

REPUBLIC OF KENYA
IN THE TAX APPEALS TRIBUNAL AT NAIROBI
APPEAL NO 150 OF 2017

**PRAJAPATI BIPINCHANDRA RAMJIBHAI AND PRAJAPATI VIJAY
KUMAR TRADING AS MIMANI ENTERPRISES..... APPELLANTS**

-VERSUS-

THE COMMISSIONER OF DOMESTIC TAXES.....RESPONDENT

JUDGEMENT

BACKGROUND

1. The Appellants, Mr. Prajapati Bipinchandra and Prajapati Vijay Kumar are partners in Mimani Enterprises. The same is engaged in trading in fast moving consumer goods, hardware materials and transport business.
2. The Respondent is a principal officer of Kenya Revenue Authority (KRA) and which Authority is established under Chapter 469 Laws of Kenya and is charged with the mandate of assessment and collection of all government revenue.
3. A Notice of Intention to Audit was issued to the Appellants on 8th of April 2016. Specifically, the audit focus was on verification of sales, purchases, stock and confirmation of debtors and creditors. The Audit exercise commenced on 5th May 2016 and was concluded on 1st March 2017.

4. The Appellants were served with the Respondent's Findings and Demand for Taxes due in its letter of 7th June 2017 being: -
 - a. An additional VAT assessment on the business of Kshs 8,052,640.00.
 - b. Income tax payable by each partner of Kshs 19,555,247.00.
5. The Appellants sent an objection letter dated 6th July 2017. As a follow up, on 30th August 2017 there was a further correspondence by the Appellant to the Respondent quoting operational problems affecting profit generation. They stated that such operational issues affect the generation of profits, hence gross profit margin cannot be used in arriving at cost of goods sold.
6. An objection decision was formally communicated by the Respondent as per the letter dated 5th September 2017 confirming the tax amounts assessed as well as VAT amounts as per the original tax demanded.

APPELLANTS' CASE

7. The Appeal is premised on the following grounds:
 - a. The Respondent erred in law in raising the assessment of income tax and vat amount based on estimated gross profit margin against the actual trading results also assuming that all that was bought was sold and revenue collected. It also disregarded the actual accounting practice in arriving at gross profit margin taking into account of opening stocks at the starting day of business

operations, add purchases during the period, add direct costs of goods purchased less closing stock at the end of the financial year.

- b. That the Respondent confirmed the assessments of income tax and vat amount disregarding the objection letter dated 6th July 2017 and further clarification in the letter dated 30 August 2017.
 - c. The income tax assessed and vat amount assessed is erroneously charged where the charge should be as per return and accounts for the years 2013, 2014 and 2015.
 - d. The sample taken to determine the gross profit margin was not adequate and disregarded operational problems and losses made in day to day activities.
8. Additionally, the Appellants also aver in their Statement of Facts that the Respondent failed to consider that the partnership carries wholesale business where discounts are allowed for promotion of sales and for the purpose of generating cash to meet operational expenses.
9. The Appellants sent their supporting reasons to the objection to the Respondent. They cited the following grounds that would affect the computed mark-up: -
- a. Lack of qualified and trained personnel
 - b. Theft of goods from the shop
 - c. Damaged goods
 - d. Expired stocks

- e. Theft by sales men
- f. Weather conditions, mites and rats
- g. Sickness, Absenteeism and social issues
- h. Competition.

RESPONDENT'S CASE

10. The Appellants' grounds of objection cited by the Respondent were as follows:
- a. Assessment is estimated and not correct.
 - b. Inadequate samples for the period under audit.
 - c. Profit earned on cement is below expected margin.
 - d. Gross profit margin is theoretical not actual.
11. The Respondent through its correspondence dated 5th September 2017 communicated its decision. The following were the contents of the decision: -
- a. The additional assessment is based on the true mark-up determined from actual purchases and sales records of the business. It is not based on estimates hence not excessive.
 - b. The sampling done in the determination of true mark-up of the business was adequate. It captured data for 8 months out of the 12 months in year 2013.
 - c. Evidence was not provided to support whether there were operational challenges that affected the business. It is not possible

to determine the impact of such operational problems without evidence.

