

Tax Alert

Offsetting tax credits against tax liabilities is prohibited unless the credit is validated by the revenue authority



Background

This Alert brings to your attention the Tax Appeals Tribunal's (TAT) decision in the case of **National Bank of Kenya Limited (Appellant) vs. Commissioner of Domestic Taxes (Respondent), Tax Appeal No. 474 of 2020.**

The Appellant had moved to the TAT seeking to overturn the Respondent's corporation income tax (CIT) assessment relating to alleged underpayment of CIT for the period 2015 - 2018. The underpayment was as a result of the Appellant's utilization of tax overpayments from 2014 in offsetting CIT liabilities in later years.

The main point of contention was whether the Appellant was justified in utilizing CIT overpayment to offset CIT liabilities arising in subsequent years. The Appellant used the "credit under special arrangement" field of the Self-Assessment Return (SAR) template which relate to foreign tax credits as per the provisions of Section 42 of the Income Tax Act ("ITA").

The Appellant lodged an appeal at the TAT against the Respondent's decision in September 2020.

The Appellant's grounds of appeal at the TAT

The Appellant challenged the Respondent's decision on the following grounds: -

- a) It was the Respondent's responsibility to design a Self-Assessment Return (SAR) template that would allow the Appellant to appropriately claim its tax credits arising from the overpayments. This forced the Appellant to claim the refund in the field designated for credits under "special arrangements" as per Section 42 of the ITA.
- b) Section 47 of the Tax Procedures Act, Act No.29 of 2015 (TPA), is titled "Refund of overpaid tax". This section should not be applicable where a taxpayer opts to utilize tax overpayments in offsetting future tax liability.
- c) The use of the word "may" under section 47 is merely permissive or directory and not obligatory. This allows the Appellant freedom to either lodge an application for refund or not.
- d) The Respondent's longstanding practice of allowing taxpayers to automatically offset tax overpayments within the same tax head gave rise to a legitimate expectation. The longstanding practice can only be abrogated by an overriding change in law or other matters of inordinate public interest.

- e) The Respondent was not justified in disallowing tax overpayments on a mere fact that they were declared in the wrong field of the return while it had failed to provide an alternative field where such overpayments could be declared.

The Respondent's submissions

In rebutting the Appellant's arguments at the TAT, the Respondent stated that:

- a) The provisions of Section 42 of the ITA do not apply to the Appellant's overpayments claimed in their annual income tax returns.
- b) Section 47 of the TPA allows the Appellant to apply for refunds of tax overpayments. It also states that the Respondent may audit the refund claims to determine their validity.
- c) The Appellant's claiming of credits between 2015 and 2018 had created multiple erroneous refund tasks as they were not related to foreign taxes payable as provided for in Section 42 of the ITA.
- d) The Appellant's only proper claim of refund was overpaid tax for the year 2014. The Respondent stated that the refund was in the process of being validated and the Appellant would be informed once the process is complete. Any approved overpayments would be utilized as per Section 47(4) of the TPA.
- e) The Respondent was justified in disallowing all the credits claimed "under special arrangements" on the basis that the claims were not related to foreign tax and were made under the wrong provision of the law. The resulting refund tasks for the multiple claims were thus erroneous and were to be disallowed.

Issues for determination

The issues for determination were whether:

- i. The Appellant was entitled to tax credits as per Section 42 of the TPA;
- ii. It is justified for the Appellant to utilise the tax overpayment to offset tax liabilities in subsequent years; and
- iii. The taxes confirmed by the Respondent via the Objection Decision (31 August 2020) were payable.

The TAT finding

The TAT dismissed the Appellant's case, holding as follows:

- a) Section 42 of the ITA relates to credits arising from foreign tax payable in respect of income earned under special arrangements. The TAT agreed with the Respondent that it was incorrect for the Appellant to claim overpayments under Section 42.
- b) Section 47 of the TPA was the only avenue available for the Appellant to utilize its overpayments. The TAT held that the Appellant cannot use the overpayment without going through the validation process set out under Section 47 of the TPA. The TAT concluded that offsetting a tax due from an overpayment of tax is not automatic and that the taxpayer must apply under Section 47 of the TPA for validation.
- c) The taxes assessed as per the Respondent's Objection Decision were due and payable.

Our opinion on the judgment

Taxpayers who had previously been using Section 42 of the ITA and the field for foreign credits in iTax to offset their liabilities against overpayments will come under KRA's audit scope and may face potentially material tax assessments.

The Tribunal's judgment reiterates that taxpayers will be subject to the provisions on refunds as stated in the tax laws. Taxpayers will not be able to base their arguments on practical challenges on iTax if doing so results in contravention of a specified law.

Additionally, taxpayers will face increased administration costs due to the requirement to apply for refunds of tax overpayments as per Section 47 of the TPA. The refund process is long and comes with the risk of an audit on the circumstances leading to the overpayment. This is plainly illustrated by this case where the Appellant's overpayment from 2014 is still being verified by KRA.

In our view, the ruling appears to fly in the face of what it means to be under a self-assessment regime of taxation from the taxpayers' point of view. Nevertheless, KRA should come up with a way of fast-tracking validation of overpayments and refunds, and also engage taxpayers who have a perception that tax audits are meant to delay refunds or scare away taxpayers from applying for refunds.

Businesses often need the money from the refunds urgently to support their operations, especially if paid following over estimations of their tax obligations. KRA stands to benefit more if the refunds are processed quickly and given back to businesses to generate more income.

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

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