Tax & Exchange Control

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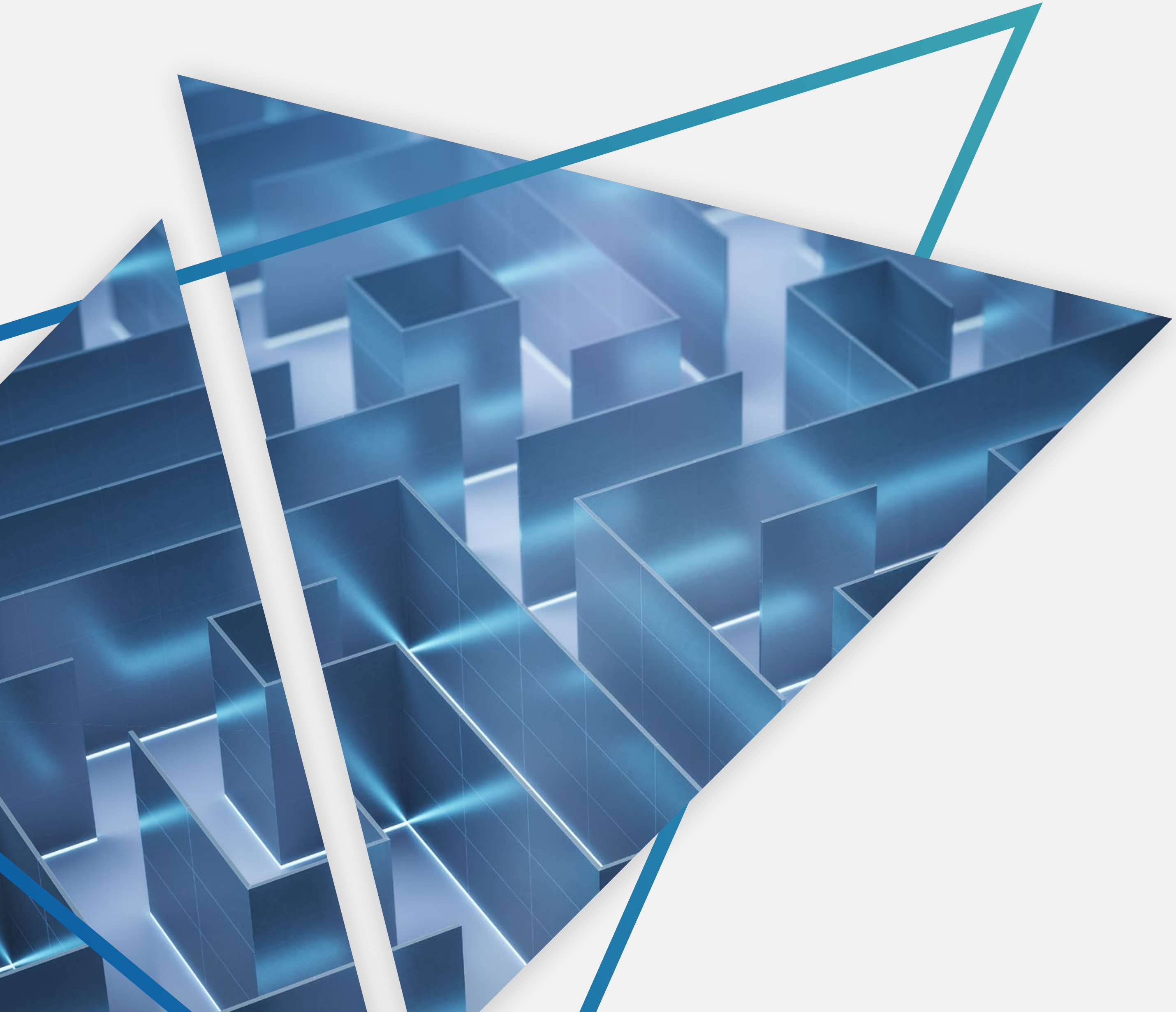

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Place of effective management as the basis for taxation of offshore transactions in Kenya

In what appears to be an intentional targeting of offshore transactions, the Kenya Revenue Authority (KRA) has intensified its audit and assessment of these transactions. To complement the taxman's efforts, the Tax Appeals Tribunal (TAT) has also rendered determinations that make it easier to attribute gains from offshore disposals to Kenya and hence provide the basis for their taxation.

