

HIGH COURT OF KENYA PROVIDES CLARITY ON THE TAXATION OF INSURANCE SUMS PAID AS COMPENSATION ON DESTRUCTION OF BUILDINGS - COMMISSIONER OF DOMESTIC TAXES V SONY HOLDINGS LIMITED [2021] EKLR HIGH COURT INCOME TAX APPEAL E042 OF 2020

A. BRIEF FACTS OF THE CASE

On 30th April 2021, the High Court of Kenya delivered its judgment in the case of **Commissioner of Domestic Taxes Vs Sony Holdings Limited, E042 of 2020**. This was an Appeal from the decision of the Tax Appeal Tribunal.

Sony Holdings Limited (Hereinafter “Sony”) was engaged in the business of development, owning, and letting of real estate. Its flagship project was the Westgate Shopping Mall (“the Mall”) from which it received rental income. On 21st September 2013, the Mall was the subject of a terrorist attack. At the time of the attack, Sony held a terrorism and political violence insurance cover for property damage (buildings and outbuildings) and loss of rent receivable in the sum of KES. 6,000,000,000 and KES. 1,200,000,000 respectively with Kenindia Assurance Company Limited (“Kenindia”).

After the attack, Sony claimed from Kenindia and was granted the insurance compensation and accordingly received a total compensation for loss of rent receivable of KES. 1,200,000,000 and an amount of KES. 3,100,000,000 for loss/damage of buildings and outbuildings. Further, it sought exemption from withholding tax on rental income from the Cabinet Secretary, National Treasury.

In response to the request for exemption, the Commissioner requested for supporting documents. However, the Commissioner gave notice of its intention to make an additional assessment and thereafter proceeded to issue an additional assessment for Income Tax, VAT and

Withholding Tax. The Commissioner thereafter assessed the Respondent’s tax liability as KES. 380,388,596.00 being principal corporation tax, penalty and interest thereon.

It is this Tax Assessment that Sony Objected to and filed its Notice of Objection and subsequent appeal at the Tax Appeals Tribunal. The Appeal was later decided in favour of the Sony leading to the Appeal at the High Court by the Commissioner.

B. ISSUES FOR DETERMINATION

1. Whether the insurance compensation of KES 6,000,000 paid to the Sony for loss of building and outbuildings is taxable under Section 4(c) of the Income Tax Act (“the ITA”);
2. Whether Sony is entitled to Commercial Building Allowance under Paragraph 6A of the Second Schedule of ITA; and
3. Whether the Commissioner is entitled to deduction for unrecovered service charge incurred in the years 2015 and 2016.

C. ANALYSIS OF ISSUES

I. WHETHER INCOME TAX CHARGEABLE ON 600,000,000.00 KES INSURANCE COMPENSATION

The Commissioner contended that it acted within the law by charging income tax on the sum of KES. 600,000,000 received by the Respondent for insurance compensation in accordance with Section 4 (c) of the Income Tax Act (ITA). Further, that Sony had the burden to support its case that

the KES. 600,000,000 it had received was compensation for loss of buildings and outbuildings which it did not discharge.

It was the Commissioner's contention that Sony had not discharged its burden in showing that the amount it had received was not taxable. In the circumstances thus, the Commissioner submitted that its actions were within Section 4(c) of the ITA. Further, the Commissioner contended that Sony did not demonstrate that the insurance compensation was for loss of building and outbuildings.

In arriving at its holding, the Court noted that the question whether the Commissioner acted within the law by charging income tax on KES 600,000,000.00 as received by Sony for insurance compensation was determined under Section 4(c) of ITA. That under Section 3(2)(a)(i) of the ITA, income tax is chargeable on **"gains and profits from any business, for whatever period of time carried on."** It was the Court's observation that the reading of Section 4 (c) of the ITA was plain and obvious as follows: -

For purposes of section 3(2)(1)(a) – (c) any sum received under any insurance against loss of profits, or received by way of damages or compensation for loss of profits, shall be deemed to be gains or profits of the year of income in which it is received;

It was the Court's ruling that the compensation subjected to taxation was insurance compensation received by the taxpayer in respect of compensation for **loss of profits** which were subject to taxation in line with Section 3(2)(a)(i) of the ITA. To this end, it was the Court's holding that the Tribunal correctly observed that Section 4(c) of the ITA did not deal with or affect insurance sums paid as compensation for destruction of buildings and outbuildings as such payment did not constitute income as it is intended to replace the destroyed or lost asset.

As to whether Sony had demonstrated that the Commissioner was incorrect in concluding that the KES. 600,000,000 received by it was compensation for profits within the meaning of Section 4(c) of the ITA, the Court relied on the conclusion by the Tribunal that the evidence before it indicated that KES 600,000,000 was received by Sony as compensation of buildings and outbuildings. Further, that it was not in dispute that there was a Policy Document issued by Kenindia indemnifying Sony from losses and damages arising out of acts of terrorism. That the losses covered by the policy included Buildings and Outbuildings and 24 Months' Rent Receivables.

Based on the above, the Court noted that Kenindia was better placed to clarify the basis of the KES. 600,000,000. As such, the Commissioner did not have any basis to reject the clarification if at all it was initially in doubt as to the purpose of the payment. Further, there was no other reason for Kenindia to pay Sony other than in accordance with the policy as indemnity for the loss of buildings and outbuildings because of terrorism.

