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Tax Briefly
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Tax briefly 2017
Keeping you informed

We are pleased to share with you our Tax Briefly, which brings together recent developments in the taxation space. In this issue, we highlight:

1. The Tax Appeals Tribunal ruling on the application of excise duty on insurance brokerage commissions;

2. The raging topic on whether supplies to the Defence Forces Canteens Organization (DEFCO) should be exempted from VAT and Excise Duty;

3. Use of Transfer Pricing documentation in Customs valuation;

4. The motion filed by the Law Society of Kenya challenging the enforcement of Stamp Duty and Capital Gains Tax payments on the grounds that it contravenes fundamental rights and freedoms;

5. Our view on the KRA Notice on Betting, Lotteries and Gaming Taxes; and

6. Our view on the KRA Notice on Filing of VAT returns and invalid Tax invoices.

Please download the document and follow the bookmarks to access the specific sections.

Tax Appeals Tribunal ruling on excise duty on brokerage commissions

The Tax Appeals Tribunal has ruled in a case between an insurance brokerage company and the Commissioner of Domestic Taxes that excise duty is applicable on commissions earned between July 2013, and September 2015.

Background information

The Customs and Excise Act Cap 472 introduced excise duty on other fees charged by financial institutions through the Finance Act 2012 with effect from 9 January 2013. However, the new provisions did not define the scope of other fees nor the financial institutions subject to excise duty. Furthermore, the law did not specify who was responsible for collecting the excise duty and how the same should be remitted to the Kenya Revenue Authority ("KRA").

The Finance Act 2013 which came into force on 18 July 2013 subsequently addressed the aforementioned gaps by:

- Defining other fees as any fees, charges or commissions charged by financial institutions but does not include interest;
- Defining financial institutions as persons licensed under, inter alia, the insurance Act; and
- Providing that excise duty was to be collected and submitted to the KRA by the financial institutions.

KRA has over the past couple of years aggressively demanded outstanding excise duty from the financial institutions including insurance brokerage companies. Due to the controversy surrounding the implementation of the new provisions, many of the brokerage firms objected to the demands and eventually appealed to the Tax Appeals Tribunal ("TAT").

Points of Contention

The appellant in this particular case argued that the term **"other fees"** was vague, ambiguous, indeterminate, confusing and difficult to implement. In addition, insurance brokers are intermediary agents who place business with the insurer in exchange for a commission and as such the charging and payment of commissions is done by the insurer who also collects withholding tax. The appellant further argued that: the excise duty was contrary to the principles of public finance due to lack of openness; the tax was contrary to the principle of legitimate expectation; and that the law must be clear without room for ambiguity.

KRA had argued that the appellant's case should have been denied on the premise that the appellant was party to two similar matters already decided against the appellants by the High Court. However, the Tribunal concluded that the matters in contention in the two decided cases were both different from the substantive matters raised by the appellant and proceeded to make a determination.

Ruling

The Tribunal ruled that the Finance Act 2013 clearly defined other fees and that *"the definition was neither confusing nor indeterminate and that one only needed to read the relevant statute carefully to discern the true intention of the legislation"*. The Tribunal also observed that the Finance Act 2013 defined financial institutions as including amongst others insurance brokers licensed under the Insurance Act. The Tribunal determined that *"financial service providers, money transfer providers, communication providers, are all intermediaries connecting persons who need to do business with each other and further established that commissions earned by these intermediaries are the tax target of the Finance Act 2013"*.

The tribunal relied on the case between Astall and Customs Commissioners (2009) where it was held that:

"...applying purposive interpretation involves two distinctive steps: First identifying the purpose of the relevant provision. In doing so the courts should assume that Parliament did not legislate without a purpose. But the purpose must be discernible from the statute. The court must not infer one without a proper foundation for doing so. The second stage is to consider the transaction against the actual facts which occurred fulfils the statutory conditions."

The Tribunal observed that the definition of financial institutions under the Finance Act 2013 had the effect of bringing persons licensed under the Insurance Act within the ambit of excise duty.

