.

51. The contention is whether the consideration received from the farm-out transactions falls within the ambit of Sec 3(2) (a) (i) or 3(2) (a) (iii).

52. The rights in the Blocks being transferred i.e. Block 9 and 12A assigned to AOKBV constitute 'property' of the Government as defined by the Constitution of Kenya. The consideration for the assignment of rights is referred to be income of the assignor under the provisions of Ninth Schedule, Par 7(1) and chargeable to tax under Section 3(2) (a) (iii). This is because AOKBV is not the owner of the property but a mere holder of rights to the property being assigned. AOKBV made a gain out of the rights they were granted by the government as such the same income chargeable to tax.

53. The Tribunal should not be misled by the interpretation taken by the Appellant based on a ***MASON, HERRING AND BROOKS v HARRIS AND ANOTHER (1921).*** This case is premised on the Increase of Rent and Mortgage Interest Act (Restriction) Act, 1920 of the England. This Act is what in our country referred to as the Landlord and Tenant (Rent Restriction) Act. The

circumstance and the contest which the King Bench referred to the grant as provided under s.8, sub-s. 1 are too distinct and unique to the Act therein and not applicable to the dispute before it and is of no help. It therefore only reasonable that such submissions be ignored.

54. It is clear that the legislature intended to treat the disposal of interest under a farm out as a separate source of income as such, the Appellant cannot be allowed to treat it in any manner which is contrary to the letter of the law. From the foregoing and in line with the provisions of Sections 15 (7) (a) and 15(7) (e) (i) the Respondent correctly treated the consideration from farm out as a specified source of income separate from the extraction and production of oil and gas.

55. It is not disputed that the Appellant incurred intangible drilling costs from inception to the farm-out date. The intangible drilling costs include site surveys, seismic acquisition, geological studies, personnel costs, time writing and processing costs etc. As per the provisions of Ninth Schedule, Par 5(1), these expenses are allowable expenses for purposes of ascertaining the gains or profits for a petroleum company for a year of income from income determined as per Ninth Schedule, Par 2 i.e. production income. The same are however not allowable as against the Income from farm out which is separate source of Income.

56. **Section 15(7)** of the Income Tax Act provides that:

> a. ***the gains or profits of a person derived from one of the six sources of income respectively specified in paragraph (e) of this subSection (and in this subSection called "specified sources") shall be computed separately from the gains or profits of that person derived from any other of the specified sources and separately from any other income of that person***
> b. ***where the computation of gains or profits of a person in a year of income derived from a specified source results in a loss, that loss may only be deducted from gains or profits of that person derived from the same specified source in the following year and, in so far as the loss has not already been so deducted, in subsequent years of income;***
> c. ***the subparagraphs of paragraph (e) shall be construed so as to be mutually exclusive;***
> d. ***gains chargeable to tax under Section 3(2)(f) and losses referred to in subSection 3(f) of this Section shall not be deemed income or losses derived or resulting from specified sources for the purposes of this subSection;***
> e. ***the specified sources of income are -***
> ***(i) Rights granted to other persons for the use or occupation of immovable property;***

(ii) Employment (including former employment) of personal services for wages, salary, commissions or similar rewards (not under an independent contract of service), and a self-employed professional vocation;

(iii) Employment the gains or profits from which is wife's employment income, profession the gains or profits from which is wife's professional income and wife's self-employment the gains or profits from which is wife's self-employment;

.....

57. What comes out from the above is that **Section 15(7) (b)** specifies that the losses may only be deducted from gains of the person from the specified sources. As per Section 15(7) (c) the specified sources are construed to be mutually exclusive and therefore losses from petroleum business cannot be deducted as against the farm out income.

58. The Appellant had not made any oil discoveries during the period under review, all the expenses relating to intangible drilling ought to be capitalised for accounting purposes and allowed for tax purposes in the tax computation against nil income earned in line with the provisions of Sec 15 and Par 5(1) of the Ninth Schedule.

59. Paragraph 7(2) of the Ninth Schedule indicates that if an assignment of rights involves disposal of assets which represent qualifying expenditure, there shall be deducted from the consideration any qualifying expenditure not yet allowed against income. Par 5(1) of the Ninth Schedule also indicates that for ascertaining the gains or profits of a petroleum company, one should deduct expenditure relating to intangible drilling costs, geological and geophysical costs, production expenditure etc.

60. The Respondent restates that Paragraph 7(3) of the Ninth Schedule provides that the only expenses allowed against the consideration from the farm-outs are qualifying expenditure not yet allowed against income previously i.e. any un allowed capital expenditure incurred on the acquisition of or of rights in or over, petroleum deposits in Kenya and discovery and testing petroleum deposits in Kenya, or gaining access thereto.

61. Paragraph 7 only deals with qualifying expenditure that is capital in nature and not revenue expenditure described under Par 5(2) which is allowable against production income. Further Par 7(5) provides that the consideration paid by the assignee shall be treated as qualifying expenditure and as such the assignee does not get a share of the costs previously incurred by the Assignor. The assignee can only claim the costs of acquisition as qualifying expenditure at the specified rates prescribed in the Second Schedule or Par 5(3) and (4) of

the Ninth Schedule. Therefore, the income from a farm-out should thus not be combined with the business income of the parties.

62. As we rightly pointed out in the Respondent's Statement of Facts, if the assignor is allowed to claim intangible drilling costs, geological and geophysical costs, processing costs etc. relating to exploration costs, he would then enjoy a double relief from taxation since he is still entitled to claim the costs during production and also not be taxed on the farm-out proceeds. This is because the assignee cannot claim the costs of exploration not incurred and the fact that the ITA only allows the assignee to claim the cost of acquisition as qualifying expenditure and not allowable expenditure of Par 5(2) of the Ninth Schedule. From the foregoing, the past costs cannot be offset against the farm-out proceeds as per the provisions of the Ninth Schedule at paragraph 7.

