



**Dac Aviation EA Limited v Commissioner of Legal Services & Board Co-Ordination
(Appeal 481 of 2021) [2023] KETAT 144 (KLR) (Civ) (17 March 2023) (Judgment)**

Neutral citation: [2023] KETAT 144 (KLR)

**REPUBLIC OF KENYA
IN THE TAX APPEAL TRIBUNAL
CIVIL**

APPEAL 481 OF 2021

E.N WAFULA, CHAIR, RO OLUOCH, RM MUTUMA & EK CHELUGET, MEMBERS

MARCH 17, 2023

BETWEEN

DAC AVIATION EA LIMITED APPELLANT

AND

**COMMISSIONER OF LEGAL SERVICES & BOARD CO-
ORDINATION RESPONDENT**

JUDGMENT

1. The Appellant is a limited liability company incorporated in Kenya and is a subsidiary of Trident Enterprise. The company is incorporated in Mauritius and is based in Montreal, Canada, South Africa and Kenya. Its principal activity is providing contract for air services and related aviation support system.
2. The Respondent is a principal officer appointed under Section 13 of the [Kenya Revenue Authority Act, 1995](#). Under Section 5(1) of the Act, the Kenya Revenue Authority is an agency of the Government for the collection and receipt of all tax revenue. Further, under Section 5 (2) of the Act with respect to the performance of its functions under subsection (1), the Authority is mandated to administer and enforce all provisions of all written laws as set out in Part 1 & 2 of the First Schedule to the Act for the purposes of assessing, collecting and accounting for all revenues in accordance with those laws.
3. The dispute herein arose when the Respondent conducted an audit on the Appellant for the period 2013 to 2015 and thereafter issued a VAT and
Income Tax assessment letter dated 25th June 2020 totaling Kshs. 2,923,461,962.00.
4. The Appellant filed a Notice of Objection dated 30th July 2020 contesting the whole assessment.



5. The Respondent issued its Objection decision on the 28th of June 2021 confirming part of the assessment and reducing the assessed tax to Kshs 2,584,047.80
6. The Appellant being dissatisfied with the said Objection decision filed a Notice of Appeal dated 28th July, 2021.

The Appeal

7. The Appeal is premised on the grounds of appeal as set out in the Memorandum of Appeal dated and filed on 10th August, 2021 as follows:
 - a. That the Respondent erred in law and in fact by concluding that DAC International created a Permanent Establishment (PE) in Kenya;
 - b. That the Respondent erred in law and in fact by presuming two journal vouchers (inter-company promissory note and related party payables to equity) for the year 2015 to be income to the Appellant from DAC International;
 - c. That the Respondent erred in law and in fact by disallowing a deduction of bad debts written off on the basis that the Appellant had not provided sufficient evidence of efforts for debt recovery;
 - d. That the Respondent erred in law and in fact in assessing tax on reserves for maintenance of aircrafts including the repair and overhaul of engines on basis that there was no evidence that the expenses incurred by the Appellant relating to maintenance and repair of aircrafts leased by the Appellant were paid out of those reserves;
 - e. That the Respondent erred in law and in fact by disallowing input incurred in making exported services That are zero rated.

Appellant's Case

8. The Appellant's case is premised on the hereunder filed documents and the proceedings before the Tribunal:-
 - a. The Appellant's Statement of Facts dated and filed on the 10th August, 2021.
 - b. The witness statement of Peter Muya Oguna filed on 16th March, 2022 and admitted in evidence on oath on the 19th October, 2022.
 - c. The written submissions dated 10th November, 2022 and filed on 14th November, 2022.
 1. The Appellant identified the following issues for determination in this Appeal.
 - a. Presuming two journal vouchers (inter-company promissory note and related party payables to equity) for the year 2015 to be income to the Appellant from DAC International and assessing tax thereon;
 - b. Disallowing a deduction of bad debts written off on the basis that the Appellant had not provided sufficient evidence of efforts for debt recovery and assessing tax thereon;
 - c. Assessing tax on reserves for maintenance of aircrafts including the repair and overhaul of engines on the basis that there was no evidence that the expenses



incurred by the Appellant relating to maintenance and repair of aircrafts leased by the Appellant were paid out of those reserves;

- d. Disallowing input tax incurred in making exported services that are zero rated.

a. Unsupported Journal vouchers

- 10. The Appellant argues that the Respondent picked two journal vouchers (inter-company promissory note and related party payables to equity) for the year 2015 and deemed them to be income to the Appellant from DAC International. As a result, the Respondent has assessed a principal tax amount of Kshs 160,594,866.00 which is erroneous because of the following reasons:

- i. The Appellant owed Trident Holdings Kshs. 548,973,00 in the year 2015. It subsequently forfeited its dues from DAC International in the form of a promissory note worth USD 2.3 million and reassigned the same to Trident Holdings in 2015 so as to clear part of its outstanding dues to Trident Holdings.

