

REPUBLIC OF KENYA
IN THE TAX APPEALS TRIBUNAL
TAX APPEAL NUMBER 45 OF 2015

SITA INFORMATION NETWORKING COMPUTING BV.....APPELLANT

=VERSUS=

THE COMMISSIONER OF DOMESTIC TAXES.....RESPONDENT

JUDGEMENT

BACKGROUND:-

1. The Appellant is a Kenyan Branch (Liaison office) of SITA Inc BV of Holland with its offices situate at I & M Building on Ngong Road in Nairobi. The Liaison office covers a large part of Africa and reports to the mother company in Holland.
2. The Appellant was contracted by the mother company in Holland to offer various online services, including check-in systems, airline communication systems, networking facilities and logistics to various Airlines.
3. The Respondent upon the conclusion of an audit of the Appellant on the 28th day of May, 2013 and on consideration of the audit findings proceeded to issue additional tax assessments under the Income Tax Act, CAP 470 of the Laws of Kenya for the years 2009, 2010 and 2011.
4. The findings of the audit and the assessment of the additional taxes payable was formally communicated to the Appellant vide the Respondent's letter dated the 28th day of May, 2013
5. The Appellant objected to the additional assessment of taxes in the aggregate sum of **Kshs.46,330,911/=** in respect of Withholding Tax and Corporate Tax vide a letter dated the 28th day of June, 2013
6. In the ensuing discussions between the parties, the Appellant conceded to Withholding Tax liability of **Kshs.1,088,879/=** and income variance as noted per the Respondent in the earlier

assessment was excluded as the same was found to be included in the finance income as opposed to sales as per the Appellant's audited financial statements. Further, the Respondent noted it had erroneously applied the rate of 30% applicable to resident entities for the purposes of computing Corporate Tax as opposed to the rate of 37.5% given that the Appellant is a branch of a non-resident entity.

7. The Respondent vide a letter dated the 8th day of November, 2013 confirmed the reviewed additional tax assessment in the aggregate sum of **Kshs.53,018,859/=** thereby prompting the Appellant to commence the appeal process as against the aforesaid additional tax assessment.
8. The Appellant issued a Notice of Appeal on the 5th day of December, 2013 and subsequently proceeded to file the Memorandum of Appeal and the Statement of Facts before the hitherto Local Committee for Nairobi Area on the 19th day of December, 2013 through its Tax Consultants, to wit, BDO East Africa.

THE APPEAL:-

9. The Appeal against the Respondent's notice of confirmation of the additional tax assessment was premised on the ground set forth in the Memorandum of Appeal as hereunder:-
 - i) The End of Service Indemnity (EOSI) is not a general provision but specific amounts computed and accrued based on the contractual agreements between SITA, its employees and the union (CBA) as a global policy. The amounts are computed using a specific agreed formula applied in basic pay and accrued at the end of each year. We attach a worksheet to demonstrate this concept.
 - ii) These accruals are ultimately paid upon leaving employment without any adjustments as it is a fixed contract. At the point of actual payment, like in the case of two employees who retired in September, 2012, the full PAYE tax is deducted and paid and the specific amounts so provided over the years are reduced accordingly by the payments. Please note that an add back of these expenses and taxing it

on the company while retiring employees are taxed under PAYE on the same amounts will lead to double tax.

iii) While Section 16 (1) of the Income Tax Act prohibits expenditure or loss not incurred in the production of income, this is not the case in this expense as it has indeed been incurred in its income determination mark-up and corporate taxes paid on the same. This type of expense as you will note does not in any way reduce the taxable profits as happens in normal trading enterprises because any expenses charged to the profit and loss account works to inflate profits because of the mark-up concept.

10. The Appellant in the Memorandum of Appeal prays that the Tribunal amends the assessment or authorizes the Respondent to amend the assessment to show the correct chargeable income as being a sum of Kshs.21,098,896/=.

