

Environmental Law and Tax & Exchange Control



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KENYA

- Unpacking the Tax Appeals Tribunal's decision on the tax treatment of income from the sales of carbon credits generated in Kenya

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Unpacking the Tax Appeals Tribunal's decision on the tax treatment of income from the sales of carbon credits generated in Kenya

The Tax Appeals Tribunal (Tribunal) delivered a significant decision in *Wildlife Works Sanctuary Ltd v Commissioner of Legal Services & Board Coordination*, Appeal No. E1290 of 2024, providing guidance on the tax treatment of income from the sales of carbon credits generated in Kenya.

The Tribunal allowed the taxpayer's appeal, setting aside the assessment of KES 6,888,330,444 in relation to corporate income tax and withholding tax. The Tribunal held that the Kenya Revenue Authority (KRA) had erroneously reallocated the functions, assets and risks between related entities and faulted its reliance on estimated carbon credit sales as opposed to actual sales reported by the taxpayer in its financial statements.

Background

The KRA issued a tax assessment claiming that the Kasigau Project was conducted by Wildlife Works Sanctuary Limited (WWS Kenya) and should be taxed on the full carbon credit income. WWS Kenya is a Kenyan resident entity within the global Wildlife Works Group (WWG), an international group of companies involved in generating, purchasing, managing, holding and selling carbon credits, biodiversity credits, and other ecosystem services.

In Kenya, WWG operates the Kasigau Corridor REDD+ (Reducing Deforestation and Forest Degradation) project (Kasigau Project) that aims to protect forests, reduce deforestation and support surrounding communities.





The project is structured such that Wildlife Works Carbon LLC (WWC), a US-based entity, is the project developer whose principal activity is generating and selling carbon credits and ecosystem services. WWS Kenya, on the other hand, provides operational support services, such as forest management and community engagement to WWC, and is remunerated on a cost-plus basis with a 7.5% mark-up on the project costs, applying the Transactional Net Margin Method (TNMM).

Analysis of the main issues for consideration by the Tribunal

The Tribunal's analysis focused on the three key issues, which are discussed below.

Was the Commissioner justified in attributing income based on projected carbon credit sales?

The Tribunal found that WWS Kenya's role in the Kasigau Project was limited to the provision of operational support services and that the KRA erred in recharacterizing the controlled transaction from the provision of operational support services to the sale of carbon credits. Further, the Tribunal held that the documentary evidence presented demonstrated that the revenues from the sale of carbon credits pertained to WWC and not WWS Kenya. Therefore, WWC's income from the sale of carbon credits was taxable in Kenya pursuant to Section 18 (1) and Section 3 (1) of the Income Tax Act (ITA). However, since WWS Kenya had not been appointed as WWC's tax representative, WWS Kenya could not be held liable for WWC's income.

Was the KRA justified in the reallocation of functions, risks and assets between the group entities?

The KRA argued that the Kasigau Project was developed and controlled from Kenya and that WWS Kenya performed the substantive functions that generated the carbon credits. The KRA relied on generic website job descriptions, assumptions about on-the-ground activities, and argued that pre-incorporation functions must have been undertaken through Wildlife Works EPZ Limited. However, WWS Kenya demonstrated that the upstream and core functions of the project were undertaken by WWC.

The Tribunal agreed, finding that WWC owned the carbon rights, funded the project and bore the significant risks associated with the generation and sale of carbon credits. It faulted the KRA's recharacterisation of the related party transaction performed by WWS Kenya from the provision of operational support services to the sale of carbon credits. Consequently, the Tribunal, upheld WWS Kenya's use of the TNMM as the appropriate transfer pricing method, with the mark-up on total cost as the profit level indicator.

Was the KRA justified in assessing withholding tax on deemed dividends?