- d. The impact of low mark up on cement on the overall mark up of the business is marginal due to the fact that purchases of hardware products accounted for only 7% of the total purchases of the business. The actual impact however can only be determined from the purchase and sale records of hardware products which were not provided.
 - e. Cost of sales reported in the accounts was based on estimated closing stock. Stock records were not provided to verify closing stock reported hence the alternative to compute mark-up of the business from actual purchases and sales records. The test takes into account the weighted contribution of each product to the overall mark up using the product weights computed from purchases records.
12. The Respondent argued that the assessments were arrived at by conducting weighted Average Mark-up which is one of the methods of testing the credibility of firms on income tax returns and the exercise provides a basis for the calculation of an assessment. The principle behind the calculation of an average weighted mark-up is that an actual achieved mark-up is calculated for all the main selling lines of goods purchased for resale and is done by noting the actual selling prices of goods on the shelves (or where they can be accurately identified from recent sales invoices, and extracting from the registered taxable persons records the actual buying purchase prices.

13. According to the Respondent, the Appellants reported gross profit margin as per accounts and returns of 1.12% and 1.11% which was not in conformity with established gross profit margin derived from the Appellants' primary records of 10.59%.
14. The Appellant's closing stock in the returns and accounts were estimates (not backed by any empirical evidence).
15. The purpose of a mark-up test is to effectively reconstruct gross sales and/or taxable sales utilizing a mark-up percentage computed from the Appellants purchases and selling prices.
16. The Appellants brought issues that required adjustment during objection but did not provide supporting evidence to back up the assertion.
17. The Respondent averred that analysis of the audited accounts showed that the Appellants reported gross profit mark-up of 1.12% and 1.11% in years 2013 and 2014, respectively.
18. Moreover it was stated that there were no documents to verify closing stock figures hence the need to apply alternative approaches to confirm mark-up. The true mark-up of the business was determined as follows:
 - a. Obtained unit purchase and sale prices of various products from the physical purchase and sale invoices and cash sale receipts on sample basis. It was assumed that a product is largely sold within the same or the next one month from the date of purchase in

order to match the purchase and sale of the same item. This was done for 8 months.

- b. The mark-up per item per transaction was computed using data obtained from step a. above.
 - c. Contribution of each product to the mark up of the business was computed by multiplying the average mark-up of the product with the weight of the product. This gives weighted average mark-up of the product category.
 - d. Weight of the product category was obtained by analysing total cost of purchases for the year per product as a ratio of total cost of purchases reported by the taxpayer.
 - e. The weighted average mark-up of the business was determined as the summation of weighted average mark ups of all product categories.
 - f. The weighted average mark-up obtained from this test was 10.59%.
19. The Appellants however disagreed with the finding on the basis that the test was based on sampling rather than total purchases and sales. It was then agreed that the test should then be conducted for one month taking into account all purchases and sales without sampling. Mark-up analysis was then done for the month of June 2013 and the mark-up based on this second test was found to be 12.175%. The Respondent settled on the lower mark-up figure of 10.59% as the basis of computing additional income.

20. According to the Respondent, the Banking analysis test done also corroborated mark-up analysis results as per Annexure Marked 7, being a copy of the Banking analysis. Additional income arising from the revised mark-up was Kshs 37,587,223.00 and Kshs 49,646,457.00 in years 2013 and 2014, respectively.
21. Additional assessment on VAT was raised on the partnership while additional assessment on income tax was raised on the partners on the basis of 50% profit sharing ratio.
22. Having reviewed the Appellants grounds for objection the Respondent confirmed the assessment on the following grounds:
- a. The additional assessment is based on the true mark-up determined from actual purchases and sales records of the business. It is not based on estimates hence not excessive.
 - b. The sampling done in the determination of true mark-up of the business was adequate. It captured data for 8 months out of the 12 months in year 2013 and hundred percent mark-up analysis was done for the month of June 2013. It is worth noting that mark up for the two years was the same (1.11% and 1.12%) and the analysis done applied for the two years.
 - c. Evidence was not provided to support whether there were operational challenges that affected the business. It is not possible to determine the impact of such operational problems without evidence.