This alert highlights the place of effective management as the basis of taxation of offshore transactions in Kenya. We highlight three key determinations of the TAT in this regard, noting how the concept has evolved from the first to the most recent determination.

Place of effective management as the determinant of residence for tax purposes

The place of effective management of a company being disposed offshore is usually a determining factor in assessing whether the proceeds will be subjected to tax in Kenya. This is pursuant to section 2 of the Income Tax Act Cap 470 Laws of Kenya, which stipulates that in a year of income, a company will be deemed to have been resident in Kenya if the management and control of its affairs were done from Kenya.

The TAT's recent determinations on an entity's proper place of effective management

Naivas Kenya Limited v Commissioner of Domestic Taxes (Tax Appeal No. 934 of 2022)

In this case, Gakiwawa Family Investments (GFI) disposed of a minority stake of its share in Naivas International Limited in Mauritius to Amethis Retail, in a deal priced at KES 5,2 billion. This amount was assessed for corporation tax, interest and penalties, and Naivas Kenya Limited (Naivas) was appointed as the tax representative liable to remit the tax on behalf of GFI.

The TAT determined that Naivas and its holding company were both being managed and controlled from Kenya, meaning that both entities were therefore tax residents in Kenya and liable to pay tax in Kenya. The idea that management and control were happening from Kenya was deduced from the fact that the majority of GFI's directors were Kenyans resident in Kenya, had significant knowledge about the business and were a key part of it, most of the meetings for GFI were held virtually, and there was no evidence of travel of all the directors except one, to Mauritius. Importantly, the TAT noted that Kenyan directors had the power to initiate and authorise transactions of the bank accounts in Mauritius, confirming that the financial management was done from Kenya.

Place of effective management as the basis for taxation of offshore transactions in Kenya

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Naivas was ultimately found liable to pay corporation tax assessment of KES 1,794 billion inclusive of penalties and interest. Naivas appealed against the decision in the High Court and reached consensus with the KRA to settle the case.

ECP Kenya Limited v Commissioner of Domestic Taxes (Tax Appeal No. 335 of 2022)

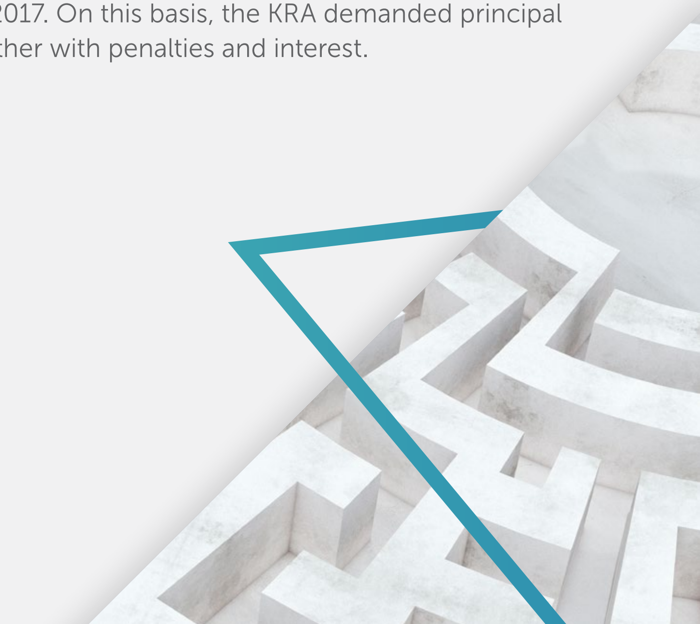
In this case, the KRA demanded corporation tax from an offshore transaction in which ECP Africa Fund III PCC (ECP Fund) disposed of 100% of its stake in Java House Mauritius Limited. At the time of the sale, Java House Mauritius Limited owned 100% stake in Nairobi Java House Limited. The KRA asserted that the income from the offshore disposal was chargeable to tax in Kenya because it had determined (through a set of documents filed with the US tax authorities) that ECP Fund was being managed by its fund manager based in the US through ECP Kenya Limited (ECP Kenya). A taxable presence for ECP Fund had been established in Kenya on that basis.

