REPUBLIC OF KENYA
IN THE TAX APPEALS TRIBUNAL
APPEAL NO.193 OF 2015

PRIMAROSA FLOWERS LIMITED....................................APPELLANT
VS
THE COMMISSIONER OF DOMESTIC TAXES...............RESPONDENT

JUDGEMENT

BACKGROUND

1. The Appellant is a limited company incorporated in Kenya since 2002. The company is engaged in the floricultural industry and has two farms in Nyahururu and Athi River; the Appellant grows and exports cut flowers to Europe and Asia through direct sales and Auction. The Appellant is owned by Crest Oversees Holdings (COH) incorporated in India with 99.9% share ownership. The company is based in the British Virgin Islands.

2. The Respondent is a state corporation is established under the Kenya Revenue Act (Cap 469) of the Laws of Kenya and with a mandate to manage the tax regime in Kenya.

3. Following an audit on the affairs of the Appellant during the years of income 2009-2012, the Respondent raised and confirmed an assessment vide Confirmation notices dated 29th June 2015, assessment numbers 0305200900192/5, 0305201000187/5 and 0995201100053/5 for under declaration of sales in financial statements as follows:

Details	Tax loss Adjustment (Kshs)	Tax payable (Kshs)
Sales variance	132,574,804	
Restriction of interest expense	20,025,989	
Foreign exchange losses	191,065,863	
Withholding tax on deemed interest		101,590,575
VAT on Sales Variance		975,346

Total	343,666,656	102,565,921

THE APPEAL:-

4. The Appellant objected to the assessment on the following grounds:-
    i) The Commissioner erred in fact and in law in finding that withholding tax is payable by the Appellant;
    ii) That Withholding tax demanded of Kshs.101,590,575/= inclusive of penalties and interest is excessive and erroneous;
    iii)The tax loss adjustment of Kshs.343,666,656/= is estimated and erroneous;
    iv) The Commissioner's assessment on VAT is not supported by existing VAT legislation;
    v) The Commissioner confirmed the notice based on computations which were largely estimated;
    vi) The Commissioner confirmed the notice without due regard to all information provided to consider the Appellants case;
    vii) That it is only fair that the Commissioner takes into account all the information provided before the final conclusion of the matter.

5. The Appellant prays that:
    i) The Tribunal quashes the Assessment ;and
    ii) Awards costs to the Appellant

ISSUES FOR DETERMINATION

6. Having heard and read the submissions of both parties, the Tribunal determined that the following issues were for determination.
    (a)Whether there existed sales variances between the actual auction sales and sales declared by the Appellant;
    (b)Whether interest expense that relates to the borrowings should be restricted in proportion to interest free advances to related party and interest bearing borrowings;
    (c) Whether foreign exchange losses incurred through conversion of debt to equity is allowable;
    (d)Whether withholding tax is chargeable on deemed interest in respect to interest free advances;
    (e)Whether unreconciled sales between VAT3 returns and sales as per audited accounts are chargeable to VAT

APPELLANT'S CASE

7. The Appellant argued that the Respondent adjustment to the tax loss of Kshs.132,589,674/= being sales variances between the reported sales and the sales reported from the auction reports are excessive and not reflective of the Appellants sales activities. It argued that the method used in arriving at the sales figures is highly estimated and incorrect and that the calculations from the Respondent revealed that the auction sales made in Japan were converted directly from Japanese yen to Kenya Shillings while this was not reflective of the Appellants process. The Appellants argued that the process was that Sales were transacted in Japanese Yen, thereafter converted to US Dollars for remittance to the Appellant's Dollar Account. The Sales figures were then subsequently converted to Kenya Shillings for purposes of reporting in the financial Statements. The Appellant further argued that the method of estimation was not supported by the Kenyan Income Tax Act thus implying that the Respondent was on a fishing expedition.

8. Appellant further argued that the Respondent failed to take into account the effects of foreign exchange losses/gains when converting the multiple currency transaction. Appellant went on to add that the Respondent's workings revealed a Uniform conversion rate for the years under consideration which was highly exaggerated and that the exchange rates applied were highly overstated and superficial.