Our view

There has been an outcry amongst the insurance brokers that the imposition of excise duty on premium based commissions was inequitable as they are unable to transfer the tax to consumers given that excise duty is an indirect tax whose burden ultimately falls on consumers.

The other key concern has been that premiums earned by insurance companies and interest earned by banks are exempted from excise duty because they are considered to be a core income of the two institutions. The charging of excise duty on commissions, a core income of insurance brokers, has thus been argued to be unfair and discriminative.

The question that arises is whether the excise duty will be borne by the insurance companies. Considering the low penetration of insurance in Kenya, it may be difficult to pass on the cost to consumers through higher premiums. This calls for a rethink of the tax especially in view of the policy objective of imposing excise duty on goods and services whose production, supply or consumption may cause harmful effects, or create negative externalities.

In our view, the ruling by the Tribunal will set precedence for determination of similar cases before the TAT. Although the other appellants may present different arguments, the Tribunal may rule in a similar fashion that the law is very clear as to chargeability of excise duty on commissions.

The National Treasury has in the recent past advised insurance companies who have received excise duty assessments and demands from the KRA to apply for abandonment of excise duty through the Commissioner of Domestic Taxes as provided for under Section 37 of the Tax Procedures Act and Section 158B of the Customs and Excise Act. We understand that the Commissioner has objected to some of the applications already submitted by some of the brokers which were based on the grounds of inequity, and hardship for the tax payer.

It remains to be seen how the ongoing KRA demands of excise duty on insurance companies will play out in light of this.
If you would like more information on this **please contact your Tax Relationship Manager.**

Should supplies to the Defence Forces Canteens Organization (DEFCO) be exempted from VAT and Excise Duty?

The Finance Act 2016 through Section 30(a) introduced into the VAT exemption schedule, all goods including material supplies, equipment, machinery and motor vehicles for the official use by the Kenya Defence Forces (KDF) and the National Police Service (NPS).

Similarly, Section 25 of the Finance Act introduced into the Excise duty exemption schedule, all goods including material supplies, equipment, machinery and motor vehicles for official use by the KDF and the NPS.

The big question has been whether supplies to DEFCO are exempted on the basis of the above provisions.

Background information

Paragraph 2 of the Eighth Schedule to the repealed VAT Act provided for zero-rating of all goods including material supplies, equipment, machinery and motor vehicles for official use by the KDF. Paragraph 15 further zero-rated goods supplied to the Armed Forces Canteen Organization (AFCO) (now DEFCO). However, the zero rating was done away with upon the enactment of the VAT Act 2013 on 2 September 2013, implying that imports and purchases by the KDF and AFCO became either taxable at 16%, 0% or exempt for the goods specified in the First Schedule of the VAT Act 2013.

In the same vein, Section 139(1) (e) of the repealed Customs and Excise Act Cap 472 (C&E), provided for remission of excise duty on supplies made to the KDF and AFCO among other privileged institutions. This provision was repealed by the enactment of the Excise Duty Act 2015, effectively implying that excise duty became chargeable on excisable goods supplied to the KDF and the AFCO with effect from 1 December 2015.

Various unfortunate incidences of attacks experienced in some parts of the country and general concerns regarding insecurity have prompted the Government to significantly increase its expenditure on security equipment in a bid to better equip the KDF and NPS to bolster efforts to better secure the country. In order to ensure that the cost of security equipment and other critical supplies to the security agencies does not escalate due to the VAT and excise duties levied on some of these supplies, the Government moved to exempt from VAT and excise duty, all supplies for official use by the KDF and NPS, vide the Finance Act 2016.

We however note that the provisions exempting supplies to the KDF and the NPS are silent on the status of supplies made to the DEFCO and canteens run by the NPS. This has caused a considerable level of uncertainty, especially to the companies that make supplies to the DEFCO. Most suppliers are not sure whether to treat supplies to the DEFCO as exempt or to treat them as taxable from both a VAT and excise duty perspective.