THE RESPONSE BY THE RESPONDENT:-

11. The Respondent subsequent to being served with the Memorandum of Appeal and the Statement of Facts proceeded to file the Statement of Facts dated the 9th day of March, 2016 before the Tribunal on the same date.
12. The Respondent's Statement of Facts signed by Hudson Omari, Assistant Manager, on behalf of the Respondent sets out in detail the facts giving rise to the Appeal, the substantive response to the grounds of appeal and what the Respondent considers to be the issues for determination by the Tribunal.
13. The Respondent contends that End of Service Indemnity (EOSI) was a provision for future expenditure as opposed to expenditure already incurred as required by Section 15 of the Income Tax Act, CAP 470 of the Laws of Kenya and that Section 16 of the Income Tax Act prohibits such a deduction.
14. That under both Sections 15 and 16 of the Income Tax Act, CAP 470 of the Laws of Kenya a deduction is allowed only when the expense is incurred wholly or exclusively to earn the income of the year under consideration.

15. That the End of Service Indemnity (EOSI) was an amount of money not at the employees' disposal but rather a contingency fund strictly dependent on retirement and redundancy. Employees dismissed from employment were absolutely not entitled to that amount.
16. That the mark up formula used by the Appellant in arriving at the turnover attributable to the Appellant does not confer the right to deduct the End of Service Indemnity (EOSI) provisions from taxable income.
17. That making provisions for the End of Service Indemnity (EOSI) in addition to the statutory limit for contributions to the pension fund permissible for an employee would totally violate the provisions of Section 22A of the Income Tax Act, CAP 470 of the Laws of Kenya.
18. That whereas the End of Service Indemnity (EOSI) may have been partly paid out to some retired employees and PAYE accordingly remitted, the provision has a practical effect of deferring the payment of tax against the law.
19. That with the Appellant still making provisions in their annual accounts, the Respondent's prayer is for the Tribunal to:-
 - i) **Declare that End of Service Indemnity (EOSI) is not deductible expense;**
 - ii) **Uphold the corporate tax position stated in the table 3 of the Respondent's Statement of Facts.**

THE HEARING:-

20. When the matter came up for hearing on the 30th day of June, 2016 the parties by the very nature of the dispute informing the Appeal did not call any witnesses in the matter but rather opted to proceed by way of oral submissions on the basis of the Pleadings and documents filed before the Tribunal.
21. The parties were subsequent to the hearing directed by the Tribunal, with the consent of the Parties, to file and serve upon each other Written Submissions. Both parties duly complied with the Appellant filing its Written Submissions before the Tribunal on the 11th day of July, 2016 while the Respondent filed its Written

Submissions in reply dated the 18th day of July, 2016 before the Tribunal on the same date.

22. The Appellant in its Written Submissions reiterates that it recognizes its income as being based on transfer pricing concept as its income is based on the expenses it has incurred and it is reimbursed at an agreed mark-up of 5% on the expenses.
23. That the Appellant operates in several countries around the world but does not operate like a normal ordinary or conventional business which when preparing its Profit and Loss account (P&L) will start from the revenues and deduct expenses to arrive at the net profit.
24. That the Appellant's Profit and Loss account works in the opposite manner where all expenses are summed up and a mark-up added hence that ensures every expense is incurred to earn income which is consistent with Sections 15 and 16 of the Income Tax Act, CAP 470 of the Laws of Kenya.
25. That the End of Service Indemnity (EOSI) expense is an agreed amount under a Collective Bargaining Agreement (CBA) between the Appellant and the Union, which is computed using a formula of 1.5 times the salary for a year worked and that it is a specific provision and not a general expense.
26. That End of Service Indemnity (EOSI) is not a pension scheme but a loyalty bonus paid to employees who either leave employment on attaining retirement age or on being declared redundant and therefore the provisions of Section 22(A) of the Income Tax Act, CAP 470 of the Laws of Kenya do not apply in this case.
27. That the Respondent should not add back the End of Service Indemnity expense as this will result in a third level taxation contrary to the impartiality rule enshrined in the KRA's Tax Payers Charter which provides that ***"It is the responsibility of KRA to collect only the correct amount of tax, duties and fees, no more no less."***
28. The Respondent in its Written Submissions reiterates the issues and matters raised in its Statement of Facts with the emphasis being that End of Service Indemnity (EOSI) reflects an anticipated rather than

an incurred expense and hence offends the provisions of Sections 15 and 16 of the Income Tax Act, CAP 470 of the Laws of Kenya.

29. That the provision of the End of Service Indemnity (EOSI) was actually calculated to circumvent the provisions of Section 22A of the Income Tax Act, CAP 470 of the Laws of Kenya.