63. In response to the Submissions that the Respondent erred in by failing to take into account the full value of tax losses brought forward and thereby confirming corporation tax in respect of assignment of 25% interest in Block 13T in the year 2015, the Respondent submitted that the guiding principles as to the deductibility of any expenditure or cost against an income is found in Section 15(1) and (2) of the Income Tax Act which 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.***
>
> ***(2) Without prejudice to subSection (1), in computing for a year of income the gains or profits chargeable to tax under Section 3(2) (a), the following amounts shall be deducted -***

64. What comes out from this provision is that for any expenditure to be deductible as against an Income it must have been incurred in the generation of that specific income. This was the law at all material times.

65. **Section 3(2)(g) of** the Income Tax Act provides that:
Subject to Section 15(5A), the net gain derived on the disposal of an interest in a person, if the interest derives twenty per cent or more of its value, directly or indirectly, from immovable property in Kenya;

66. Sec 3(3) defines immovable property to include an interest in a petroleum agreement or petroleum information. Section 15(5A) provides for the computation for the net gain chargeable from disposal of interest, directly or indirectly, from immovable property in Kenya.

67. The Ninth Schedule defines contribution to include in relation to a petroleum right or petroleum information, the total amount received or receivable for the disposal. Par 9(2) indicates that if a contractor disposes of an interest in a petroleum agreement the cost of which was deducted the exploration expenditure, the consideration for the disposal is considered income of the contractor and chargeable under Section 3(2)(a)(i) in the year of disposal.

68. Section 15(7) (vibe) on ring-fencing specifies that the income of one license area as determined in the Ninth Schedule is considered a specified source and the gain or loss should be computed separately. It therefore follows that only losses in relation to that particular disposal can be claimed against the income from the said disposal of the immoveable property. The Farm out for the Block 13 T was entered into after the enactment of ringfencing provisions and the Income in question derived after the ringfencing provisions come into force. It is bound by the ringfencing requirements.

69. The ringfencing provisions was introduced by Finance Act, 2014 with the effective date being 01 January 2015. The computation should therefore only take into account the full expenses giving rise to the income. It is important to note that sec 15 (1) already provided how to assign expenditures as against revenue. Prior to ring fencing provisions all the incomes and expenditures were recognized together. Ring fencing provision segregated the incomes. Having done that the income derived thereafter can only be followed by cost that relates to its generation and not any other cost. In any case this particular case the Income was derived after the ring fencing provisions were in operation and the said regulations are applicable to it.

70. The Appellant has based its submission that the application of the principle that cost follow revenue is being retrospective, nothing can be further from the truth for two reasons:

    a. The principle existed under Section 15(1) and when the law introduced ring fencing what it essences happened is that the cost and revenue which were recognized together were just housed and each house become independent with its past existing cost. If any revenue had been earned prior to the same, the same would have been deductible in the whole before ring fencing of the cost.

b. The Income in question was derived after the enactment of provision and only past cost that were incurred in deriving it can be deducted as against it.

71. It can therefore not be said that there was retrospective application of the law as at all time, the law provided that the cost shall follow the Income hence if the revenue is to be reported separate, only cost that relate to it can follow it. The concept that revenue follow cost cannot be said to be retrospective as it existent at all material times even long before the Income was derived. This argument must therefore fail.

72. In response paragraph 44 to 47 of the Appellant's Submissions and **Ground 3** of Memorandum of Appeal that the Respondent erred in law and facts in by disallowing joint operations agreement and the Production Sharing Agreement overhead uplift cost.

73. The Respondent reiterated that the guiding principle for deductibility of any expenditure as against an income is found in Section 15 (1) of the Income Tax Act which 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.***

74. The expenditure must be wholly and exclusively incurred in the production of the Income. The key word is ***"Incurred".*** The **Macmillan Dictionary** and **the Cambridge Dictionary** both define the word "Incur" as;

> ***To experience something unpleasant as a result of something that you have done (Macmillan) to experience something, usually something unpleasant, as a result of actions you have taken (Cambridge)***

75. Further in **Republic v Kenya Revenue Authority Exparte Bata Shoe Company (Kenya) Limited [2014] eKLR**, the Superior Court stated that:;

Payment of tax is an obligation imposed by the law. It is not a voluntary activity. That being the case, a taxpayer is not obliged to pay a single coin more than is due to the taxman. The taxman on the other hand is entitled to collect up to the last coin that is due from a taxpayer.

The Ordinary meaning of incur is that it has to be suffered. For a cost/expenditure to be allowable as against an income the same must have been wholly and exclusively suffered in the generation of the Income.

76. The JOA cost of 3% and PSC cost of 3% uplift cost are not actual cost suffered rather they are boardroom agreed ratios/margins that form part of the contract. They may be allowable for accounting purpose but under the taxing regime only expenses which have been suffered as against the Income can be deducted.

77. The Court of Appeal in **COMMERCIAL & INDUSTRIAL CREDIT LIMITED V COMMISSIONER OF INCOME TAX [1986] eKLR** stated that;

That was the view of Lord Cave in Atherton's case (supra). But Sir Charles Newbolt has assisted me with the following comment at p.684 in Hutchings Beemer case (supra);

> ***"I agree with him (i.e. Lord Cave) that whether the expenditure was incurred for the direct purpose of producing profits and consequently is expenditure wholly and exclusively incurred in the production of income is, once the legal principles have been ascertained, a question of fact."***

The issue whether the Appellant has incurred the cost is a matter of fact. The Respondent invited the Tribunal to find that the uplift cost are boardroom ratios and not actual cost incurred are not be allowable by any means.

78. The Appellant failed to demonstrate that in fact the JOA and PSC uplift cost are incurred in the generation of the Income to warrant it being deducted and have since shifted the burden to make its case to the Respondent. At paragraph 47, they sought that the Tribunal find in their favour as the Respondent has allegedly failed to provide cogent basis for disallowing the uplifts.

79. The Burden of proof at all times rely with the Appellant. **Section 56 (1)** of **the Tax Procedures Act, 2015** states that: ***(1) in any proceedings under this Part, the burden shall be on the taxpayer to prove that a tax decision is incorrect.***

80. This provision was further reinforced by the **Section 31 of the Tax Appeal Tribunal Act** which states that:-

In a proceeding before the Tribunal, the Appellant has the burden of proving

(a) Where an appeal relates to an assessment, that the assessment is excessive; or
(b) In any other case, that the tax decision should not have been made or should have been made differently.