9. The Appellant submitted that the Respondent's restriction of interest expenses of Kshs.20,025,989/= in respect of funds borrowed by the Appellant from financial institutions on the premise that the funds were thereafter loaned to Riverside Ten Limited (a related company) were speculative. They submitted that the funds sourced by the Appellants from financial institutions were used solely for purchase of high value assets and that the interest paid by the company emanated from hire purchase agreements for the purchase of company assets which were in turn used in generating taxable income.

10. Appellant further submitted that the interest expense incurred by the Appellant was from loans advanced to the Appellant by Diamond Trust Bank for the purchase of equipment under a hire purchase agreement. They also contend that the associated interest cost was

claimed by the Appellant in the statement of comprehensive income and tax computation. Appellants explained that the method of financing of their assets was purely based on business decisions as financing assets through a hire purchase as opposed to cash purchase cash flow from business operations. They argued that funds advanced to the related party were not sourced from funds advanced to the Appellant by financial institutions and that in most years under review; the advances to Riverside Holdings were higher than bank borrowings.

11. The Appellant submitted that the loan from the holding company was converted to equity on 8th June 2010 when the General Meeting endorsed a Board decision to increase its share capital. They argued that an allocation of shares pending allotment is indeed an equity transaction as per the international Financial Reporting Standards (IFRS) and that interpreting such a transaction as debt would be unjust, unfounded and unreasonable. They further contend that the Appellant complied with Section 4A and Section 16(3) of the Income Tax Act by taking into account foreign exchange gains and losses from related party transactions when determining taxable income while on the other hand refraining from charging withholding tax on deemed interest. The Appellant has also disputed the Respondent's assertion that the meeting of 9th June 2013 never was never convened and that the event was back dated to avoid payment of tax and that invoking section 23 of the Income Tax Act was in bad taste and intended to portray the Appellant in bad light.

12. The Appellant submitted that at the time when the Commissioner conducted the audit, the Appellant was not thinly capitalized and as contemplated by the provisions of the Income Tax Act because the loan had been converted to equity therefore relinquishing the loan. The import of this was that the Appellant did not have to compute Withholding Tax on the deemed interest. They submitted that the provisions of the law relating to deemed interest and accounting for the same came to effect as of June, 2011. They pointed out that the loan was converted in 2010 thereby the Appellant did not have a responsibility to account for Withholding Tax on the deemed interest as at that date. The Appellant further submitted that filing documents with the Register of Companies and payment for the stamp duty in 2014 was just an allotment of shares but not conversion of the loan to

equity. The Appellant contended that the loan could not be allotted and that what were allotted were shares that had been converted to equity in 2010. They held the view that the burden of proof lay with the Commissioner to show that indeed the board meeting and the special general meeting was never held as in 2010.

13. The Appellant submitted that they had agreed to pay the amount of VAT assessed by offsetting against the VAT refund due and prayed that the matter be marked as settled and that it will be contained in the consent .

THE RESPONDENT'S CASE

14. In response, the Respondent argued that the values of the sales upon which the assessment was made were obtained from customs export entries, monthly VAT returns and accounting ledgers. They argued that in the case of export of cut flowers to the European Union and Asian Market, the Auctioneers generated final sales Report sheets once the sale was complete. The final sales sheets were used to make adjustments in the Appellant's records to arrive at the correct and actual sales values for the Accounts. However, some of the actual auction sales values for Flora Holland BV, Misato Flower Trading Company and Shima Trading company were not duly adjusted in the books of the Appellant and their sales in the books were retained as per pro forma hence the understated sales. The Respondents conceded that there was foreign currency transaction effects of sales denominated in Japanese yen to the Kenya Shilling leading to understatement of sales of not more than Kshs.5,000,000/=.

15. Respondent submitted that when, the Appellant, on request failed to submit Final Sales reports for the months that were not adjusted as per prices indicated in the Proforma invoices, they proceeded and made adjustments in respect of the understated sales and reduced the corporation tax losses declared in the annual returns. They submitted that they applied the necessary conversion factors from the months preceding those in which no records had been availed to raise additional assessments. They argued that though records were later produced by the Appellant, they did not address the variances.

16. The Respondent contends that they carried out an audit and found that the Appellant had obtained loans from financial institutions and incurred finance costs by way of interest expenses. At the same period, the Appellant lent interest free loans to Riverside Ten Limited, a related company. At the end of the audit, the Respondent sought to tax the proportion of the finance cost in respect of the borrowed loan that was advanced to Riverside Ten Limited.