To this end, the High Court upheld the decision of the Tribunal to the effect that Section 4(c) of the ITA did not deal with or affect insurance sums paid as compensation for destruction of buildings and outbuildings as such payment did not constitute income as it is intended to replace the destroyed or lost asset.

II. WHETHER SONY WAS ENTITLED TO COMMERCIAL BUILDING ALLOWANCE

The other issue was whether Sony was entitled to commercial building allowance. It should be noted that after the terror incident, Sony proceeded to partially re-open the business in July 2015 and fully in 2017. During the period, Sony had accumulated tax losses by the end of 2015 whereupon it sought an opinion from the Commissioner on whether it was entitled to the Commercial Building Allowance.

The Commissioner subsequently replied noting that: -

- (i) The reconstruction expenditure must be capital in nature.**
- (ii) Sony can claim commercial building deduction in the relevant return of Income after completion of construction and after the building is put to use but subject to (iii) below.**
- (iii) The claim for the deduction is allowable if the commissioner is satisfied that it meets the conditions set out in paragraph 6A of the second schedule to the Income Tax Act: that besides the capital expenditure on commercial building, Sony must have provided roads, water, sewers, and other social infrastructure.**

Sony however complained that despite complying with the conditions set out in the Private Ruling contained in the letter dated 6th May 2015, the Commissioner wrongfully rejected its claim for the allowance on the ground that the construction did not meet the conditions of the Paragraph 6A of the Second Schedule of the ITA.

It should be noted that Paragraph 6A of the Second Schedule of ITA allows for deductions on income based on capital expenditure incurred in respect of a commercial building and more specifically: -

6A. Expenditure in respect of commercial building

(1) Where a person incurs capital expenditure on the construction of a commercial building to be used in a business carried on by him or his lessee on or after the 1st January, 2013, and the person has provided roads, power, water, sewers and other social infrastructure, there shall be deducted, in computing the gains or profits of that person for any year of

income in which the building is so used, a deduction equal to twenty-five percent per annum.

(2) For the purpose of this paragraph “commercial building” includes a building for use as an office, shop or showroom but shall not include a building which qualifies for deduction under any other paragraph, or a building excluded for industrial building under paragraph 5(3) of this Schedule

In its arguments, the Commissioner noted that Westlands area, where Sony’s Mall was located, is an urban area within the Nairobi County for which it had provided a sewer system. That the area was already connected with power and a good network of roads. As such, Sony could not argue that it had provided those facilities as they existed before the reconstruction of the mall. Moreover, that the facilities were not for the sole use of Sony’s business as they were also being used by members of the public.

However, Sony on the other hand submitted that it had provided for roads, water, sewer, electricity, and other social infrastructure supported by documents provided to the Commissioner including the construction contracts, bill of quantities, payments, construction ledgers, photographs and other evidence demonstrating that it incurred capital expenditure.

In arriving at its decision, the Court observed that it was common ground that Paragraph 6A of the Second Schedule of ITA allowed for deductions on income based on capital expenditure incurred in respect of a commercial building. That the interpretation of Paragraph 6A of the Second Schedule of ITA is that all a taxpayer needs to do is to put up roads, power, water, sewers, and other social infrastructure while incurring capital expenditure on construction of a commercial building. That it did not matter that roads, power and other social infrastructure were already in

place or that the same was not being utilized solely by the taxpayer. That the use of the word **social** was deliberate and implied that infrastructure was not only for use by the taxpayer but also for members of the public.

To this end, the Court observed that the Commissioner could not claim that Sony had not fulfilled these conditions considering the evidence on record, for it to disallow Sony's application for the Commercial Building Allowance. To this end, the Court proceeded to uphold the decision of the Tribunal to the effect that Sony could claim for commercial building allowance.

III. WHETHER THE COMMISSIONER OF TAXES IS ENTITLED TO DEDUCTION FOR UNRECOVERED SERVICE CHARGE INCURRED IN THE YEARS 2015 AND 2016

As relates to this issue, Sony noted that for the consideration of the unrecoverable service charge for years 2015 and 2016, the same was grounded on the fact that any property that was leased out to tenants required certain services to be supplied for the smooth running of the property including cleaning, advertising, security, land rent, rates, insurance amongst others. That these services were incurred whether the property was leased out or not and while the same may be

recovered from tenants as service charge in proportion to the areas of the property occupied by tenants, where the area was unoccupied the landlord had absorbed the cost of those services. Consequently, these were necessary expenses to produce the income earned from the property and were therefore deductible under Section 15(1) and 16(1)(a) of the ITA.

Based on the evidence presented at the Tribunal, the Court observed that Sony had incurred service charge expenses which ought to have been deducted from the Sony's income for the years 2015 and 2016. To this end, the Court

proceeded to affirm the Tribunal's decision to the effect that there was no basis for the Commissioner to subject the unrecoverable service charge to corporation tax.

D. CONCLUSION

We note that based on the above holdings, the same clearly affirmed that Section 4(c) of the ITA did not deal with or affect insurance sums paid as compensation for destruction of buildings and outbuildings as such payment did not constitute income as it is intended to replace the destroyed or lost asset.

Further, that based on Paragraph 6A of the Second Schedule of ITA, for a taxpayer to be entitled to commercial building allowance, a taxpayer just needed to put up roads, power, water, sewers, and other social infrastructure while incurring capital expenditure on construction of the said commercial building. That it did not matter that the roads, power, and other social infrastructure were already in place or that the same was not being utilized solely by the taxpayer.

Let's talk

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