It stated further that the Respondent's assumption that this conversion which is a balance sheet item was a revenue stream was erroneous. It attached a board resolution dated the 30th of December 2015 which approved this reassignment.

- ii. The remaining amount payable to Trident Holdings post issuance of the promissory note were converted to equity worth Kshs. 300,000,000 as Trident Holdings became a new shareholder in the Appellant via allotment of new shares in the Company.

It again stated that this is a balance sheet item which should not be subject to tax. The same was reflected in an extract of its 2015 financial statements.

b. Bad Debt

- 11. Under this title the Respondent asserted that the Appellant had erroneously disallowed a deduction of bad debts written off on the basis that the Respondent had not provided sufficient evidence of efforts for debt recovery. As a result, the Respondent has assessed a total of Kshs 26,811,429.03 made up of principal tax of Kshs. 16,124,622.33, penalties of Kshs. 508,895.56 and interest of Kshs. 10,177,911.17.

The Appellant submitted that it has demonstrated sufficient debt recovery measures and, in its opinion, the debt has become bad debt and unrecoverable. It affirmed that this decision was guided by the International Accounting Standards (IAS) No. 39 which provided as follows:

A financial asset or group of financial assets is impaired and impairment losses are incurred if, and only if, there is objective evidence of impairment as a result of one or more events that

occurred after the initial recognition of the assets ('loss event') and that loss event (or events) has an impact on the estimated future cash flows of the financial asset or group of financial assets that can be reliably estimated.

Objective evidence that a financial asset or group of assets is impaired includes observable data that comes to the attention of the holder of the asset about the following loss events:

- a. Significant financial difficulty of the issuer or obligor;
- b. A breach of contract such as a default or delinquency in interest or principal payments;



- c. The lender, for economic or legal reasons relating to the borrower's financial difficulty granting the borrower a concession that the lender would not otherwise consider;
- d. It becoming probable that the borrower will enter bankruptcy or other financial re-organization;
- e. The disappearance of an active market for the financial asset because of financial difficulties; or
- f. Observable data indicating that there is a measurable decrease in the estimated future cash flows from a group of financial assets since the initial recognition of those assets, although the decrease cannot yet be identified with the individual financial assets in the group....

12. It affirmed that it was also guided and supported by:

- a. Section 15(2)(a) of the ITA which states as follows:

Without prejudice to subSection (1), in computing for a year of income the gains or profits chargeable to tax under Section 3(2)(a), the following amounts shall be deducted- Bad debts incurred in the production of these gains or profits which the commissioner considers to have become bad, and doubtful debts so incurred to the extent that they are estimated to the satisfaction of the Commissioner to have become bad, during that year of income and the Commissioner may prescribe such guidelines as may be appropriate for the purposes of determining bad debts under this sub paragraph.

- b. Legal Notice 37 OF 2011 which provides as follows:

I. A debt shall be considered to have become bad if it is provided to the satisfaction of the Commissioner to have become uncollectable after all reasonable steps have been taken to collect it.

II. A debt shall be deemed to have become uncollectable under paragraph 1 where

- a. The creditor loses the contractual rights that comprises the debt through a court order;
- b. No forms of security or collaterals is realized whether partially or in full;
- c. The securities or collaterals have been realized but the proceeds fail to cover the entire debt;
- d. The debtor is adjudged insolvent or bankrupt by a court of law;
- e. The costs of recovering the debt exceeds the debt itself; or
- f. Efforts to collect the debt are abandoned for any other reasonable cause.

III. A bad debt shall be deductible expense only if it is wholly and exclusively incurred in the normal course of business. (Emphasis ours)

IV. For the purpose of these guideline a bad debt which is of a capital nature shall not be allowable expense.

- a. The following authorities :