17. The Respondent contested the Appellants contention that the borrowings were secured for the sole purpose of engaging in capital intensive projects involving purchase of plant, machinery and motor vehicles. They also contended that the funds disbursed to the related company over the same period created a shortfall in the Appellants Cash flow hence the need for loans from financial institution. The Respondent also argued that Section 15(1) of Income Tax Act only allows expenses incurred in production of income. In this case, business income under section 3(2) (a) (i). It is their contention that, if the loan to Riverside Ten Limited earned investment income as a return for the money lent, then the finance costs would be deductible under section 15(3) of the Income Tax Act. The Respondent asserted that the deduction admissible under section 15(3) was not applicable against business income but applicable on investment income. The Tribunal was referred to the case of ***Punjab Stainless Steel Ltd (2010) 41 DTR 289*** where interest in respect of funds borrowed and advanced to a sister company was proportionately disallowed. The Respondent also relied on the case ***Abhishek Industries Ltd (2006) 286 ITR 1 and Beekay Engineering Corp (2010) 38 DTR 289*** to buttress their position and submitted that the Appellant and Riverside Ten Limited were related and that the advances were not in the ordinary relationship of business and therefore the interest expense on the bank loans and credits in proportion to amounts advanced to Riverside Ten be disallowed.

18. The Respondent submitted that the exchange loss deferral on account of thin capitalization is provided under the Income Tax Act. They further submitted that the loan from the holding company was not converted to equity as at 17^{th} October 2013 and that this conversion occurred in November 2014 when the payment of stamp duty was paid. Respondent submitted that the Board meeting of 9^{th} June 2013

never happened and that the deferral of foreign exchange loss on account of thin capitalization be confirmed.

19. The Respondent submitted that the board meeting of 9th June 2013 never happened and that the actual conversion took place in November 2014 when the transaction was filed with the AG and the regulatory stamp duty paid. They submitted that the charge of withholding tax on deemed interest on account of an offshore loan was in accordance with section 3(1) of the Income Tax Act. The Respondent further argued that the Commissioner was on record having conducted an audit covering the period 2005 to June 2011. The said audit raised a demand emanating from the same loan and the Appellant did not produce any records to the Local Committee to show that the loan was converted to equity in 2010 despite the fact that the said audit assessment covered the years 2010 and part of 2011.

ANALYSIS AND FINDINGS

20. The Tribunal finds that the Appellant was in a business that involved perishable goods and that they were bound to be variances between what was declared on export entries and what was finally purchased in the auctions. It also finds that there was bound to be losses and gains in converting currency from Yen to dollar and from dollar to Kenya shillings. Section 73(2)(b) of the Income Tax Act provides that "***Where a person has delivered a return of income, the Commissioner may if he has reasonable cause to believe that such return is not true and correct, determine, according to the best of his judgment, the amount of the income of that person and assess him accordingly.***" It is clear from a reading of the said provision that the Respondent are indeed clothed with powers to estimate taxes payable by a taxpayer in certain circumstances. The Respondent having sufficiently shown that those circumstances existed in the Applicant's case.

21. The Tribunal finds that the responsibility for reconciliation of actual sales and export figures lay solely on the Appellant and that this responsibility could not be discharged by a claim that they (the Appellant) were relying on third party documents. The Tribunal is persuaded by the view held in ***Kenya Commercial Bank vs. Kenya Revenue Authority High Court (Milimani Commercial Courts) Income***

Tax Appeal No. 14 of 2007, which found that the Appellant alone had the responsibility to devise workable procedures to ensure compliance with the Tax Law. Similarly, in the Australian case ***Mulheim v Commissioner of Taxation* [2013] FCAFC 115** the Full Federal Court of Australia (FFC) affirmed the critical need for supporting evidence in tax disputes, and emphasized that tax payers must satisfy the burden of proof to successfully challenge income tax assessments. The FFC held that it is not enough for a taxpayer to simply demonstrate that the assessment issued by the Commissioner is incorrect. Rather, the onus is on the taxpayer in proving that an assessment issued by the Commissioner is excessive can only be discharged by the taxpayer by adducing positive evidence which demonstrates the taxable income on which tax ought to have been levied. That onus requires the taxpayer to positively prove his or her 'actual taxable income' and in doing so, must show that the amount of money for which tax is levied by the assessment exceeds the actual substantive liability of the taxpayer.

