

Tribunal limits expense apportionment in mixed-income businesses

Summary

This alert brings to your attention a recent Tax Appeals Tribunal decision in the case of Prime Capital and Credit Limited v Commissioner for Legal Services and Board Coordination (KRA) (Tribunal Appeal E101 of 2023) [2024] (24 May 2024) (Judgment).

The Tax Appeal Tribunal partially upheld Kenya Revenue Authority's (KRA's) objection decision by setting aside the confirmed assessment on apportionment of general expenses incurred by the business in earning exempt income and donations which the KRA had apportioned in a direct proportion to the exempt income earned. In addition, the Tax Appeals Tribunal upheld the assessment related to the unrealised foreign exchange loss and overstated unrealised foreign exchange gains.

Background

The Appellant is a limited liability company incorporated in Kenya under the Companies Act and engaged in lending money and investing in shares listed on the Nairobi Securities Exchange and private related companies, government and foreign bonds.

Following a review of its tax affairs for the period January 2017 to December 2021, the KRA disallowed portions of expenses claimed by the Appellant in relation to exempt income, adjusted for foreign exchange gains and losses and recomputed the company's annual tax computations, resulting in a **KES 274,970,145** reduction of the company's tax losses.

After the Appellant lodged an objection, the KRA partially amended the tax liability by allowing some expenses and confirmed a tax loss reduction of **KES 271,940,415**.

Dissatisfied with this outcome, the Appellant filed an appeal before the Tax Appeals Tribunal.



The Appellant's Arguments

In its appeal, Prime Capital argued that the Respondent had erred both in law and fact by disallowing expenses incurred in the generation of taxable income, which are allowable for tax purposes. The Appellant argued as follows:

- It generates both taxable and exempt income with the main business being the lending, whose interest income was taxable.
- Dividend earned from Prime Bank Limited and Northend Estates Ltd, in which it owns 14.39% and 25% of the shareholding respectively, is exempt from tax as provided for under Section 7(2) of the Income Tax Act (ITA).

The Tribunal's Findings

The Tribunal identified one key issue for determination:

- Whether the Respondent's confirmed assessments were justified

The Tribunal noted that the Appellant earned both taxable and exempt income. The taxable income was derived from lending of money to its clients while the exempt income was derived from investment in various bonds such as infrastructure and foreign bonds.

The Tribunal therefore found that:

- The general expenses that the company incurred which are: insurance expenses, salaries, employer's contribution to NSSF, work permit expenses, directors' fees, postages, mobile phone charges, telephone charges, E-mail service, medical charges, audit fees and legal, consultancy and accountancy fees were not incurred in the generation of the Appellant's exempt income and therefore were utilised in its taxable business and should therefore not be apportioned.
- The donations by the Appellant to the Social Service League and Shree Jalaram Satsang Mandal were backed by valid tax exemption certificates in compliance with Section 15(2)(w) of the ITA and Paragraph 10 of the First Schedule to the ITA.
- On unrealised exchange loss and overstated unrealized exchange gain, the Appellant did not produce any documentation to support its averments. The only reference made to this item is on the tax computations with a reference to a note in its financial statements which were not adduced as evidence to support its averments.



The taxable income was derived from lending of money to its clients while the exempt income was derived from investment in various bonds such as infrastructure and foreign bonds.



In conclusion, the Tribunal varied the KRA's objection decision by setting aside the apportionment of general expenses and disallowance of donations by Prime Capital and, upheld the assessment relating to unrealised exchange loss and overstated unrealized exchange gain.

The KRA was directed to recompute the tax assessment based on the Tribunal's finding within 30 days of the delivery of the judgment.

Our Opinion

The Tribunal's decision provides guidance for financial institutions and investment holding companies with mixed income streams on the limits of expense apportionment under Kenyan tax law.

The concept of matching expenses and costs is a key consideration when determining deductibility of expenses from a tax perspective. As highlighted in Section 15(1) of the ITA, only expenses wholly and exclusively incurred in the generation of taxable income is deductible for tax purposes.

Expenses incurred in generating exempt income are not deductible for tax purposes. This principle is critical in determining deductibility of expenses incurred in generating both taxable and exempt income.

Interest income earned from infrastructure bonds and qualifying dividends are passive in nature. Therefore, the effort involved in earning these incomes is minimal and common business running costs cannot be deemed to have been incurred in earning this income, especially when the business has other more involving business operations.

Another consideration in determining deductibility of expenses incurred in earning exempt income is the source of funding. As highlighted in this case, the Appellant borrowed funds to invest in foreign bonds, whose interest was not subject to tax in Kenya. This is because the said interest income has not been accrued or derived from Kenya. The interest expenses and related costs such as foreign exchange losses would not be deductible for tax purposes.

The decision affirms that the general operating costs are primarily tied to the core business income. Therefore, the Commissioner must show a reasonable nexus between expenses and exempt income before applying apportionment.

For the taxpayer, clear expense allocation and segmented accounting for income streams is critical as taxpayers will be required to provide evidence to show that expenses are wholly and exclusively tied to taxable income. Without such evidence, taxpayers' risk having legitimate business expenses disallowed for tax purposes.



Overall, the case heralds a shift towards stricter standards in apportionment of expenses relating to generation to both exempt and normal business incomes and highlights the importance of substance-based reviews in tax compliance.

KPMG is happy to assist on any issues arising from this decision.

If you have any questions, do not hesitate to reach out to us on taxandregulatory@kpmg.co.ke or contact cakora@kpmg.co.ke

Contact

Clive Akora

Partner
Tax & Regulatory services
KPMG East Africa

Stephen Waweru

Technical Lead
Tax & Regulatory services
KPMG East Africa

Solomon Kihang'a

Senior Manager
Tax & Regulatory services
KPMG East Africa