- i. Republic v The Commissioner for Income Tax and another Ex-parte Stockman Rozen (K)Ltd [2015] eKLR
 - ii. Jotham Mulati Walemondi v The Electoral Commission of Kenya Bungoma HC MISC. APP. NO. 81 of 2002 [2002] 1 KLR 486; [2008] 2 KLR (EP) 393.
 - iii. Republic v Commissioner of Co-operatives, Kirinyaga Tea Growers Co-operative & Savings & Credit Society Ltd. Civil Appeal No. 39 of 1997 [1999] 1 EA 245
- c. Maintenance Reserve
13. Under this heading, the Appellant affirmed that the Respondent assessed tax on reserves meant for maintenance of aircrafts including the repair and overhaul of engines on the basis that there was no evidence that the expenses incurred by the Appellant relating to maintenance and repair of aircraft leased by the Appellant were paid out of those reserves.
14. As a result, the Respondent has erroneously assessed principal tax of Kshs. 375,724,800.00 together with penalties and interest despite clear provision in the leasing contract on the use of these reserves.
- d. Value Added Tax
15. The Appellant argued that the Respondent had disallowed a deduction of the input tax incurred in making export services which are zero rated under the VAT Act. As a result, the Respondent has assessed the principal tax of Kshs. 16,097,298.00 plus penalties and interest.
16. The Appellant's Written Statement and oral statement supported the foregoing averments.

Appellant's Prayer

17. Based on the foregoing, the Appellant prays that this Honorable Tribunal allows this appeal and orders that the cost of this appeal be awarded to the Appellant.

Respondent's Case

18. The Respondent's case is premised on the hereunder filed documents and proceedings before the Tribunal:-
- a. Statement of Facts, dated 6th September, 2021 and filed on 9th September, 2021.
 - b. Appellant's Witness Statement of Mr. Philip Munyao dated 21st September, 2021 and filed on the 22nd of September 2022, which was admitted in evidence on oath on 19th October, 2022.
 - c. Written Submission filed on 7th of November, 2022.
19. The Respondent identified the following issues for determination in this Appeal:
- a. Whether DAC International created a Permanent Establishment in Kenya through DAC EA.
 - b. Whether the two journal entries were income subject to income tax (intercompany promissory note and interparty payables to equity).
 - c. Whether there was sufficient evidence of efforts of debt recovery on the bad debts written off.
 - d. Whether there was sufficient evidence that the repairs and maintenance costs were incurred through the maintenance reserves.



- e. Whether exempt services when exported become zero rated and if the input incurred should be allowed or not.

a. Whether DAC International created a Permanent Establishment in Kenya through DAC EA.

20. The Respondent states that the activities carried out by DAC EA wherein it entered into a contract with the European Union provide it with Charter flights services created a permanent establishment status for DAC International in Kenya.
21. The Respondent states that according to the European Commission on Humanitarian Logistics within the EU Civil Protection and Humanitarian Action, (2013-2017) it states that all carriers must possess a valid air operator Certificate (AOC). Consequently, if DAC International had its residency and operations in Canada then it would not have been allowed to acquire a Kenyan AOC. It is worth noting that this certificate is critical in enabling the Appellant fulfill its contract to the European Union.
22. The Respondent affirmed that page 30 of the transfer policy document states that the operations of the ECHO Contract shall be performed by DAC EA which connotes that operations of the contract are performed by the Directors of DAC EA and the group operating officer are responsible for operationalization of the ECHO Contract.
23. The Respondent states that DAC EA is in charge of all other operational bases in Goma, Bunia and Kinshasa all in DRC further confirming that DAC EA plays a key role in the execution of the ECHO contract. In its view, these core activities performed by DAC EA on behalf of the parent company confirms that it has a permanent establishment created in Kenya.
24. The Respondent states that by virtue of the P.E created by DAC International through DAC EA means that any income earned through a PE in Kenya is subject to non-resident tax rate in line with the [Income Tax Act](#) 2013.
25. It supported its argument on Permanent Establishment(PE) with the case of GTZ International Services Versus Commissioner of Domestic Services, Appeal No. 38 of 2015, where the Tribunal held that a company which has its office in Nairobi has a PE in Kenya. It also cited the case of McKinsey and Company Inc Africa Propriety Ltd vs Commissioner for Legal Services and Board Coordination, Appeal No. 199 of 2020, where it was stated that the profits of an enterprise are taxable in that state.

b. Whether the two Journal entries were income subject to income tax (Intercompany promissory note and interparty payables to equity).

26. The Respondent states that it established the existence of an Inter- Company promissory note of Kshs. 235,316,220.00 and related party payables to equity of Kshs 300,000,000.00 It is however of the view that the costs for aircraft hire, lease and maintenance should be in the Profit and Loss Account and not in the balance sheet. It is for this reason that it opted to adjust the items and computed taxes.
27. The Respondent states that the Appellant's position is that the amounts in 2014 due to Trident from DAC EA of Kshs. 548,973,000.00 and amounts due from DAC international to DAC EA were netted off as part of balance sheet restricting and this took place in the form of a promissory note worth 2.3 Million USD.
28. The Respondent avers that the Appellant provided financial statements but did not provide transactional documents to verify that the transactions occurred therefore, the Respondent confirmed the assessments of Kshs. 160,594,866.00 together with interest.



c. Whether there was sufficient evidence of efforts of debt recovery on the bad debts written off.