- d. The impact of low mark up on cement on the overall mark up of the business is marginal due to the fact that purchases of hardware products accounted for only 7% of the total purchases of the business. The actual impact however can only be determined from purchase and sale records of hardware products which have not been provided to date.
 - e. Cost of sales reported in the accounts was based on estimated closing stock. Stock records were not provided to verify closing stock reported hence the alternative to compute mark-up of the business from actual purchases and sales records. The test takes into account the weighted contribution of each product to the overall mark up using the product weights computed from purchases records.
23. Additional income arising from the revised mark-up is Kshs 37,587,223.00 and Kshs 49,646,457.00 for the years 2013 and 2014, respectively. This implies that some income had not been declared and thus will be brought to charge as per Section 3 (1) and 3 (2) (a)(i) of the Income Tax Act Cap 470, (ITA). Adjustment in VAT arose from mark-up analysis and thus undeclared sales were brought to charge as per Section 5 of the VAT Act 2013.
24. The Respondent argued that it did not disregard the actual accounting practice in arriving at gross profit margin. This is because of the following reasons:
- a. The additional assessments were determined using the actual mark-up derived from actual costs arising from purchase invoices

and actual selling prices. Findings arising from mark-up analysis were supported by analysis of bank deposits which also indicated that sales were understated in the accounts and in VAT. The assessments are therefore not estimates and hence not excessive.

- b. Stock figures reported in the accounts were based on the partners' estimation and not on actual count of goods in store. Cost of sales and the consequent gross profit reported were therefore not factual but based on estimates. The mark up reported was therefore estimated. The formulae provided by the taxpayer for computing the cost of sales (and consequently gross profit margin) would serve the purpose if the figures provided for the variables are factual and verifiable. However, this is not the case as closing stock figures reported in the accounts are estimates which are not backed by any records.
- c. The methodology applied relied on individual transaction costs and selling prices obtained from actual purchase invoices provided by suppliers and sales invoices and cash sale receipts issued by the taxpayer. The test is based on sound reasoning, is verifiable and provides credible way to test the authenticity of the figures reported in the absence of verifiable documents from the taxpayer.

25. Tax assessed is not erroneous but based on Appellant's primary records. Returns and accounts should be reflective of the input data.

26. The Respondent submitted that the sampling done in the determination of true mark-up of the business was adequate for the following reasons;
- a. Sample data for eight months was used to arrive at the mark up. Secondly the Appellants requested that the Respondent does a hundred percent mark-up analysis for one month and the Respondent obliged and did the analysis for the month of June 2013. Resultant mark-up was 12.175%. Since the mark up from one month was higher than the eight months the Respondent based adjustments on the lower figure of 10.59%.
 - b. The Respondent did not disregard operational problems and losses made in day to day activities. It is worth noting that the Respondent requested the Appellants to substantiate the same by providing supporting evidence to the operational challenges to enable the Respondent to determine the impact of the same.
27. The Respondent determined mark-up based on prices net of discount and thus discount allowed does not affect the computation of mark-up ratio.
28. The Respondent, in conclusion submitted as follows: -
- a. The grounds of objection advanced by the Appellants are not supported by facts to support their assertions.
 - b. Additional tax on individual income tax and VAT are based on the true mark-up determined from actual purchases and sales

records of the business. They are not based on estimates hence are not excessive.

- c. The sampling done in the determination of true mark-up of the business was adequate.
 - d. Appellants have not provided evidence to support whether there were operational challenges that affected the business. It is not possible to determine the impact of such operational problems without evidence. This assertion is not based on any evidence hence ignored.
 - e. Appellants computed cost of sales based on estimated closing stock. Stock records were not provided to verify closing stock reported hence the alternative to compute mark-up of the business from actual purchases and sales records. The test takes into account the weighted contribution to the overall mark up using the product weights computed from purchases records.
29. Consequently, the Respondent stated that the additional assessments should therefore be confirmed based on the Respondent's workings.