Our view

From our review of the VAT and excise duty exemptions as provided for in the Finance Act 2016, we note that the wording of the exemption provisions expressly indicate that the exemption applies to supplies made to the KDF and NPS for official purposes, but remain mute on supplies to DEFCO. This begs the question as to whether supplies to the DEFCO were envisaged in the aforementioned exemption provisions.

DEFCO is the official trading organization for the KDF that serves as a convenient store for the KDF officers to buy consumables that they may require in their day to day lives. The items purchased by DEFCO form part of trading stock for the entity and should therefore not be considered as official supplies to the KDF. We are of the view that for a good to be considered as official, it ought to have a direct linkage to being used in provision of security by the KDF; and has to be purchased directly by the KDF. Furthermore, both the repealed C&E and VAT Acts expressly provided for the exemption of excise duty and VAT respectively on supplies to AFCO. Conversely, the Excise Duty Act and the VAT Act 2013 only provide for exemption of supplies to KDF and NPS. This is an indication that the excise duty and VAT exemptions do not cover supplies to DEFCO. Whereas it's difficult to tell whether the exclusion of DEFCO was intentional or inadvertent, one would argue that were it the Government's intention to exempt supplies to DEFCO, nothing would have been easier than to expressly exempt supplies to DEFCO.

We however note that the National Treasury, through a letter dated 15 December 2016, sought to provide a clarification that as much as DEFCO is the welfare arm of the KDF, its operations are an integral part of the operations of the KDF. In the said letter, the National Treasury directed that supplies to DEFCO should be considered as official supplies to KDF. The said directive was approved by the Cabinet Secretary for the National Treasury on 14 December 2016.

Contrary to the National Treasury's directive, the Kenya Revenue Authority is of the opinion that the aforementioned exemption provisions do not cover supplies made to the DEFCO; and that the supplies to the DEFCO need to be subjected to both VAT and excise duty where applicable.

Conclusion

In light of the above differing positions regarding the said exemption provisions, we recommend that the affected suppliers should consider making an application for a private ruling to the Commissioner as provided for in the law. This in our opinion would be the most prudent approach since a private ruling would be binding on the KRA; hence the taxpayer would not be penalized for adhering to the KRA's directive.
We anticipate that that the Kenya Revenue Authority will issue a public notice in due course to give proper direction to suppliers of goods to DEFCO.

Please contact our team who will be happy to assist with regard to seeking a ruling or other related tax matters.

Use of Transfer Pricing documentation in Customs valuation

Taxpayers engaged in cross border transactions have grappled with the challenge of different positions taken by different arms of revenue authorities regarding arm's length pricing from a transfer pricing perspective and the price applicable for purposes of Customs valuation. There has been no clear position and in many cases Customs authorities have objected to the use of transfer pricing documentation to explain the circumstances of sale for the purposes of determining whether the relationship between parties in a related party transaction has influenced the price. However, the KRA in a recent valuation ruling accepted the prices declared by an importer based on information obtained from the importer's transfer pricing documents.

Background information

Customs value means the value of goods for the purpose of levying ad valorem duties on imported goods. The methodology for determining customs value is set out in the agreement on the implementation of Article VII of the General Agreement on Tariffs and Trade ("the agreement"). Transaction Value which is the price actually paid or payable for goods when sold for export, is the primary method of customs valuation. However, this method may not be used in certain cases, for instance where the transaction is between related parties and the relationship is deemed to have influenced the price. The transaction value of goods traded between related parties is often rejected by many Customs authorities, including the Kenya Revenue Authority ("KRA"), where the relationship is deemed to have influenced the price of the goods. However, the agreement provides that circumstances surrounding the sale should be examined to determine whether the relationship influenced the price. Further, the Interpretation notes to the agreement provide that in examining the circumstances of sale, *Customs administrations should be prepared to examine relevant aspects of the transaction, including the way in which the buyer and the seller organize their commercial relations and the way in which the price in question was arrived at, in order to determine whether the relationship influenced the price.*

Transfer pricing is the mechanism through which transactions between related parties are priced. The Organisation for Economic Co-operation and Development ("OECD") Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations ("OECD TP Guidelines") are widely and generally used by taxpayers and revenue authorities for determining whether transfer prices meet the "arm's length principle" for direct tax purposes.