81. From the foregoing, the Joint Operations Agreement and the Production Sharing Contract overheads uplifts are not cost actually incurred in the production of the income and should be disallowed for tax purposes.

82. It is not in dispute that the Appellant's entire office personnel also work for Centric Energy and Africa Oil Turkana. The related companies share an office, common utility expenses, travel costs, etc. Some of the shared services between AOKBV, Centric Energy and Africa Oil Turkana include Accounting and auditing, Processing and management of accounts receivable and accounts payable etc., human resources activities such as: staffing, recruitment, training, employee development, remuneration services and developing and monitoring of staff health procedures, the monitoring and compilation of data, Information Technology services, internal and external communications and public relations support, Legal services, activities with regard to tax obligations, General services of an administrative or clerical nature etc.

83. The Appellant has not provided any document to support is allocation. The Appellant alleges that the same is based on the level of activity in the license and further called Bill Page to support the position has a practice that is carried out in other jurisdiction. The Respondent however to not have an issue with the practice what is contested is that the formulae to be applied and the ratios have to be justified by a verifiable mechanism and not just figures which cannot be explained how they are arrived at. Nothing has been brought to support this alleged level of activity. It is a well-known doctrine that he who alleged must proof. This is clearly premised under **Section 107 and 109** of the Evidence Act which provide that:

107. Burden of proof
(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.

108. Incidence of burden
The burden of proof in a suit or proceeding lies on that person who would fail if no evidence at all were given on either side.
109. Proof of particular fact
The burden of proof as to any particular fact lies on the person who wishes the court to believe in its existence, unless it is provided by any law that the proof of that fact shall lie on any particular person.

84. The Burden of proof to provide timesheet or a scientific method to determining the allocation at all times rely with the Appellant. **Section 56 (1)** of **the Tax Procedures Act, 2015** states that: ***(1) in any proceedings under this Part, the burden shall be on the taxpayer to prove that a tax decision is incorrect.***

85. A timesheet or other scientific measures would have clearly supported the allocation of how the percentages of 75%, 10%, 10% and 5% are arrived at, however no explanation or document to support the same has been availed.

86. Further, it is a fact that Block 9 is the only operated block but none of the staff has been employed or office space allocated etc. for Block 9, all the Block costs are similar. In any case the natures of the expenses, such allocation without a timesheet to confirm the hours spend working for a particular block will be impractical to determine how to allocate the costs. In the absence of any actual allocation key, the only reasonable allocation criteria is to equally divide the costs.

87. Therefore the Appellant having failed to dispense the burden of justify any alternative method, Respondent was therefore justified to reject the allocation proposal by the Appellant and adopt the formulae of equally allocation and further disallow cost relating to blocks 10BB and 10BA.

88. The Appellant is in different businesses, the one of exploration and production of petroleum and further he is also in the business of farming in and farming out blocks. This can be well illustrated by the block movement schedule which can be found at page 362 Of the Respondent's statement of fact and clearly shows a very active trader.

89. The business of farming in and farming out, is a business of capital nature just like a person in the business of development of real estate for the purpose of selling. To any other person undertaking one off selling of a house that is a capital disposal but to the real estate that is their stock of trade and there revenue is not subject to capital gains but brought to charge under Section 3 of the Income Tax act. The same is further a taxable supply within the meaning of the Value Added Tax Act.

90. The Appellants holds interest in several oil and gas exploration blocks in Kenya, namely Blocks 9, 10A, 12A and 13T. In all these blocks, it has joint interest partners including Tullow, Delaney (relinquished), Marathon Oil, Maersk Oil etc. AOKBV is only operator in Block 9. During the time the Appellant entered several farm out agreements within the said blocks. The block movement schedule clearly demonstrated the movement in the rights during the time.

91. Determining whether the activities of the Appellant constitute a trade or activity in the nature in of a trade, and are therefore activities giving rise to taxable profits is purely and issue of conduct. This can be done by taking into consideration of the frequency of transactions and the profit motive.

    a. Black's Law Dictionary, Eight Edition defines the term "trade" as ***"the business of buying and selling or bartering goods or services".*** **Halsbury's law of England Volume 23(1) at paragraph 105** states inter alia that "to **be within this wide meaning it is not essential that there should be regular business of buying and selling Profit seeking motive.**

92. This is one of the indicators that a transaction carried out is in the nature of trade and not an investment. The issue of motive is a factual issue to be determined by the circumstances of each facts. By taking a journey patterns and the amounts that are being charged for the interest and the continued transaction can mean that they are motivated by the need to make income. This can be shown from the amounts of assessed as Income Tax from the transaction. Motive may be inferred from the parties' subsequent conduct. In the case of **GRAY AND GILL IT V TILLEY (INSPECTOR OF TAXES) (1944) 26 TC 80**, the court stated in part as follows;

"If it were building land when the Appellants bought it, the presumption arises that the Appellants bought it with that object in view. This, of course, may not be the proper inference. It may be that they were minded to present it to the National Trust, or were thinking of entering into a covenant with the National Trust which would have the effect of preventing the erection of any buildings upon Grange Farm. But, in the absence of any evidence of such intention, one would naturally suppose that these two gentlemen had bought building land and intended to dispose of it for that purpose. When it is found that within six years they did dispose of part of it to a development company and the rest of it to another development company in which they held more than half the shares, and of which they were the directors, it seems only reasonable to assume that the company bought the land with that object in view . . . The fact that within six years of the purchase the whole of Grange Farm was sold at enhanced prices for development as building land, confirms the view which the other facts strongly suggest".

93. In the case of ***RUTLEDGE v. CIR CS 1929 14 TC 490***, on a business trip to Germany a taxpayer purchased one million toilet rolls. On returning to the UK the sole consignment of toilet rolls were sold to one individual for a profit. The profit made on this large quantity single purchase and resale item was 'an adventure in the nature of trade'. The case was decided on the fact that the purchase was not made for own use but for investment purposes.