ANALYSIS AND FINDINGS:-

30. The issue for the due determination by the Tribunal on the basis of the pleadings, documents and on both oral and written submissions is:-

Whether or not the End of Service Indemnity is a deductible expense in terms of the provisions of the Income Tax Act, CAP 470 of the Laws of Kenya?

31. The Appellant is not incorporated in Kenya but operates a Branch or Liaison office set up for the purposes of transacting business in Kenya on behalf of the mother company in Holland. The Appellant developed a mark-up formula as an in-house arrangement for the purposes of determining the turnover attributable to the business activities transacted at the Liaison office in Kenya.
32. The business or corporate governance policies developed by the Appellant and/or industrial agreements entered into between the Appellant and its employees, trade unions or any other partners must of necessity be consistent with the tax statutes or the tax regime obtaining in Kenya.
33. Section 3(1) of the Income Tax Act, CAP 470 of the Laws of Kenya provides as thus:-

“Subject to, and in accordance with this Act, a tax to be known as income tax shall be charged for each year of income upon all the income of a person, whether resident or non-resident, which accrued in or was derived from Kenya.”

34. The foregoing Section 3(1) as read together with Section 3(2) of the Income Tax Act specifically brings business income to charge for income tax provided the income is generated or derived from Kenya. The Appellant is to that extent liable to pay tax for income

derived from its business operations at its Liaison office situate in Kenya.

35. Pursuant to Section 15(1) of the Income Tax Act, CAP 470 of the Laws of Kenya expenses wholly and exclusively incurred in the production of income in a particular year of income are permissible deductions from the income so derived. The said Section 15(1) of the Income Tax Act, CAP 470 of the Laws of Kenya provides as follows:-

“For the purposes of ascertaining the total income of a person for a year of income there shall, subject to Section 16, be deducted all expenditure incurred by him in the production of that income, and....., for the purposes 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.”

36. Section 16(1) of the Income Tax Act, CAP 470 of the Laws of Kenya provides for expenses not permissible for consideration for deduction from income in a year and the Section provides as thus:-

“Save as otherwise expressly provided for purposes of ascertaining the total income of a person for a year of income, no deduction shall be allowed in respect of;-

- (a) expenditure or loss which is not wholly and exclusively incurred by him in the production of income;*
- (b) Capital expenditure, or any loss, diminution or exhaustion of capital.”*

37. The purport of the foregoing Sections 15(1) and 16(1) of the Income Tax Act, CAP 470 of the Laws of Kenya is that for an expense to be allowed as a deduction to reduce the income, there are two (2) material conditions precedent thereto;

- a) Such an expense ought to have been incurred and not anticipated; and
- b) Such an expense ought to have been wholly and exclusively incurred to earn that particular year's income.

38. It remained the Appellant's consistent position and which ought to be considered that disallowing the EOSI provision as a deductible

expense was not appropriate since the said provision was built into the operating expenses and therefore constituted the revenue of the Appellant for the years under review.

39. The Tribunal is of the considered view that in the event EOSI provision is disallowed as an expense and given that it forms and is intrinsically linked and so interwoven with the Appellant's revenue that excluding it would present an untrue picture of the entire operations and audited financial statements of the Appellant.
40. The Tribunal is of the view that it was not sufficient for the Respondent to decide whether the provision was a disallowable expense for the purpose of making the tax assessment but rather it was necessary to ascertain whether the EOSI provision forms part of the operating income of the Appellant given the nature of the Appellant's business and mark-up model for determining its revenue.
41. It was incumbent upon the Respondent to determine the basis of assessing the Appellant's income chargeable to tax given the nature of its business model, and whose operation that was not what one would expect in an ordinary trading Company. The Respondent in the circumstances ought not to have conducted the tax assessment as though the Appellant was an ordinary trading company.
42. Invariably, the tax assessment of an ordinary trading company and tax computation thereof involves tax adjustments to the accounting profit to arrive at the income that is chargeable to tax. Tax adjustments include non-deductible expenses, non-taxable receipts, further deductions and capital allowances and any tax losses brought forward. Ordinarily chargeable income is ascertained after detailed examination of accounts and tax computations in accordance with the relevant provisions of the Income Tax Act, CAP 470 of the Laws of Kenya. It is imperative to note that certain expenses are disallowed as the same have the effect of reducing income chargeable to tax.
43. The Appellant's Accounts are produced on cost plus mark-up basis and this being a branch of a non-resident entity makes it a cost centre reimbursed by the related parties at cost plus basis. The

Appellant's expenses being typically operating expenses which have been grossed up and included in the revenue, no major adjustments are expected to be made to the tax computation of the Appellant.