Over the past few years, there have been various international discussions as to whether transfer pricing documents can be used to explain the circumstances of sale for customs valuation purposes. There have been efforts to align the transfer pricing and customs value methodologies but this has been an uphill task given the particulars of the existing legal frameworks on which they are based. Customs value is based on the World Trade Organization ("WTO") agreement while transfer pricing is based on the OECD TP Guidelines (or local regulations which mostly follow the OECD TP Guidelines).

The World Customs Organization ("WCO") and the OECD have made attempts to establish to what extent information contained in the transfer pricing documentation provide useful information for Customs to determine whether prices of imported goods are influenced by the relationship in the case of related party transactions.

Technical Committee on Customs Valuation - Commentary 23.1

The WCO and the OECD have held various consultative meetings to discuss whether transfer pricing information may be of use in customs valuation. The most notable progress thus far has been the adoption of Commentary 23.1. This is an instrument of the Technical Committee on Customs Valuation ("TCCV") which acknowledges that the use of a transfer pricing study as a possible basis for examining the circumstances of sale should be considered on a **case-by-case** basis. In other words transfer pricing information **may** be used to explain the circumstances of sale.

Technical Committee on Customs Valuation - Case study 14.1

The WTO recently published a case study describing a situation where customs used information contained in a transfer pricing study to examine the circumstances of sale to determine whether the relationship between the exporter and importer had influenced the price of the imported goods.

The transfer pricing study that the TCCV relied on was based on the Transactional Net Margin Method.

After undertaking an examination of the circumstances surrounding the sale in respect of related party transactions and an analysis of the transfer pricing study based on the functions performed by the related parties, the TCCV concluded that the relationship between the parties did not influence the price under the provisions of Article 1.2 (a) of the Agreement.

The TCCV further reiterated that the use of a transfer pricing study for examining the circumstances surrounding the sale must be considered on a **case-by-case** basis as indicated in Commentary 23.1.

KRA ruling

The KRA recently issued a valuation ruling to a company engaging in cross-border transactions with its non-resident related party clarifying that the transaction values were acceptable for customs purposes. The company, being the sole importer of its brand of goods into Kenya, bears additional financial responsibility for imported goods, such as sales and advertising. The KRA noted that in the company's case, the prices at which the goods are imported into Kenya would be lower than the prices at which an independent third party would import identical or similar goods, since the third party would not have to bear the additional financial burden in Kenya. In issuing its ruling the KRA considered the commercial levels of operation and observed that prices of goods imported by the company could only be compared with prices of identical goods imported by third parties operating at the same commercial level and imported at or about the same time. It is on this basis that the KRA's Customs and Border Control ("C&BC") unit ruled that the transaction values declared by the company were acceptable.

Our view

The relationship between transfer pricing and customs valuation has been a matter of great concern to the business community, especially multinational corporations (MNCs). The C&BC has more often than not disputed the use of transaction value for customs valuation of goods transacted between related parties. Indeed, attempts by importers to use transfer pricing information to explain the circumstances of sale have in most cases been rejected by the KRA.

The C&BC has in the past argued that customs value and transfer pricing methodologies are governed by different legal frameworks and as such prices determined in accordance with OECD guidelines cannot be used as customs values. However, this ruling indicates that the C&BC has now began to appreciate the use of transfer pricing studies in ascertaining customs values, albeit on a case by case basis.

The move by the C&BC to use a transfer pricing study as evidence to support customs values declared by related parties is a welcome move. It is a clear indication of the C&BC's willingness to apply Commentary 23.1 by using information contained in transfer pricing documents to explain the circumstances of sale.