94. The Respondent during the Audit and subsequently during Objection stage observed that the conduct and the circumstances surrounding the sale is a clear indication that the Appellant aimed to make profits from the farm out. The key point to note is that the Appellant made a huge margins from the sale and this motivated it to repeatedly carry similar transactions. This, to the Respondent is a strong indication that the Appellant was trading.

95. The Respondent submitted that Appellant profit motive can always be derived from the fact that even after the initial sales the Appellant is still willing to engage in the trade. Nothing drives a make a going concern to redo a trade of farming in and farming out more than the actual existence of revenue. The books of the Respondent clearly show the amounts that the Appellant made from the farm out. This Honorable Tribunal to look at the financial statement at page 110-223, Joint Interest Billing Statement at page 346 -361 and finally Completion Statement at page 107-109 the huge capital outlay that goes into acquiring and releasing the interest clearly shows the motive.

96. From the foregoing, the question **whether the Appellant undertook the transactions with a profit seeking motive,** based on the evidence adduced above, the same can only be answered in the affirmative. The Appellant did indeed undertake the contentious transactions with a profit seeking motive.

b. Frequency of the Transaction

97. The Block Movement schedule clearly show a trader who is busy farming in and farming out interest in blocks. **Halsbury's Laws of England volume 23(1) at paragraph 110** states that "*the mere fact that there is one transaction does not preclude the possibility that that transaction is in the nature of a trade. Conversely, the more frequently a person buys and sells property, the more likely he is to be regarded as trading.* **Repetition of a non-trading transaction may not only be regarded as trading in itself, but may also cause the initial transaction to be re categorized.**

98. In the case of ***Pickford vs Quirke (Inspector of Taxes) (1954) 13 TC 251, CA***, the Court found that a taxpayer's participation in four separate occasions in similar transactions for the purchase of a mill-owning company and sale of assets was collectively held to constitute a trade.
In **Leach vs. Poison (1962) 40 TC 585,** the taxpayer was held to have operated a trade on each sale of around 30 driving schools. This included the first driving school set up and sold, as the court determined that the taxpayer's intention was to embark upon the business of establishing and selling driving schools immediately before he sold the original motoring school. ***(See Respondent' Bundle of Authority at page 110)***
In ***CIR v FRASER [1942] 24 TC 498***, the taxpayer was a woodcutter who bought a consignment of whisky in bond. He subsequently sold the whisky through an agent at a profit. Within the decision the judge stated:

> *"The purchaser of a large quantity of a commodity like whisky, greatly in excess of what could be used by himself, his family and friends, a commodity which yields no pride of possession, which cannot be turned to account except by a process of realization, I can scarcely consider to be other than an adventurer in a transaction in the nature of a trade... Most important of all, the actual dealings of the respondent with the whisky were exactly of the kind that take place in ordinary trade.'"*

What comes out from the Appellant's conduct cannot be in anyway said to be a person who was disposing capital assets but rather clearly a person in trade of assets of capital nature.

99. The Respondent submitted that the assignment of rights to the other parties constitutes a taxable supply and should be charged to VAT and the same meets all the requirement of the above all Section. The provisions of **Section 34 (2)** relates to persons disposing their capital assets and not persons in business of capital in nature as the Appellant and are therefore not applicable to this case. They cannot rely on the same to avoid being subjected to VAT.

100. The considerations for the Farm-out transactions exceed the limit for registration for VAT as **Section 34(1) (b)** of the VAT Act and the Appellant ought to have registered for the VAT. The Section provides as follows; ***(1) A person who in the course of a business – is about to commence making taxable supplies the value of which is reasonably expected to exceed five million shillings in any period of twelve months, shall be liable for registration under this Act and shall, within thirty days of becoming so liable, apply to the Commissioner for registration in the prescribed form.***

101. The Appellant is in the business of petroleum operations and that comes with the rights awarded by the Production Sharing Agreement (PSC). The Production Sharing Contract allows the Appellant to assign rights as per Par 35 of the PSC. The Block Movement Schedule demonstrates the frequent acquisition and assignment of rights in the several blocks. The assignment of rights is not a one-off transaction to constitute a transfer of a capital asset rather it is part of the core mandate of the Appellant and form part of the company's principal business.

102. Further, the farm out transaction as in the case of the Appellant therefore fails to even meet the definition of Capital Asset as defined by the International Accounting Standards Board (IASB) framework which the Appellant sought to rely on. The same defines an asset as "a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.

103. The Respondent further invites the Honourable to consider the arguments raised by the Appellant in ground 1 of this Appeal wherein they admitted that farm out revenue was business revenue and only contested that the same was not separate source of income. They cannot now under value added tax to change the argument and now claim the same to be a capital disposal. This amounts to Approbation and reprobation which is frowned to by the Courts and disentitle the Appellant to his argument on the issue being accepted.

104. The Superior Court in **REPUBLIC v INSTITUTE OF CERTIFIED PUBLIC SECRETARIES OF KENYA EX-PARTE MUNDIA NJERU GETERIA [2010] eKLR** stated that:

> ***It is obvious that Mundia is approbating and reprobating which is an unacceptable conduct. Such conduct was considered in EVANS V BARTLAM (1937) 2 ALL ER 649 at page 652 where Lord Russell of Killowen said;***
>
> > ***"The doctrine of approbation and reprobation requires for its foundation inconsistency of conduct, as where a man, having accepted a benefit given him by a judgment cannot allege the invalidity of the judgment which conferred the benefit."***
>
> Again in ***BANQUE DE MOSCOU V KINDERSLEY (1950) 2 ALL EER 549 Sir Evershed said of such conduct;***
>
> > ***"This is an attitude of which I cannot approve, nor do I think in law the defendants are entitled to adopt it. They are, as the***

Scottish Lawyers (frame it) approbating and reprobating or, in the more homely English phrase, blowing hot and cold."

In ABEDARE FREIGHT (supra) J. Nyamu held that an applicant could not be allowed to approbate and reprobate at the same time. The Court of Appeal in BEHAN & OKERO ADVOCATES V NATIONAL BANK OF KENYA (2007) was of the same view that a party cannot be allowed to blow hot and cold at the same time.