The TAT was able to deduce from the evidence before it that the discretionary control of ECP Fund was being done by the US-based fund manager through ECP Kenya. It arrived at this conclusion by assessing the job descriptions of some of ECP Kenya's key employees. Their roles included, among other things, identifying new opportunities, negotiating and structuring transactions, as well as monitoring and executing an exit strategy. This, in the TAT's view, constituted an integral part of the business and had created a permanent establishment for ECP Fund in Kenya. Accordingly, it ruled that the KRA had not erred in taxing the gains from the sale of Java House Mauritius Limited in Mauritius. The matter has been appealed to the High Court.

M-KOPA LLC (C/O M-KOPA Kenya Limited) v Commissioner of Domestic Taxes (Tax Appeal No. 65 of 2023)

On 23 February 2024, the TAT determined that an entity's place of effective management for tax purposes is where the top management who make key decisions sit.

Briefly, the facts are that the KRA audited M-KOPA LLC's (M-KOPA) operations for the year 2017 and demanded tax for the reason that during that year of income, it had been managed and controlled from Kenya. It based its argument on the fact that M-KOPA's executive directors were tax residents in Kenya, the chairperson of the board was a Kenyan citizen, and a majority of M-KOPA's board of managers' meetings (19/27) were held in Kenya between 2012 and 2017. On this basis, the KRA demanded principal taxes together with penalties and interest.



Place of effective management as the basis for taxation of offshore transactions in Kenya

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Chambers Global 2024 Results

Tax & Exchange Control

Chambers Global 2018–2024 ranked our Tax & Exchange Control practice in:
Band 1: Tax.

Emil Brincker ranked by Chambers Global 2003–2024 in **Band 1**: Tax.

Gerhard Badenhorst was awarded an individual spotlight table ranking in Chambers Global 2022–2024 for Tax: Indirect Tax.

Stephan Spamer ranked by Chambers Global 2019–2024 in **Band 3**: Tax.

Jerome Brink ranked by Chambers Global 2024 as an "**Up & Coming**" tax lawyer.

Chambers TOP RANKED Global 2024 Cliffe Dekker Hofmeyr

The TAT, however, found in favour of M-KOPA, defining a whole new way of assessing place of effective management to establish residency for tax purposes. To begin with, it refused to buy the assertion that Kenya was the place of effective management because a majority of the board meetings for several years of income had been held in Kenya.

It found that the number of meetings held in 2017 were not sufficient to make Kenya the place of effective management for M-KOPA. It further found that even though a majority of the directors were resident in Kenya, key business decisions affecting the company were not being made in Kenya by these directors. Rather, they were being made by a board of managers, each of whom was located outside Kenya. Therefore, the place of effective management for the year 2017 was the UK where the board of managers met and made decisions. Having met in Kenya just once that year, Kenya was not the place of effective management. M-KOPA's appeal succeeded on this basis. The KRA has appealed against this decision.

Commentary and conclusion

The *M-KOPA* case is a laudable one given the level of clarity it has provided when it comes to assessing the place of effective management of a company for purposes of determining its tax residency. The TAT has correctly determined that what is to be looked at is not where management meetings were done over a long period of time, but rather during a particular year.

It is also now clear that the place of effective management of a company in Kenya is where the top management of the company, who make key decisions affecting the affairs of the company, sit. It is therefore immaterial whether a senior member of the entity is resident in Kenya, provided that they are not solely involved in key decision-making; the place of effective management cannot be said to be Kenya. It is, however, important to note that having employees in Kenya can still trigger taxable presence through the permanent establishment principle.

The TAT has importantly determined that:

> *"[T]he place of effective management is a legal issue that requires a sequential analysis, it can never be conclusively obtained and or determined based on what one of the parties has filed or stated in their documents or filings. Its determination can only arise from a wholesome analysis of the facts and circumstances of the case."*

Alex Kanyi and Judith Jepkorir

To BEE or not to BEE

Corporate taxpayers often face the question of how to increase their broad-based Black economic empowerment (B-BBEE) credentials through equity ownership schemes. While it is important for corporate taxpayers to improve their B-BBEE credentials, funding constraints can sometimes create a challenge from a tax perspective.