Conclusion

The ruling is a welcome development which indicates that the KRA would allow businesses that engage in cross-border related party transactions to use their transfer pricing documentation to explain the circumstances of sale on a case by case basis. It is therefore imperative that taxpayers engaging in cross border related party transactions review the impact of their transfer pricing policy on their customs declarations. In addition, having updated transfer pricing documentations in place will assist companies faced with customs valuations queries from the revenue authority to mitigate the risks of double taxation.

Stamp Duty & Capital Gains Tax payments: Developments

Following to the motion application filed by the Law Society of Kenya (LSK), in which the High Court of Kenya issued an order dated 13 February 2017 restraining the Kenya Revenue Authority (KRA) from implementing the provisions of paragraph 11A of the Eighth Schedule to the Income Tax Act pending the hearing and determination of the application, the High Court issued a ruling on the petition on the 14th of March 2017.

Paragraph 11A of the Eighth Schedule to the Income Tax Act was introduced by the Finance Act 2015 and took effect from 1 January 2016. The purpose of the paragraph was to set the due date for payment of capital gains tax on the transfer of property as *'on or before the date the application for transfer of the property is made at the relevant Lands Office.'*

The KRA through a public notice earlier this year had informed taxpayers of the roll-out of an online payment module for Stamp Duty and CGT, effectively discontinuing manual payments for the two taxes. The notice further stated that the process of completing the transfer of property would entail simultaneous payment of both the stamp duty and capital gains tax.

The LSK challenged implementation of the provisions of paragraph 11A on the grounds that it contravened fundamental rights and freedoms. As it stood the KRA required capital gains tax to be paid before completion of the transfer process 'upon presentation of the transfer instrument'. In addition the provisions of the paragraph 11A were inconsistent with the provisions of paragraph 2 of the same schedule which provides that CGT accrues only on registration of the transferee as the owner of the land.

The High Court in its decision with regards to whether the paragraph 11A of the Eighth Schedule was vague and the instant when liability to pay CGT accrues, relied on principles governing statutory interpretation, the Kenyan Constitution including the Land Registration Act and general rules of international law.

The ruling declared that Paragraph 11A of the Eighth Schedule does not meet the constitutional test of rationality and proportionality hence allowed the petition. The judge granted orders that the paragraph 11A is inconsistent with the provisions of paragraph 2 of the same schedule and is therefore unconstitutional, null and void. Moreover, the ruling affirmed that the paragraph 11A violates the provisions of article 10(1) (2) and 40(2) (a) of the Constitution of Kenya 2010 by depriving the public of their right over property hence unconstitutional.

The ruling also declared that the paragraph 11A violated the provisions of article 201 (b) of the constitution of Kenya 2010 by unfairly imposing a tax burden on the public to the extent that it purports to impose an obligation on a tax payer to pay CGT 'on or before' presenting the transfer instrument for registration as opposed to 'upon' registration of the transfer instrument in favour of the transferee.

Our view

This is a great relief to both vendors, purchasers of property, developers, investors and citizens who are looking at transacting in the future as it alleviates the tax burden before transfer of instruments and the infringement on their rights to property.

Capital gains tax is therefore payable on or before the 20th day of the month following completion of transfer through: disposal of the asset via filing of the instrument; registration of transferee as proprietor of the land, lease or charge; and accrual of the chargeable gain from the disposal to a person chargeable to CGT.

If you would like more information on this **please contact your Tax Relationship Manager.**

KRA Notice on Betting, Lotteries and Gaming Taxes

The Kenya Revenue Authority ("KRA") has notified betting operators of the new betting tax regime.

Through a Public Notice dated 16 February 2017 the KRA has notified Betting, Lotteries and Gaming Operators of the amendments making KRA the designated collector of the taxes for betting tax effected by the Finance Act 2016 and Betting, Lotteries and Gaming Act.

The notice seeks to inform players in the betting industry of the new taxation regime contained in Sections 29A, 44A, 55A and 59B of the Betting, Lotteries and Gaming Act ("The Act") which introduced betting taxes at the following rates:

- Betting tax - levied at 7.5% on the gaming revenues of licensed bookmakers;
- Lottery tax –levied at 5% on the lottery turnover of persons licensed to promote a lottery;
- Gaming tax –levied at 12% on the gaming revenues of persons carrying on a gaming business; and
- Prize competition tax – levied on the cost of entry to a premium-rated competition at the rate of 15% on the total gross turnover of licensed persons.