105. From the foregoing, the farm out transaction undertaken by the Appellant is a not a transfer of a capital asset made solely for the purpose of selling a business rather the Appellant was involved in business of capital nature and was required under **Section 34 (1)** to register and account for Value Added Tax. The Respondent therefore legally brought to charge the total consideration for the farm out transactions as provided under the Value Added Tax Act.

B. Whether the assessment of 2011 & 2012 contravenes the law

106. In response to paragraph 65 to 74 of the Appellant's submissions and **ground no 7** of the Memorandum of Appeal that the Respondent erred in law in including assessments for the year 2011 & 2012 contrary to statutory five year limit contrary to Section 29 (5) and (6) of the Tax Procedures Act, 2015.

107. Your Honour, from ground A to G of the submissions herein, the Respondent has exhibited nothing but ***wilful neglect*** by the Appellant to comply with the requirements of the Income Tax Act and the Value Added Tax Act. Wilful neglect is a conduct offence and all the Tribunal need to look at is the conduct of the party.

108. In **CUNNINGHAM v. COMM'R, T.C. MEMO 2009-194 (T.C. 2009)** wherein the court found that failure to file returns timely was "***willful neglect***" and defined willful neglect as:

"Conscious, intentional failure or reckless indifference." "Whether a failure to file timely is due to reasonable cause and not willful neglect is a question of fact."

109. The Appellant willful negligence can be deduced from the following conducts and actions which were unearthed during the audit;

i. Failure to register and comply with the provisions of the VAT Act while they were dealing in taxable supplies;
ii. Failure to declare Farm out revenue separately as provided under the Income Tax Act and further proceeding to deduct unrelated cost as against the revenue;

iii. Failure to apply ring fencing provisions as against income which was derived after the provisions came into operation;
iv. Failure to provide a basis to justify for allocation of the Common Cost; and
v. Intentionally deducting JOA and PSC cost which are not incurred in the generation of the income as against the income

110. **Section 31 (4)** of the Tax Procedures Act state that:

The Commissioner may amend an assessment—
(a) In the case of gross or wilful neglect, evasion, or fraud by, or on behalf of, the taxpayer, at any time;

This Section allows the Commissioner to amend the assessment at any time where there is gross or willful neglect. The Applicant has avoided the word "***wilful neglect***" which they know they are guilty of and submitted only on gross neglect which they state is of higher threshold.

111. The massive neglect above clearly borders on tax evasion. The exhibited negligence is not only willful neglect but clearly is gross as the same led to massive loss in tax revenues amounting to billions and a very lucrative enjoyment of unwarranted tax advantage. The law has allowed the Respondent to amend assessment for the lower threshold ***(willful neglect)*** but in this case the Commissioner has also clearly met the higher threshold for gross negligence.

112. In respect to the VAT Assessment for the year 2011 and 2012, the Respondent states that the Appellant had in gross negligence declined to register and account for VAT when they knew that the farm out transactions where in their nature vatable supplies and they ought to have registered and account for the same.

113. The failure to file a tax return for VAT and fraudulently not register for VAT while making taxable supplies leading to a loss of VAT amounting to Kes.484,829,665/= cannot be in anyway said not to be gross negligence. If that is not then nothing can actually be gross negligence. Noting that the Appellant at all material time had some of the reputable firms as its auditors and tax agents.

114. It therefore follows that the case law of gross negligence does not assist the Appellant as he is still guilty of willful neglect, therefore that the corporation Tax assessments for the year 2012 and the VAT for the years 2011 and 2012 are proper in law and should stand.

RESPONDENT'S PRAYERS

115. In light of the above, the Respondent prays that this Honorable Tribunal:
    a) Uphold the Objection Decision dated 24th September, 2018 as the same was proper as provided under the Income Tax Act, the Value Added Tax and the Tax Procedures Act, 2015 and the taxes demanded therein are due and payable; and
    b) That this appeal be dismissed with costs to the Respondent as the same is without merit.

ISSUES FOR DETERMINATION

116. The Tribunal agreed with both parties that the issues for determination were:

    i. Whether the Income from Farm Out transactions is a specified source of Income;

    ii. Whether intangible drilling cost can be claimed against the consideration from the farm out;

    iii. Whether the tax losses brought forward ought to be ring fenced in Block 13T;

    iv. Whether Joint Operation Agreement and Production Sharing Contacts uplifts are allowable for tax purpose;

    v. Whether VAT is chargeable on farm out transactions;

    vi. Whether the tax assessments for the years 2011 & 2012 contravenes the Tax Procedures Act; and

    vii. Whether the Appellant can introduce documents with submissions

Whether the Income from Farm Out transactions is a specified source of Income;

117. According to the Respondent the Repealed Ninth Schedule of the ITA (in force prior to 1 January 2015) identified two sources of income of petroleum companies that are chargeable to tax. The two sources of income identified were income from production under Paragraph 2 and income from assignment of interests under Paragraph 7. The two sources are separately identified under Section 3 (2) (a) as **business income**, on one hand, and **income from any right granted to any other person for use or occupation of property** under Section 3 (2) (iii), on the other.

It argues that proceeds from assignment of an interest in a license are gains or profit from 'a right granted to another person for use or occupation of *immovable* property' as stated in **Section 3(2) (a) (iii) of the ITA.** It argues that such is a specified source of income under **Section 15(7) (e) (i).** It is on this basis that it confirmed its assessment comprising corporate Income Tax amounting to **Kes.1,324,213,125/=** on the Appellant's transfer of 50% interest in Block 9 to Marathon and **Kes.617,721,491/=** on assignment of interest in Block 12A to Tullow and to Marathon in the year 2012.

118. The Appellant's view was that the farm-out transactions do not result in the "grant" of any interest and that farm-out transactions are therefore not a separate source of income under the ITA. It argues that Section 4(f) of the ITA gives direction on the taxation of gains and profits of a licensee. The Appellant's view is that the provisions of Section 15(7)(e) are not applicable where the Ninth Schedule as read together with Section 4(f) specifically provides for taxation of income from transfers of interest as receipts of the petroleum company.