29. The Respondent states that the Appellant has not provided sufficient evidence to demonstrate debt recovery from its debtors. It was its position that issuance of demand notice was not sufficient to write off a debt under Section 15 of the *Income Tax Act* and Legal Notice Number 37 of 2011. It is for this reason that it confirmed the assessments of Kshs. 10,177,911.00

30. On the issue of debt recovery, the Respondent invoked the case of *KRA v Man Diesel and Turbo Se, Kenya* [2021] eKLR where the Court stated that a taxpayer has the burden of proof in any tax controversy. It affirmed further that failure to respond to a demand notice does not justify the writing off such a debt.

d. Whether there was sufficient evidence that the repairs and maintenance costs were incurred through the maintenance reserves.

31. The Respondent states that the maintenance reserves were paid to related parties in Mauritius.
32. It was also its argument that the Leasing contracts provide that the lessee is responsible for the maintenance of aircrafts including repair and overhaul of the engines. However, there was no evidence in the period under review that the maintenance and cost of the aircrafts leased by DAC EA have been paid out of those reserves. It is for this reason that the Respondent therefore confirmed the assessments of Kshs. 375,724,800.00 together with the interest and penalties payable.

e. Whether exempt services when exported become zero rated and if the input incurred should be allowed or not.

33. The Respondent submits that exempt services when exported remain exempt sales and therefore the input incurred is not allowed.
- Consequently, the tax due under this head of Kshs. 16,097,298.00 were due and payable.
34. Therefore, the tax computed together with the resultant interest and penalties are due and payable.



Respondent's Prayer

35. The Respondent prays that this Honorable Tribunal do dismiss this Appeal with costs.
36. The Respondent brought up the issue of validity of the Appeal In its submission. It argued that the Appellant only appealed against a tax assessment of Kshs. 1,781,804,752.00. In its view, this implied that a tax liability of Kshs. 1,781,804,752 had not been appealed against and no arrangement had been entered into on how it would be paid. It supported this position with the case of *Pesalus Suppliers Limited v Commissioner for Investigations and Enforcement* and *Victorious Investment Limited v Co Commissioner for Investigations and Enforcement*

Issues For Detemination

37. The Tribunal upon consideration of the pleadings and submissions filed by both parties is of the view that the following issues have crystallized for its determination:-
- a. Whether the Appeal is valid.
 - b. Whether DAC International created a Permanent Establishment in Kenya through DAC EA.
 - c. Whether the two journal entries were income subject to income tax (intercompany promissory note and interparty payables to equity).
 - d. Whether there was sufficient evidence of efforts of debt recovery on the bad debts written off.
 - e. Whether there was sufficient evidence that the repairs and maintenance costs were incurred through the maintenance reserves.
 - f. Whether exempt services when exported become zero rated and if the input incurred should be allowed or not.

Analysis And Detrmination

a. Whether the Appeal is valid.

38. The issue of validity of appeal is covered under Section 52(2) of the [Tax Procedures Act](#) (TPA) which provides as follows:
- “A notice of appeal to the Tribunal relating to an assessment shall be valid if the taxpayer has paid the tax not in dispute or entered into an arrangement with the Commissioner to pay the tax not in dispute under the assessment at the time of lodging the notice.”
39. The Respondent alleges that the Appellant failed to pay or make arrangements for payment of undisputed tax and that this should render this Appeal invalid under Section 52(2) of the TPA.
40. The Tribunal has looked at all the documents presented before it by both parties and it has not seen any document authored by the Appellant where it has conceded in whole or any part of the Respondent's assessed tax liability.
41. The prayer in the Appellant's Memorandum of Appeal reads as follows' "wherefore the Appellant prays that the Objection decision be annulled'.
42. This can only mean that the Appellant had appealed against the whole assessment decision that was made by the Respondent.



43. The Respondent's claim that the Appellant had not appealed against all taxes in dispute is therefore unfounded and is hereby dismissed.

b. Whether DAC International created a Permanent Establishment in Kenya through DAC EA.

The issue of whether the Appellant created a PE in Kenya has not been disputed and or addressed by the Appellant in its pleadings and submissions. Indeed, the tone of its submission was that it was not opposed to payment of tax incurred within the Republic of Kenya. Its only contestation was that the taxes claimed by the Respondent were not due and or payable.

The Appellant's concession that it has a nexus in Kenya leaves the Tribunal with nothing to determine under this head.

c. Whether the two journal entries were income subject to income tax – unsupported journal vouchers.