The KRA argued that WWC's involvement in the Kasigau Project amounted to shareholder activities and that any compensation for those functions should therefore be treated as dividends, giving

rise to withholding tax. Applying the OECD Transfer Pricing Guidelines, the Tribunal rejected this characterisation, finding that the functions that WWC performed constituted substantive operational activities rather than shareholder functions. Having determined that the underlying transfer pricing adjustments were unjustified, the Tribunal consequently held that the KRA was not justified in assessing withholding tax on amounts treated as deemed dividends

Key takeaways

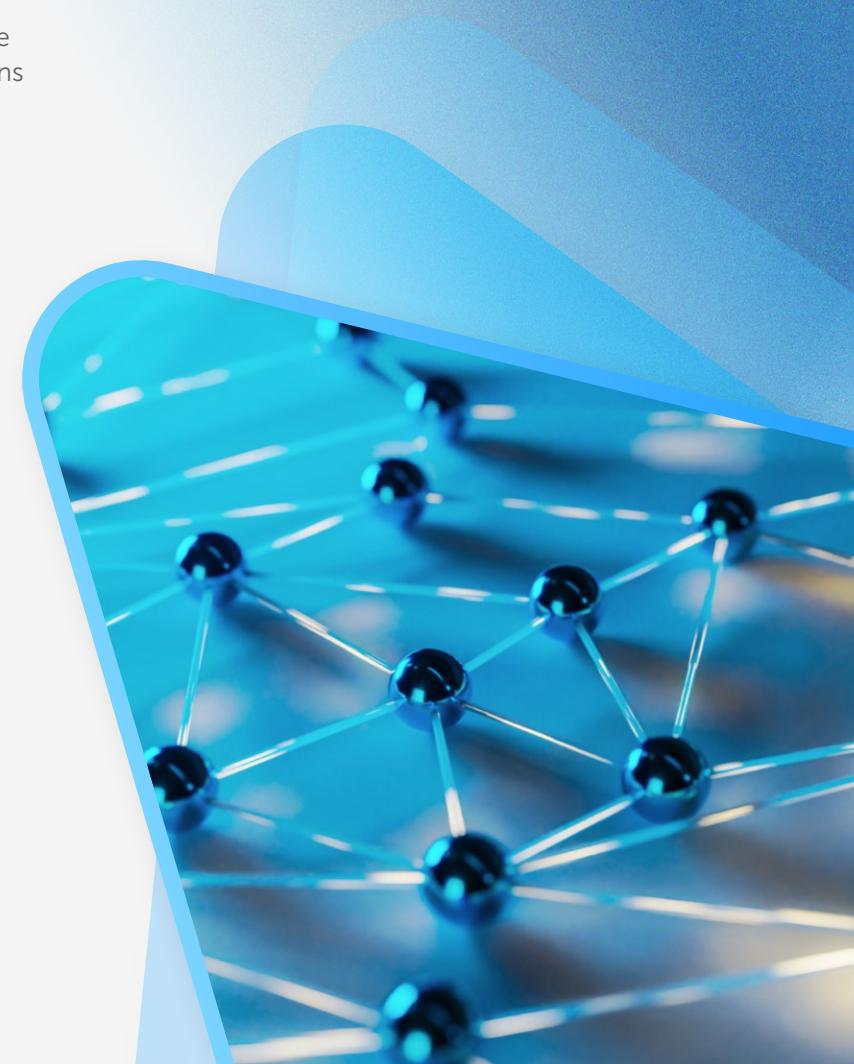
Firstly, WWS Kenya's success is attributable to proper documentation, which provided substantial evidence to discharge its burden of proof and rebut the KRA's assertions.

Secondly, from the decision, carbon revenues from projects physically located and carried out in Kenya may be regarded as having accrued and derived from Kenya, and hence are taxable in Kenya irrespective of where the carbon credits are marketed, contracted or sold. In this case, the assessment failed on procedural grounds as it was raised against the wrong taxpayer, not because the income was non-taxable.

Thirdly, tax assessments must be grounded in actual, verifiable income rather than projections. The Tribunal rejected the KRA's reliance on historical monitoring reports and hypothetical carbon credit volumes. Any income attribution or transfer pricing adjustment must have a clear statutory and evidentiary basis.

Lastly, notwithstanding the Tribunal's findings, the decision may be subject to appeal. The KRA retains the right to challenge the ruling before the High Court on matters of law.

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