119. In the Appellants view, the licensee does not grant a right to another person as envisaged under Section 3(2)(iii), but is simply reducing its equity in the license by selling off a portion of its already existing interest to a third party. It argues that Farm-out transactions are part of petroleum operations and are specifically dealt with in the Ninth Schedule. Therefore, there is no requirement to charge to tax on farm out consideration separately from business income. It argues that farm-out consideration is not a specified source under Section 15(7) (e) to the ITA. Indeed, farm-out consideration is a receipt of the petroleum company and is therefore business income (Section 15(7) (e) (v)), and should be taxed accordingly in line with Para 7(1) to the Ninth Schedule.

120. In its simplest form a farmout is a contractual agreement with an owner who holds a working interest in an oil and gas lease to assign all or part of that interest to another party in exchange for fulfilling contractually specified conditions. The farmout agreement often stipulates that the other party must drill a well to a certain depth, at a specified location, within a certain time frame; furthermore, the well typically must be completed as a commercial producer to earn an assignment

121. The Tribunal agrees with the Respondent that the contention is whether the consideration received from the farm-out transactions falls within the ambit of Sec 3(2)(a)(i) or 3(2)(a)(iii). If income is received under Section 3(2)(a)(i) then it is treated as part of the normal business income. If it is categorized under Section 3(2) (a)(iii) then it is accounted for as a specified source of income and computed separately from the gains or profits derived from any other income.

122. The Tribunal observed that farmout could not possibly be treated as a grant of right given that only such a grant could only be given by the licencing Authority (the Government). As such, such transfer could only be treated as an assignment of rights that were granted to it. Consequently, gain or profit from a transfer of rights to a third party are to be dealt with under Section 4(f) which specifically provides for income of a petroleum company, including income from the transfer of an interest.

123. Section 4(f) provides that:

> ***"4(f) In computing the gains or profits of a 'licence', 'contactor', or 'subcontractor' as defined in the Ninth Schedule, the provisions of that schedule shall apply."***

In view of this Section, the Appellants gains from its farmout operations should be dealt with under the provisions of 9th Schedule and in particular **Paragraph 7(1)** of the repealed Ninth Schedule in respect of assignments of interest in a petroleum agreement provided that:

> ***"An assignment of a right under a petroleum agreement shall not give rise to a chargeable gain under the Eighth Schedule but, subject to this paragraph, the consideration for the assignment shall be treated as a receipt of the petroleum company, and tax shall be charged accordingly."***

124. The Tribunal was of the view that revenue from farmout should to be treated as part of the normal business income chargeable to tax under Sec 3(2) (a) (i). Furthermore, Section 15(7) (e) (ivB) which provides that profits or gains from a PSC contract area are to be treated as a separate source of income was introduced in 2014 and therefore not applicable to the farm-outs in question since they took place in 2012.

Whether intangible drilling cost can be claimed against the consideration from the farm out;

125. The Respondent disallowed expenses totaling **Kes.489,784,237** relating to Joint Operating Agreement ("JOA") and Production Sharing Contract ("PSC") overhead uplift on the basis that these are not allowable for Income Tax purposes. These costs include site surveys, seismic acquisition, geological studies, personnel costs, time writing and processing costs etc. The Respondent submitted that these costs are not allowable as against the Income from farm out as it is separate source of Income. It argued that Sections 15 & Section 16 of the ITA, provides that no deduction is allowed apart from actual

expenditure and that the PSC overhead cost is not incurred wholly and exclusively in the generation of the income of the Contractor.

126. The Appellant on the other hand submitted that the value of work obligation is expressly excluded from being taken into account when determining the value of consideration for Income Tax purposes under Paragraph 7(4) of the repealed Ninth Schedule and should not have been disallowed. It further submitted that the entire value designated as exploration carry on costs and discretionary amounts in the farm-out agreements had subsequently been paid for by the farmee towards exploration activities in the relevant licenses. That is to say they formed part of the consideration for the assignment of the licenses.

127. Paragraph 7 of the ninth schedule provides that:

> *i) qualifying expenditure" means capital expenditure, other than intangible drilling costs, incurred in the operations of a petroleum company .....*
> *ii) Where an assignment of a right under a petroleum agreement involves the disposal of assets which represent qualifying expenditure, there shall be deducted from the consideration for the assignment the amount of the qualifying expenditure not yet allowed against income.*
> *iii) Where the assignment is of part only of the rights held by a petroleum company, or where not all the assets which represent qualifying expenditure are included in the assignment, the amount of qualifying expenditure not yet allowed against income which is to be deducted from the consideration for the assignment shall be apportioned by the Commissioner.*
> *iv) The amount to be treated as a receipt for the purposes of subparagraph (1) shall be, in the case of an assignment at arm's length, the consideration therefor and in any other case, the market value of that which is assigned, but where part of the consideration consists of the undertaking by the assignee of a work obligation, no amount in respect thereof shall be taken into account under this paragraph.*

128. In view of the fact that drilling costs had been called out in paragraph 1 of the repealed 9th schedule as not forming part of qualifying expenditure and that only qualifying expenditure was to be deducted from the consideration, the Tribunal finds that the Respondent was right in disallowing intangible drilling costs.

Whether the tax losses brought forward prior to 2015 ought to be ring fenced in Block 13T;

129. The Respondent confirmed CIT of **Kes.433,142,567/=** in respect of the Appellant's transfer of 25% interest in Block 13T, in 2015 arguing, *inter alia,* that the ring-fencing by license which was introduced effective 1st January 2015 pursuant to the Finance Act, 2014, applies to the losses incurred by the Appellant before 31 December 2014.

130. The Respondent contends that effective 1 January 2015 when ring-fencing by licence was introduced under the ITA, the Appellant could not have claimed all losses for all blocks leading up to year 2015 under one licence. According to the Respondent, the new ring-fencing regime applies retrospectively to losses generated before 31 December 2014.

131. The Appellant's view was that Respondent incorrectly applied the ringfencing regime retrospectively and therefore did not take into account the total value of tax losses available for utilization by the Appellant in arriving at the tax payable on the farm-out transaction in the year 2015.