22. The Tribunal also did not find justification in collecting a tax loss through conversion of yen into dollar and then into Kenya shillings and concurs with the approach taken by the Respondent in converting the yen directly into Kenya shillings for purposes of assessing the value of exports to Japan. The Tribunal finds that the yen is an acceptable currency for trade purposes and therefore there was no need to rely on the United State Dollar currency. No evidence was adduced to the effect that the currency of transaction on export documents were in dollars or that the payment for the sales was received in dollars.

23. The Tribunal then addressed itself to the question of whether interest expense that relates to the borrowings should be restricted in proportion to interest free advances to the related party and interest bearing borrowings. There was no dispute that the Appellant had received a loan from a related company and at the same time had offered an interest free loan to a related company. The loan relationship regime contains a number of specific anti-avoidance measures concerned with deeming loan relationships to exist where funding transactions are structured in a way which would otherwise keep income out of charge to tax. The Tribunal finds the Appellants argument that the loan to the related company was from different

sources and not from the foreign loan to be weak and unsubstantiated. This was not demonstrated and the Tribunal could only conclude that the Appellant used part of the money at its disposal, which included the loan it advances the related company.

24. Turning to the question of whether foreign exchange losses incurred through conversion of debt to equity is allowable, the Tribunal took note of the provisions of section 4A of the ITA which provides that: - ***"a foreign exchange gain or loss realized on or after 1st January 1989 in a business carried on in Kenya shall be taken into account as a trading receipt or deductible expenses in computing the gains and profits of that business for the year of income in which that gain or loss was realized."***

25. The Tribunal also took note of the determination in the case of **Delmonte v Commissioner of Domestic taxes Tax Appeal NO TAT/81 of 2015** that events leading to realization of foreign exchange gains and losses and timing of the realization are most succinctly constructed in the Division 775 and subdivision 960-C and 960- of the Australian Income Tax Assessment Act (ITAA) which this Tribunal wishes to borrow best practice from to fill the lacuna left by the Kenyan ITA. **Division 775 of the ITAA 1997** constructs four foreign exchange realization events:

    i. Disposal of foreign currency
    ii. Ceasing to have right to receive foreign currency
    iii. Ceasing to have obligation to pay foreign currency
    iv. Ceasing to have a right to pay foreign currency

    The Tribunal further finds that foreign exchange loss or gain are realized when there is a permanent cessation of an obligation to pay or receive foreign currency and not by mere translation of denomination of currency of debt and further found that payment of outstanding debt through conversion to receivables and share capital did create cessation of obligation to pay and right to receive foreign currency. The Tribunal therefore finds that the instant transaction created an event for realization of foreign exchange loss or gain to the extent that it creates a transaction of a revenue nature.

26. As in the case cited above, the Tribunal cannot separate the act of conversion of the debt into equity from the debt status and the purpose for which the loan was used. In this case it finds that the loan was used to pay for an expenditure of a capital nature and therefore any losses incurred were not allowable.

27. On the issue of whether withholding tax was chargeable on deemed interest in respect to interest free advances the Tribunal found that there was no dispute as to the chargeability of tax on deemed interest. The issue of contention is whether the Appellant continued to have an obligation to pay withholding tax after making a Board resolution to convert the loan into equity. The Tribunal addressed itself to the contestation by the Respondent that the Board meeting did not take place but deliberated on whether transfer of shares would be effective by a resolution or would be deemed to be effective when the transfer is recorded in the register and all the statutory stamp duties paid. It found that the resolution is a mere expression of intention and that the effective date of the transfer is the date when all the regulatory requirements are complied with and that was when the stamp duty was paid and the transfer recorded in the Register.

DECISION

28. The Tribunal having made the above findings dismisses the Appeal and upholds the Confirmation of Assessment Notice dated 29th June 2015.

29. Each party shall bear it's own costs.

DATED and DELIVERED at NAIROBI this 7th Day of December,2016

In the presence of:-

RACHAEL MWISU for the Appellant

DOREEN KARUITHA
FIONA KERUBO KIYUKA for the Respondent

....
LILIAN RENEE OMONDI
CHAIRPERSON

....
BONIFACE DIMMO
MEMBER

....
GABRIEL KITENGA
MEMBER

....
DANIEL TANUI
MEMBER

....
ABDULBASID AHMED
MEMBER