ISSUES FOR DETERMINATION

30. The Tribunal having considered the parties' pleadings, documentation and submissions respectively notes that the issues that call for its determination are as follows: -

- a) Whether the Respondent's Income Tax Assessments against the partners were lawful?**

b) Whether the VAT was correctly brought to tax charge?

ANALYSIS AND FINDINGS

a) Whether the Respondent's Income Tax Assessments against the partners were lawful?

31. Business income is taxed under Section 3 (2) (a) (i) of the Income Tax Act (ITA). The same provides as follows: -

“Subject to this Act, income upon which tax is chargeable under this Act is income in respect of -

(a) gains or profits from –

(i) a business, for whatever period of time carried on;”

32. Furthermore, Section 4 of the Income Tax Act Cap. 470 states that: -

“For the purposes of section 3(2)(a)(i)-

... (b) the gains or profits of a partnership shall be the sum of -

(i) remuneration payable to him by the partnership together with interest on capital so payable, less interest on capital payable by him to the partnership; and

(ii) his share of the total income of the partnership, calculated after deducting the total of any remuneration and interest on capital payable to any partner by the partnership and after adding any interest on capital payable by any partner to the partnership, and where the partnership makes a loss, calculated in the manner set out

in subparagraph (ii), his gains or profits shall be the excess, if any, of the amount set out in subparagraph (i) over his share

of that loss;

(c) a sum received under an insurance against loss of profits, or

received by way of damages or compensation for loss of profits, shall be deemed to be gains or profits of the year of income in respect of which it is received;

(d) where in computing gains or profits for a year of income any expenditure or loss has been deducted, or a deduction in respect of any reserve or provision to meet any liability has been made, and in a later year of income the whole or part of that expenditure or loss is recovered, or the whole or part of that liability is released, or the retention in whole or in part of that reserve or provision has become unnecessary, then any sum so recovered or released or no longer required as a reserve or provision shall be deemed to be gains or profits of the year of income in which it is recovered or released or no longer required: Provided that if the person so chargeable with tax in respect of any such sum requests the Respondent in writing to exercise his power under this proviso, the Respondent may divide the sum into as many equal portions, not exceeding six, as he may consider fit, and one such portion shall be taken into account in computing the gains or profits of that person for the year of income in respect which the sum is so deemed to be gains or profits and for each of the previous years of income corresponding to the number of portions;

(e) where under the Second Schedule it is provided that a balancing charge shall be made, or a sum shall be treated as a trading receipt, for any year of income, the amount thereof shall be deemed to be gains or profits of that year of income.”

33. Moreover, Section 54 (A) (1) of the ITA provides as follows “A person carrying on a business shall keep records of all receipts and expenses, goods purchased and sold and accounts, books, deeds, contracts and vouchers which in the opinion of the Commissioner, are adequate for the purpose of computing tax”. In view of this, the Appellant was under a legal duty to produce documents in support of its case. In our view it failed to do so. The Respondent in this case not having been satisfied that adequate records were kept for purposes of computing tax resorted to alternative methods.
34. We note that the mark-up calculation was conducted for one month, June 2013, as a sample, and a profit margin of 12.75% was found, however, what was relied on was 10.59%. The reason the Respondent settled for 10.59% is due to another exercise conducted by the Respondent. Using actual purchase and sales figures on a sample basis for 8 months, the Respondent calculated the weighted average mark-up of the product category.
35. It is clearly evident that the Respondent did not go with the 12.75% GPM calculated, but instead relied on the lower mark-up of 10.59%. The additional income amount of Kshs 37.6m in 2013 and 49.6m in 2014 was the difference between 1% and 10.59% for the years 2013 to 2014.