132. The farm out in question came into effect on ***1st December, 2015*** while the ringfencing provisions introduced by the finance Act, 2014 came into effect on ***1st January, 2015.*** Par 9(2) indicates that if a contractor disposes of an interest in a petroleum agreement the cost of which was deducted the exploration expenditure, the consideration for the disposal is considered income of the contractor and chargeable under Sec 3(2)(a)(i) in the year of disposal. Section 15(7)(iv)(b) on ring-fencing specifies that the income of one license area as determined in the Ninth Schedule is considered a specified source and the gain or loss should be computed separately.

133. The impact of ring fencing was that expenditure incurred by a contractor in undertaking petroleum operations in a contract area during a year of income can be allowed only against income derived by the contractor from petroleum operations in the contract area during the year. Petroleum operations means authorized operations undertaken under a petroleum agreement. This means that losses from one oil block cannot be used to reduce the taxable income in respect of another profitable oil block.

134. Be that as it may, since the provision became effective from 1st January 2015 going forward, tax losses carried forward prior to 31 December 2014 were not subject to ring fencing. The import of this is that losses carried forward prior to December 2014 by the Appellant were not subject to ring fencing but were to be utilized until exhausted.

135. In making this finding the Tribunal was informed by **Athlumney [1898] 2 QB 547,551-552** where it was stated;

> ***"Perhaps no rule of construction is more firmly established than this - that a retrospective operation is not to be given to a statute so as to impair an existing right or obligation, otherwise than as regards matter of procedure, unless that effect cannot be avoided without doing violence to the language of the enactment."***

Furthermore, as observed by Bernard Vail (1968) in *When Should a Bill Become Effective? - A Problem for the Constitutional Convention, 17DePaul L. Rev.567* (1968),

> ***"Inherent in the concept of a rule of law, rather than a rule of men, is the principle that people have a right to know the content of the laws which govern them. In order to observe this right, it is necessary that all laws be published before they become effective, so that people can order their conduct accordingly"***

Whether Joint Operation Agreement and Production Sharing Contract uplifts are allowable for tax purposes

136. The Respondent disallowed overhead uplift costs of **Kes.489,784,237/=** arising from Joint Operations Agreement ("**JOA**") and PSC and in so doing, failed to deduct these costs for the purposes of CIT. It argued that the costs are not deductible as they were not incurred wholly and exclusively in the generation of income of the Appellant and that the PSC and JOA are irrelevant for the purposes of assessing tax.

137. The Appellant averred that these costs are considered necessary for the joint operations and are allowable for tax purposes in line with provisions of Section 15 (1) of the ITA and Paragraph 9(1) to the Ninth Schedule. They are actual costs incurred and are meant to compensate the operator for costs on indirect services and related general & administrative overheads that the operator is not able to bill directly to its partners because it may not be practical to identify or associate them with specific projects.

138. Some of the costs the Appellant shared with related companies with whom it shared an office included Accounting and auditing, Processing and management of accounts receivable and accounts payable, human resources activities such as: staffing, recruitment, training, employee development, remuneration services and developing and monitoring of staff health procedures, the monitoring and compilation of data, Information Technology services, internal and external communications and public relations support,

Legal services, activities with regard to tax obligations, General services of an administrative or clerical nature etc.

139. Although the Respondent had argued that the Appellant had not submitted evidence to justify the distribution of among the related parties, the Appellant had actually explained that the costs had been shared according to the size of operations among the related parties. To this end, the Tribunal found that the Appellant had discharged its obligation to explain the expenditures by providing its formula for allocating its costs. It was not for the Appellant to suggest the formula. in Hero Cycles (P) Ltd vs **Commissioner of Income-tax (Central) Ludhiana [2015] 63 taxmann.com 308 [SC]** The Supreme Court of India Held;

> ***"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 assesse 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."***

Whether VAT is chargeable on farm out transactions

140. The Respondent issued a VAT assessment of **Kes.2,778,163,730.42** on the basis that the Appellant ought to have registered and accounted for VAT because the Appellant's farm-outs were taxable supplies which surpassed the Shillings Five million turnover threshold in the years 2011, 2012 and 2015.

141. The Appellant argues that a transfer of a PSC interest is a taxable supply of a capital asset and is therefore excluded in determining whether a person exceeds the Shillings Five million turnover threshold (by virtue of Section 34(2)(a) of the VAT Act, 2013). To buffer its position the Appellant cites **HUGHES (H M INSPECTOR OF TAXES) v THE BRITISH BURMAH PETROLEUM CO, LTD 17 TC 286**, where the Court held that a payment for the acquisition of interests in oil wells was of a capital nature. The court noted that If you have an expenditure of that sort, an expenditure to buy an asset of the nature of a mine or an oil well or anything of that sort, that is capital expenditure and cannot be deducted it further argues that a farm-out transaction constitutes a taxable supply made solely as a consequence of the person selling the whole or a part of the person's business or permanently

ceasing to carry on the person's business and is therefore also excluded under Section 34(2)(b).

142. The Tribunal applied its mind on whether exclusion from registration had the effect of excluding farm-out consideration from the computation of VAT. There is no dispute among the parties that farmout is a supply of a capital asset. Neither is there dispute that supply of capital asset is a taxable supply.

143. Section 2(1) of the VAT Act 2013 defines taxable supply as:
"Taxable supply" **means a supply, other than an exempt supply, made in Kenya by a person in the course or furtherance of a business carried on by the person, including a supply made in connection with the commencement or termination of a business.**

144. Section 5(1) imposes VAT on taxable supply thus:

A tax, to be known as value added tax, shall be charged in accordance with the provisions of this Act on—

> ***(a) a taxable supply made by a registered person in Kenya;***
> ***(b) the importation of taxable goods; and***
> ***(c) a supply of imported taxable services.***

The Tribunal observed that pursuant to Section 5(1) of the VAT Act, farmouts are taxable supplies when made by a registered person in Kenya. This fact was not disputed by any of the parties. What was in dispute was whether or not the Appellant should have been a registered person. Guidelines on registration are found in Section 34 of the VAT Act.