The notice is based on the provisions of the Betting, Lotteries and Gaming Act ("The Act") which contains legislations that are specific to the betting industry.

The law is however silent on whether the said taxes can be claimed as a deduction under corporate tax. This is because none of the taxes has been included under section 39 which deals with set-off of income tax or the exemption schedule of the ITA. The affected tax payers are therefore left to shoulder the huge tax burden arising from both corporate tax and betting taxes and this may hinder the growth of the industry.

Our view

These being new taxes taking effect from 1 January 2017, the Public Notice was to sensitize the industry players on their obligations to deduct the tax and remit to the KRA.

It is therefore critical that affected taxpayers comply with the new legislation to avert future KRA queries and audits arising from non-compliance.

Furthermore, it is important that businesses enable their ERP systems to cope with this change so as to be able to account for the taxes. Please contact your relationship manager or myself in case you require assistance on this.

KRA Notice on Filing of VAT returns and invalid Tax invoices

In an effort to enhance tax compliance, the Kenya Revenue Authority ("KRA") has issued a public notice bringing to the attention of taxpayers the provision of VAT Act with regard to the claim of input tax and the use of valid tax invoices while filing VAT returns.

Through a Public Notice dated 16 and 17 February 2017 directed particularly to VAT registered taxpayers who are filing and claiming inputs using invalid tax invoices, the KRA has re-emphasized the importance of claiming input VAT based only on valid tax invoices.

The notice is based on the provisions of Section 42 (1) of the VAT Act 2013 ("The Act") which requires a VAT registered person making a taxable supply to furnish the recipient, at the time of supply, with a valid tax invoice containing the requisite details for the supply.

Further, for the purposes of input tax deduction, one must also keep in mind the provisions of Section 17 (3) of the Act wherein it is stated that *for a registered taxpayer to be eligible to deduct input tax, he/she should have an original valid tax invoice issued for the supply, or a certified copy in lieu of the original.* Additionally, it is important to note that a recipient of a taxable supply is only eligible to deduct input tax where a valid tax invoice for the supply is received and claimed within six months from the time the supply occurred.

The notice states that KRA has validated all invoices credited in the VAT returns of tax payers from July 2016 to date and will automatically disallow all invalid invoices not recognized by iTax system.

In view of the above, KRA advices all taxpayers to amend their returns accordingly in order to avoid penalties under the Tax Procedures Act, which may arise from the erroneous declaration. On affected cases, KRA asserts that system generated assessments will be issued based on the information and data obtained from iTax system.

Furthermore, the KRA has posted a list of the all affected taxpayers and their PIN on their website. It is advisable that taxpayers should confirm if their PINs are among those with issues and that they should seek appropriate assistance from KRA office where their files are or the nearest KRA office.

Our view

Perhaps, the Public Notice is the result of efforts by the KRA to match, through the iTax system, input tax deducted by recipients of taxable supplies against output tax declared by respective suppliers. Assuming that the matching works in practice, it will go a long way in curbing tax evasion.

It is therefore important that taxpayers claim only input tax that arose from valid tax invoices to avoid the input tax being disallowed later resulting in back taxes.

The notice goes to show the need to deal with credible suppliers to avoid being blacklisted by the tax authority.

If you would like more information or assistance on this matter, **please contact your Tax Relationship Manager.**

Contact Us

For more information and guidance, please feel free to contact the following or your usual Deloitte contact person:

Name	Phone contact	Email address
Nikhil Hira	+254 (0)20 423 0377	nhira@deloitte.co.ke
Fred Omondi	+254 (0)20 423 0318	fomondi@deloitte.co.ke
Lilian Kubebea	+254 (0)20 423 0113	lkubebea@deloitte.co.ke

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