Various funding mechanisms exist, from notional vendor funding to simply issuing shares for nominal consideration. Often taxpayers are concerned regarding the manner in which the South African Revenue Service (SARS) will view these funding arrangements, and the option of applying to SARS for a binding private ruling (BPR) can assist with alleviating that concern. Recently, another one of these has come before SARS in the form of BPR400.

The applicant in BPR400 was a trust established to hold shares in a company (referred to as Company A) which in turn held shares in a listed company (ListCo). The beneficiaries of the applicant were employees of ListCo or other entities within its group, and therefore the applicant was used to facilitate the incentivisation of employees through providing indirect exposure to the economic benefit of holding shares in ListCo.

Corporate social investment trust

ListCo, however, wanted to increase its B-BBEE credentials further. It therefore devised a transaction whereby a corporate social investment trust (CSI trust) would be established to hold an indirect interest in it. The beneficiaries of the CSI trust would all be Black people for B-BBEE purposes, and the CSI trust would hold its interest in ListCo through Company A.

In order to facilitate this, ListCo (or another company in its group) would make a capital contribution to the applicant, which the applicant would use to subscribe for additional shares in Company A. Company A would then use the subscription proceeds to subscribe for more shares in ListCo. Following this, Company A would then issue shares for nominal consideration to the CSI trust.

Given that the shares issued by Company A to the CSI trust would have value at the time of issuing, the question with which the applicant approached SARS was whether this would constitute a donation to the CSI trust in terms of sections 55 or 58 of the Income Tax Act 58 of 1962 (ITA).

Section 55 defines a "*donation*" to be: "*any gratuitous disposal of property including any gratuitous waiver of renunciation of a right*".

Section 58 then provides that:

> "*Where any property has been disposed of for a consideration which, in the opinion of [SARS], is not an adequate consideration that property shall ... be deemed to have been disposed of under a donation.*"

To BEE or not to BEE

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A similar question has been dealt with before by SARS in BPR343. In that ruling, the question was whether a company could issue shares to a trust at a discount for purposes of increasing its B-BBEE score. There SARS held that this issuing of shares would neither constitute a donation nor a deemed donation as defined in section 55 or section 58 of the ITA respectively. One should also bear in mind that the common law definition for a donation, as dealt with in the Estate Late Welch judgment, still applies alongside the definition in section 55.

BPR400

In BPR400, SARS merely ruled that the issuing of shares to the CSI trust for nominal consideration would not give rise to a donations tax liability under section 54 of the ITA. Although this is the charging section for donations tax, it does not necessarily mean that by implication SARS ruled that no donation (actual or deemed) would be made by Company A to the CSI trust.

SARS' ruling in BPR400 is based on the assumption that the CSI trust is an approved public benefit organisation in terms of section 30 of the ITA and on the assumption that no beneficiary of the CSI trust is a connected person in relation to any beneficiary of the applicant.

Notably, SARS did state in BPR400 that it would not express a view as to whether the capital contribution made to the applicant (so as to enable the applicant to subscribe for additional shares in Company A) was deductible for tax purposes. In light of the court's decision in *Commissioner, SARS v Spur Group Proprietary Limited* [2021] JDR 2530 (SCA) (discussed here), it is possible that contributions made to the applicant would be deductible to the extent these directly benefitted the ListCo employees.

BPR400 appears to indicate that the issue of shares at nominal value to increase a company's B-BBEE credentials can be done without attracting donations tax. It appears to be similar to the decision in BPR 343 where the facts were slightly different but the outcome was similar. As BPRs are specific to an individual taxpayer, however, it is advisable that taxpayers looking to do this still seek professional advice based on the facts of their specific transaction so as not to fall foul of the donations tax (and other) provisions in the ITA.

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BBBEE STATUS: LEVEL ONE CONTRIBUTOR

Our BBBEE verification is one of several components of our transformation strategy and we continue to seek ways of improving it in a meaningful manner.

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