145. Section 34 provides the following;

> ***34. (1) A person who in the course of a business—***
> ***(a) has made taxable supplies or expects to make taxable supplies, the value of which is five million shillings or more in any period of twelve months; or***
> ***(b) is about to commence making taxable supplies the value of which is reasonably expected to exceed five million shillings in any period of twelve months,***
> ***shall be liable for registration under this Act and shall, within thirty days of becoming so liable, apply to the Commissioner for registration in the prescribed form.***

There was no dispute that the Appellant made taxable supplies exceeding the Kes 5 Million threshold, however, an issue arose as to whether the

supplies would qualify under Section 34(2) which would lead to a finding that the Appellant need not have registered.

146. Section 34(2) provides that:

> (2) **In determining whether a person exceeds the registration threshold for a period, the value of the following taxable supplies shall be excluded—**
> **(a) a taxable supply of a capital asset of the person; and**
> **(b) a taxable supply made solely as a consequence of the person selling the whole or a part of the person's business or permanently ceasing to carry on the person's business.**

The Tribunal was of the view that the nature of business of the Appellant involved supply of capital assets in the form of assignment of interests in oil exploration licenses it held in various Blocks. It would get a license, add value and sell part of the licensing rights at a gain. In view of this, the Tribunal concluded that the interests it held in various blocks were indeed similar to stock in a stable and could not be treated as capital assets of the nature contemplated in Section 34(2)(a).

The Tribunal recalled that earlier on, the Appellant had submitted that proceeds from farmouts were by virtue of Section 3(2)(a)(i) of ITA taxable as normal business income. Having taken the same position, the Tribunal made a finding that the taxable supply was made in the ordinary course of business and was not **solely** as a consequence of the Appellant selling whole or part of its interest in a business. Furthermore, a farmout agreement is an agreement with a working interest owner ("Farmor") whereby the Farmor agrees to assign working interest to the Farmee in exchange for certain contractually agreed services. This is hardly the same as the outright sale of interest contemplated in Section 34(2)(b).

The Tribunal therefore made the finding that the Appellant should have registered for, computed, collected and remitted VAT on its farmout transactions.

Whether the tax assessments for the years 2011 & 2012 contravenes the Tax Procedures Act;

147. The relevant transactions were dated 12 October 2011 (Block 9, Marathon), 12 October 2012 (Block 12A, Marathon), and 9 July 2012 (Block 12A, Tullow) the last date of reporting period were 31 January 2011, 31 July 2012 and 30 April 2012 respectively. The notice of assessment on 29 June 2018, which is beyond the applicable time limit under Section 29(5).

148. The Respondent submitted that the Appellant had in gross negligence declined to register and account for VAT when they knew that the farm out transactions were in their nature vatable supplies and they ought to have registered and account for the same. It argued that under Section 31(4) of the TPA, the Commissioner had power to amend any assessment at any time, in the event of *"gross neglect"*. This is the provision it seeks to rely on for its VAT assessment and to counter the Appellant's objection in respect of the CIT assessment.

149. The Appellant notes that gross negligence is "*something more fundamental than failure to exercise proper skill and/or care constituting negligence*" (see **RED SEA TANKERS LTD v PAPACHRISTIDIS [1997] 2 LLOYD'S REP 547)** and that the burden of proving that this high threshold has been met rests with the Respondent (see **Income Tax Appeal No.7 of 2014 National Social Security Fund Board of Trustees.**

150. Section 29 on default assessments provides that;

29(1) Where a taxpayer has failed to submit a tax return for a reporting period in accordance with the provisions of a tax law, the Commissioner may, based on such information as may be available and to the best of his or her judgment, make an assessment (referred to as a "default assessment")
.....
(5) Subject to subSection (6), an assessment under subSection (1) shall not be made after five years immediately following the last date of the reporting period to which the assessment relates.
(6) SubSection (5) shall not apply in the case of gross or wilful neglect, evasion or fraud by a taxpayer.

151. In **National Social Security Fund Board of Trustees V Commissioner of Domestic Taxes, Kenya Revenue Authority. (2016) eKLR** the High court ruled that;

> ***"In order for the Kenya Revenue Authority to become entitled to carry out a tax assessment for any 3years in issues, it would have needed to specify in respect of each year, the factor which they deemed to enlarge time"***

The Court further held that:

> **There is a world of difference between an assertion and proof. That which a party states to be his case is an assertion, The Party needs to adduce evidence to support the said assertion with a view to proving his case.**

In light of the above, the onus is on the Respondent to demonstrate to the Tribunal with **sufficient evidence** the grounds for raising tax assessments beyond the 5 year statutory period and not make assertions without producing evidence.

152. Based on the submissions of both parties the Tribunal made the finding that the Respondent had not proven wilful neglect on the part of the Appellant and therefore should have complied with the provisions of Section 29(5) and refrained from making an assessment beyond five years of the due date.

ORDERS

153. The Tribunal having entered the above findings, makes the following orders

i. Demand for Kes.1,324,213,123/= being income in respect of the Appellant's assignment of its 50% interest in Block 9 to Marathon International Oil Company, in 2012 be vacated.

ii. Demand for Kes.617,721,941/= being Income Tax in respect of the Appellant's assignment of its 30% interest in Block 12A to Marathon International Oil Company (15%) and Tullow Kenya BV (15%) in 2012 be vacated.

iii. Demand for **Kes.433,142,567/=** being Income Tax in respect of the Appellant's assignment of its 25% interest in Block 13T to Total E&P International K3 Limited, in 2016; be vacated.

iv. Demand for **Kes.2,293,334,065.44** being VAT on farm-out transactions for 2011, 2012 and 2016 be reviewed to exclude assessment in respect of 2011 and 2012.

v. **Kes.489,784,237/=** being overhead uplift under a Product Sharing Contract and Joint Operating Agreement; be allowed.

vi. **Kes.67,085,060/=** common costs in respect of operated and non-operated licenses. Be allowed.

It is so Ordered

DATED and **DELIVERED** at **NAIROBI,** this **25th** day of **March, 2020**

.....
MOSES OBONYO
CHAIRMAN

.....
NGINA MUTAVA
MEMBER

.....
ABRAHAM KIPROTICH
MEMBER

.....
WILFRED GICHUKI
MEMBER

.....
GABRIEL KITENGA
MEMBER