36. The Appellant has raised a number of factors which have interfered with profit margins. Factors such as lack of qualified and trained personnel, theft of goods, damaged and expired goods, competition, absenteeism, weather conditions, mites and rats that have affected actual profit figures. Notwithstanding the fact that no evidence has been submitted to the Tribunal on this matter, such challenges in the trading business are not uncommon. It would therefore be highly unlikely that 100% of all stock purchased in 2013 and 2014 were sold without any damage or theft occurring, for example. The Appellant, having not provided any supporting evidence leaves the Respondent with little choice in the matter. Indeed, the Respondent could have gone the extra mile and performed an industry comparison as a sanity check on their finding.
37. It is worth noting that lacking supporting evidence are the stock figures in the accounts, which were based on the partners' estimation and not on actual count of goods in store. Closing stock figures reported in the accounts are therefore also estimated. Again, there is little more the Respondent could do here for improving their estimates.
38. The Respondent also claims that these findings from the mark-up analysis were supported by analysis of bank deposits (though statements have not provided to the Tribunal). Bank statements would have been helpful in this matter, so would have financial statements of the Appellant.
39. There is a key assumption in raising the additional assessments that all that was purchased by the trading operation was sold at this 10.59% margin. The task of estimating the mark-up was indeed not made any

easier by the Appellant. Provision of verifiable documents would have greatly assisted in the cause.

40. The assumption by the Respondent that a 10% increase in Gross Profit will surely lead to a 10% increase in profit before tax is somewhat simplistic. Even though the Appellant has given ample reasons as to why this could not be the case, they have failed to provide any evidence on the same.

41. The burden of proof in such instances as shown above rests on the Appellant as provided for under Section 30 of Tax Appeals Tribunal Act, (TAT Act), which states as follows;

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

i. where an Appeal relates to an assessment, that the assessment is excessive; or

ii. in any other case, that the tax decision should not have been made or should have been made differently,”

42. Purchase and Sales records of hardware products seem not to have been provided to the Respondent and therefore are excluded from the analysis. The Respondent claims this business consist of just 7% of the total trading and therefore the difference would be minimal. In the absence of further information, one can only assume that the impact of low mark-up on hardware items such as cement on the overall margin would be minimal if indeed the hardware business is just 7% of the total. The actual impact however can only be

determined from the purchase and sale records of hardware products which were not provided.

43. By the Respondent's own admission stock figures reported in the accounts were based on the partners' estimation and not on actual count of goods in store. Cost of sales and the consequent gross profit reported were therefore not factual but based on estimates. The mark-up reported was therefore estimated and not actual. The formulae provided by the taxpayer for computing the cost of sales (and consequently gross profit margin) would serve the purpose if the figures provided for the variables are factual and verifiable. However, this is not the case as closing stock figures reported in the accounts are estimates which are not backed by any records.
44. This assessment should be categorised as an Additional Assessment to what would have been the partners' individual self-assessments where reliefs and graduated taxes would have been applied. Only then would a top tax rate of 30% be applicable on additional income on the respective partners.
45. It has been demonstrated by the Respondent that the Appellants had time to furnish proof to dissuade the Respondent from their estimation. However, this was not to the satisfaction of the Respondent. In the circumstances, the Tribunal finds that the Respondent lawfully assessed the income tax against the partners.

b) Whether the VAT was correctly brought to tax charge?

46. During the proceedings and on being probed further by the Tribunal on the issue relating to VAT assessed, the Respondent categorically

stated that the VAT was indeed to be left out of the Assessment, as this was an error on their part. The Tribunal will therefore not delve further into the matter given that the Respondent admitted during the hearing that indeed VAT was not correctly brought to charge.

FINAL DECISION

47. In view of the foregoing, it is our finding that the Appeal partially succeeds.

48. Consequently, the Tribunal makes the following Orders;

- a) The Appeal in respect to additional VAT in the sum of Kshs 8,052,640.00 is hereby upheld.
- b) The Respondent's Tax Assessment vide its objection decision dated 7th June 2017 in respect to Income tax only, payable by each partner in the sum of Kshs 19,555,247.00 is hereby affirmed.
- c) Each party to bear its own costs.

DATED and DELIVERED at NAIROBI this 4th day of September 2020.

**JOSEPHINE K. MAANGI
CHAIRPERSON**

**GEOFFREY KARUU
MEMBER**

**DELILAH KADZO NGALA
MEMBER**

**TANVIR ALI
MEMBER**