44. The cost plus or mark-up method is used to analyze transfer pricing issues involving tangible property or services under the OECD Transfer Pricing Guidelines. The operative legal provision on transfer pricing in Kenya is contained in Section 18(3) of the Income Tax Act, which provides thus:-

"Where a non-resident person carries on business with a related resident person and the course of that business is so arranged that it produces to the resident person either no profits or less than the ordinary profits which might be expected to accrue from that business if there had been no such relationship, then the gains or profits of that resident person from that business shall be deemed to be the amount that might have been expected to accrue if the course of that business had been conducted by independent persons dealing at arm's length."

45. The High Court of Kenya has since pronounced in the case of **Unilever Kenya Limited v the Commissioner for Income Tax (2005) eKLR** that in the absence of any guidelines on transfer pricing in Kenya The Organization for Economic Cooperation and Development (OECD) Guidelines were acceptable. It was in this context that the Minister for Finance enacted the Income Tax (Transfer Pricing) Rules 2006. The Rules are substantially based on The Organization for Economic Cooperation and Development (OECD) Guidelines. Rule 7 thereof provides several methods that may be applied to determine which pricing is on arm's-length terms. The recognized methods comprise: the comparable controlled price method, the resale price method, the cost-plus method, the transactional net margin method and any other method occasionally prescribed by the Commissioner for Income Tax if, in the Commissioner's opinion and in view of the nature of the transactions, the arm's-length price cannot be determined by using any of the above methods. Rule 4 thereof further provides that a taxpayer may choose any of the above methods.
46. It is imperative to appreciate the accounting methods and principles that underpin the Appellant's business model. The Tribunal notes that ordinarily all costs are added together and a mark-up percentage (to create a profit margin) is included in order to derive

the price of the product. In the Appellant's case the mark up percentage is 5% and that in the Tribunal's view is the gross profit that is chargeable to tax save for any finance income/costs. The Respondent ought to have allowed the chargeable income of the Appellant to be computed based on the mark-up on the total expenditure incurred without any further adjustments. Disallowing any expenses and subjecting the same to tax will amount to double taxation in respect of the same income.

47. In essence, the Tribunal's view is that these are questions of fact and do not give rise to any substantive questions of law and that the Respondent failed to appreciate the Appellant's business model and on how it determines income chargeable to tax and instead assumed the Appellant to be an ordinary trading company and hence conducted the tax assessment on that mistaken basis. The Tribunal finds this approach erroneous and flawed and is in the circumstances in agreement with the Appellant's contention that the inclusion of End of Service Indemnity (EOSI) provisions does not have the effect of reducing the income chargeable to tax.
48. The Tribunal upon the foregoing determination finds that End of Service Indemnity (EOSI) is not a deductible expense in terms of the provisions of the Income Tax Act, CAP 470 of the Laws of Kenya but is rather an intrinsic component of the income chargeable to tax.
49. The Tribunal notes with concern the otherwise casual manner in which both parties addressed the matter and dealt with the material issue for determination in the Appeal inspite of the substantive amount of the tax under dispute.

FINDINGS ON FINAL DETERMINATION:-

50. The Tribunal finds the Appeal to have merit and accordingly proceeds to dismiss the notices of assessment and confirmation for additional taxes in the sum of **Kshs.53,018,859/=** and any accrued interest and penalties thereon.
51. The Tribunal hereby accordingly orders as follows:-
 - a) The Appeal is hereby allowed as prayed.
 - b) Each party to bear its own costs.

DATED and DELIVERED at NAIROBI this 2nd DAY of February, 2017.

In the presence of:

.....Henry Sang.....for the Appellant

.....Lebanan Lemiso.....for the Respondent

.....[Signature].....
ERIC NYONGESA WAFULA
CHAIRMAN OF THE PANEL

.....[Signature].....
WILFRED N. GICHUKI
MEMBER

.....[Signature].....
PHILOMENA KIROKEN
MEMBER

.....[Signature].....
OMAR J. MOHAMMED
MEMBER

.....[Signature].....
ABDULBASID AHMED
MEMBER