44. The Appellant argued that the Respondent had in essence taxed a balance sheet item that ordinarily does not attract taxation. The Respondent was of the opinion that it taxed the transaction because it was a related inter- company promissory note and a related party payable which ought to attract tax.
45. The Tribunal sighted the Appellant's Board Resolution dated the 30th of December 2015 assigning its receivable worth 2,300,000 USD to DAC Jet. The validity of this deed of assignment was not contested by the Appellant save for its argument that this were related parties.
46. The Appellant's action of forfeiting its dues and assigning them to Trident holdings is a balance sheet transaction that does not attract tax liability unless it can be confirmed that the relationship of the parties was intended to be used in a tax evasion exercise. This is not the case here and the Respondent has not averred and or raised the issue that the relationship of the parties could have imputed a tax evasion endeavor in this Appeal. The same cannot therefore be inferred by the Tribunal.
47. Having held that the deed of transfer dated the 30th of December, 2015 is uncontested and valid, and that subject of that deed is a balance sheet transaction that is not taxable, it thus follows that the Respondent's tax assessment of Kshs 160,594,866.00 in regard to unsupported journals is hereby set aside for invalidity.

d. Whether There Was Sufficient Evidence of Efforts of Debt Recovery on The Bad Debts Written Off - Bad Debts

48. The issue under this head was whether the Appellant was justified in writing off bad debts and whether there was sufficient evidence to prove that the Appellant had made sufficient effort to recover the debts due before declaring them as bad debts.
49. Whereas the Appellant relied on International Accounting Standards (IAS) No. 39, Section 15(2)(a) of the ITA and Legal Notice 37 of 2011 to support its case, it did not provide any evidence that it made sufficient effort to recover these debts that it had declared as bad debts. The averment by its witness that it had sent demand letter requesting for the payment of debt were mere allegations which were not proved by production of documentary evidence of the said demand letters.
50. Section 56(1) of TPA envisages that the Appellant would have the burden of proving that it had done all within its power to recover this debt without success. Nothing has been presented before this Tribunal to prove that the Appellant has done enough to recover this debt. The Respondent therefore, did not err when it disallowed a deduction of bad debts written off on



the basis that the Appellant had not provided sufficient documents to prove efforts it had made at debt recovery. The tax assessment of Kshs 26,811,429.03 is thus valid and lawful.

e. Whether there was sufficient evidence that the repairs and maintenance costs were incurred through the maintenance reserves.

51. The issue under this heading was whether the Respondent had assessed tax on reserves meant for aircrafts including repairs and overhaul of engines.
52. Section 56(1) of the TPA behoved the Appellant to provide the Respondent with evidence and supporting documents that confirm that the expenses incurred from the reserves related to repair and maintenance of aircrafts that had been leased by the Appellant. Such evidence was never provided by the Appellant. The Tribunal therefore agrees with the Commissioner that it was justified in the circumstances to confirm the assessed tax of Kshs 375,724,800.00 under this head.

f. VAT on exported services

53. The issue for determination under this head is whether a deduction of input tax incurred in making exported services is zero rated.
54. The Tribunal has looked at Schedule I to the VAT Act that covers exempt supplies and it has not come across a provision that allows for mutation of exempt to zero rated supplies.
55. It is trite that producers cannot claim a credit for the VAT inputs in cases of exempt supplies. Claims for VAT inputs is only allowed on zero rated goods. The Appellant's decision to claim VAT input for its exempt supplies was thus unlawful. It follows therefore, that the Respondent's tax assessment of Kshs 16,097,298.00 under this head was valid and lawful.

Final Decision

56. The upshot of the foregoing is that the Appeal partially succeeds and the Tribunal accordingly proceeds to make the following Orders; -
 - a. The Appellant's appeal succeeds partially.
 - b. Respondent's tax assessment of Kshs 160,594,866.00 in regard to unsupported journals be and is hereby set aside for invalidity.
 - c. The Respondent's tax assessment of Kshs 26,811,429.03 in regards to bad debts written off is held as valid and lawful.
 - d. The Respondent's tax assessment of Kshs 375,724,800 for maintenance reserves is hereby held as valid and lawful..00
 - e. The Respondent's tax assessment of Kshs 16,097,298.00 for disallowed VAT input is hereby held as valid and awful.
 - f. Each party to bear its costs.

DATED AND DELIVERED AT NAIROBI THIS 17TH DAY OF MARCH 2023.

ERIC N. WAFULA

CHAIRMAN

RODNEY OLUOCH



MEMBER

ROBERT MUTUMA

MEMBER

EDWIN CHELUGET

MEMBER

