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Appeal Court ruling on withholding tax

The Kenyan Court of Appeal delivered a judgement on 5 February 2019 to the effect that an accrual (of an expense) in the books of accounts falls within the meaning of the word “paid” for Income Tax purposes and therefore withholding tax becomes due upon such accrual.

In this alert we provide a summary of the facts of the case and the implications for the tax payer.

Background

Fintel Ltd, the respondent in the appeal before the Court of Appeal, entered into an agreement with a contractor for the construction of a rental building. As per the terms of the contract, Fintel was required to pay the contractor interest on any outstanding fees after the due

date. In the course of the contract, Fintel experienced difficulties in settling the outstanding fees and as a result interest arose on outstanding payments. The interest due to the contractor was recorded as a liability in Fintel’s book of accounts. The Kenya Revenue Authority

(KRA, the appellant) carried out an audit of Fintel’s books and issued a withholding tax assessment on interest on the basis that the interest had already been claimed as an expense in the audit accounts.

The KRA's position was challenged at the High Court in the Republic vs Kenya Revenue Authority ex-parte Fintel Limited HC Misc. Civil Application No. 1768 of 2004. The High Court found in favour of Fintel and ruled that "paid" in Section 2 of the Income Tax Act (ITA) assumes its ordinary meaning and the use of the words "include" is merely illustrative of the kinds of activities that constitute payment. The Court held that payment implies delivery of money or some other valuable thing and that payment is prerequisite for withholding tax to apply. The implication of the ruling was that withholding tax would only become due upon actual payment/settlement of obligation.

The KRA appealed the High Court ruling and On 5 February 2019 the Court of Appeal overturned the High Court decision. The Court of Appeal found that the High Court adopted a restrictive interpretation of the word "paid". The main issue of contention was the definition of the words "paid" and "upon payment" as provided in Section 2 and Section 35 of the Act. The Court of Appeal adopted a contextual interpretation of words by using the definition of "paid" in the ITA to interpret the words "upon payment". "Paid" has been defined to include distributed, credited, dealt with or deemed to have been paid in the interest or on behalf of a person. The Court of Appeal held that payment is deemed to be made even where no money has passed over. Furthermore, the Court pointed out that the sense in which the word "deduct" is used for withholding tax purposes, does not require physical movement but includes book entries recognising amounts due, taking into account that the income tax regime is based on the accrual system.

Our view

This ruling has major implications for all taxpayers both from a practical and compliance perspective. The ruling effectively reverses the prevailing practice of withholding tax on actual payments.

The implication is that taxpayers will be required to deduct and remit withholding tax on the eligible fees at the point when accrual is recorded in the book of accounts. This will have negative cashflow impact on taxpayers.

From a compliance perspective, there will be a number of administrative challenges in accounting for the withholding tax on iTax. In many cases the accrued amounts do not match the actual invoiced amounts which may result in the taxpayer underpaying or overpaying the withholding tax on iTax. This also arises where credits/rebates are given or suppliers do not impose expected charges such as interest or penalties. The taxpayer will spend a considerable amount of time reconciling the correct withholding tax position. The iTax system does not allow one to offset tax amounts.

Where there is an overpayment, the only party allowed to apply for a refund is the supplier/payee. The refund process for withholding tax is currently not established and in practice, there is reluctance to process refunds, not to mention other hurdles such as tax audits that may be triggered when an application for refund is made. Taxpayers would therefore need to ensure any accruals accurately reflect the payment obligation; the timing of accruals becomes even more critical at this point. It would be important for taxpayers to carefully consider the impact of their accruals policy on their withholding tax obligations.

A few questions linger from the judgement. Firstly, where taxpayers relied on the High Court ruling or prevailing practice, there is possibility of reopening past periods. Secondly, where the taxpayer has made an accrual in their books of accounts for services received, but the supplier has neither issued an invoice nor recognised the income in their books of accounts, there will be a mismatch between the withholding tax and the supplier's income. This will create additional burden of reconciling income with iTax records.

Conclusion

Whereas the Court of Appeal ruling sets a precedence and creates greater certainty on the question of the tax point for withholding tax purposes, the overall impact on taxpayers will be adverse. Taxpayers will need to fund tax payments upfront and face additional challenges of accurately accounting for withholding tax.

There is a need for taxpayers to review their compliance status in light of this ruling and consider potential risks and efficiencies vis-à-vis the accruals policy.

Should you wish to discuss this further, kindly contact the tax team below or your relationship manager at Deloitte who will be more than glad to offer you guidance and assistance.

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