



Withholding Tax on Accruals

Summary

This alert brings to your attention a recent Court of Appeal decision in the case of Kenya Revenue Authority and Republic (ex parte: Fintel Limited) on the treatment of Withholding Tax (WHT) on accruals as per the provisions of the Income Tax Act (ITA).

Facts of the Case

Fintel Limited (Fintel) had contracted China Juangsu International Economic Technical Cooperation Corporation (CJIETCC) for the construction of a rental building.

Fintel experienced financial difficulty in settling outstanding fees to CJIETCC, triggering an interest charge on the outstanding amounts. Fintel accrued for the interest in its books but did not account for WHT on the interest. Following an audit of Fintel, the Kenya Revenue Authority (KRA) issued an assessment demanding WHT on the accrued interest on the basis that the tax was payable upon accrual of the interest in the financial statements of the company.

Fintel applied to the high court for an order of certiorari to quash the Commissioner's demand. The high court ruled in Fintel's favour that accrual of an expense in the audited financial statements did not amount to the expense being "paid" as defined under Section 2 of the ITA. The High Court added that under Section 35 of the ITA, tax is only withheld "upon payment" and therefore payment is a prerequisite for WHT to apply. As a result, WHT was not applicable on the interest accrued in the Fintel audited financial statements as the company had not made any "payments" to CJIETCC.

The KRA appealed against the High Court decision to the Court of Appeal.

Issue(s) for determination

1. Whether the appellant's decision was a nullity for failure to give reasons;
2. Whether the appellant acted ultra vires by rejecting the respondent's objection;
3. Whether the learned judge erred in finding that judicial review was not available to the respondent without exhausting all other statutory mechanisms as provided in the Tax Procedures Act (TPA); and
4. Whether the learned judge erred in his construction of Sections 2 and 35 of the ITA in defining the words upon "payment" and "paid".

Findings

The Court of Appeal held that the reasons for rejecting the respondent's objection were clear and obvious as detailed in the demand letter and the letter rejecting the respondent's objection.

On the issue of KRA acting ultra vires to its powers, the court of appeal held that KRA is established under an Act of Parliament to collect and assess revenue and enforce statutes relating to revenue. Section 120 of the ITA empowers KRA to inquire into the accounts of a company, assess and demand payment of tax.

On the eligibility of Fintel in seeking relief through judicial review proceedings, the court of appeal held that Fintel acted in good faith by moving to the high court even after invoking the jurisdiction of the Local Committee. It further held that KRA suffered no prejudice from the institution of judicial review proceedings.

The Court of Appeal further stated that being technical terms as used in the ITA, the ITA definition should be the source of meaning for the words "upon payment" or "paid" which are key in determining the deductibility of WHT. The court further observed that the ITA is to be interpreted from a wholesome approach as opposed to adopting an isolated approach.

According to the Court of Appeal, the High Court had narrowly construed the term "upon payment" by giving it the meaning "**delivery of money or other valuable thing**". According to the court, given that the ITA provides a definition of the term "paid" under Section 2, this should have been the basis for deciphering the mean of the word.

Section 35(5) of the ITA provides that where WHT is payable, the taxpayer must deduct and remit the amount to the Commissioner. The court observed that the term "deduct" is an accounting term which means the subtraction of an item or expenditure from gross income to reduce the amount of income subject to tax. The judges ruled that the reduction may be practical or through a book entry.

The Court of Appeal held that the Income tax regime is based on an accrual system. The interest due was booked in Fintel's Profit and Loss Account and as a result reduced its taxable income. In conclusion the Court set aside the High Court ruling and ruled in the KRA's favour that WHT is due on accrual and not actual payment.

Our opinion on the judgment

Since the High Court decision was not stayed pending the decision of the Court of Appeal, it is our view that this decision cannot be applied retrospectively. Consequently, the taxpayers who accounted for WHT on qualifying expenses upon making "actual" payments during this intervening period will not be deemed to have breached the provisions of the ITA.

In essence, this means that from the date of the Court of Appeal's decision, WHT should be accounted for on an accrual basis on all expenses subject to WHT. Generally, the accrual basis of accounting focuses on when the expense is incurred and booked in the financial statements as opposed to when the actual payment is made with regards to that expense.

We will keep you updated on any developments. However, should you have a specific query or on the same please contact us.

Regards

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