



IMPOSITION OF WITHHOLDING TAX ON DEMURRAGE AND THE INTERPRETATIONS ADOPTED BY THE COURTS IN KENYA

The imposition of Withholding Tax on demurrage has been one of the main issues that has affected the revenue collection in the shipping industry. Prior to the conduct of tax audits by the Kenya Revenue Authority (KRA), most shipping agents did not withhold taxes on demurrage leading to the protracted court battles as to the interpretation and treatment of demurrage under the Income Tax Law.

It is for this reason that we analyze the contrasting interpretations and findings of courts in *Ocean-freight (E.A) Limited Vs Commissioner of Domestic Taxes, High Court Income Tax Appeal No. 13 OF 2017 (Ocean Freight Case)* AND *Maersk Kenya Limited Vs Commissioner of Investigation & Enforcement, Appeal No. 269 Of 2018 (Maersk Case)*.

For purposes of this article, we shall analyze the findings and determination of the High Court in the *Ocean Freight Case* as to whether the charges collected on demurrage for containers are chargeable to income tax.

A. BACKGROUND OF THE CASE

On 7th February 2020, the High Court Commercial Division delivered the judgment in respect of what was famously referred to as the 'shipping case'. The said case was a consolidation of the seven cases involving various shipping agents registered in accordance with Section 8 of The Merchant Shipping Agent Act and agents for International Shipping Lines. These were cases that had been determined by the Tax Appeal Tribunal and decision thereto rendered as against the shipping agents.

The main contentions in the said Appeal are highlighted as hereunder: -

- a) Whether the charges collected on demurrage for containers are chargeable to income tax;
- b) Whether VAT is chargeable to post landing charges on processing documents prepared by the Appellants;
- c) Whether Withholding Tax is chargeable on amounts received on account of transshipment cargo originating from partner states of the East African Community; and
- d) The application of Section 24 of the Income Tax Act in relation to deemed dividends where a taxpayer fails to issue dividends.

B. ANALYSIS OF THE ISSUES ON CHARGE OF INCOME TAX ON DEMURRAGE

1. WHETHER THE CHARGES COLLECTED ON DEMURRAGE FOR CONTAINERS ARE CHARGEABLE TO INCOME TAX

The issue herein was whether demurrage charges were part of freight or rent for detained containers. The determination of whether the same were either freight or rent had a direct tax implication as to whether the same should be

brought to charge under the Income Tax Act, CAP 470 Laws of Kenya as existing at the material time.

According to the Shipping Agents, demurrage was paid as and constituted part of the amount received on account of carriage. To this end it was part of the cost of carriage.

KRA on the other hand held the position that demurrage did not form part of the freight levied by the shipping line since the same could only be accrued after the goods had been cleared through customs and entered the country.

In arriving at its final decision on the treatment of demurrage, the Court considered the following factors: -

- i. Whether demurrage charges constituted freight or rent?
- ii. Whether demurrage charges were taxable under the Income Tax Act prior to the amendments introduced in the Finance Act, 2018?
- iii. Should demurrage be found to be taxable, then who had the obligation to Withhold the tax, the consignee or the shipping agent?

2. WHETHER DEMURRAGE CHARGES CONSTITUTED FREIGHT OR RENT?

In arriving at the treatment of demurrage as a part of freight or rent, the Learned judge gave regard to the definition of demurrage in the Black's Law Dictionary and the precedence from Australia, Canada and America.

An analysis of the case laws and more specifically the decision on *Steamship Company and Steamship Company of Svendborg and Steamship Company of 1912 Vs Commissioner of International Revenue CTA Case No. 6567*, revealed that demurrage was incurred for the period of preloading or for failure to unload the vessel before the lapse of the contract period was demurrage associated with

the freight. It was the understanding of the judge thus that freight came to an end at the port of landing and any demurrage imposed on the container for the late return after port was a post importation charge. Consequently, the charge associated with such late return was a penalty or rent and an income to the owner of the container, herein the shipping line.

To this end, the Court concluded that demurrage was a not part of freight but was rent.

3. WHETHER DEMURRAGE CHARGES WERE TAXABLE UNDER THE INCOME TAX ACT PRIOR TO THE AMENDMENTS INTRODUCED IN THE FINANCE ACT, 2018?

With the finding that demurrage is a penalty or rent on late return of the container, the Court proceeded to hold that a charge on demurrage would be derived from and accrued in Kenya and hence subject to the income tax legislation in Kenya more specifically Section 3 (1) and (2) of the Income Tax Act (ITA) CAP 470 Laws of Kenya which note in part as follows: -

- (1) Subject to, and in accordance with, this Act, a tax to be known as income tax shall be charged for each year of income upon all the income of a person, whether resident or non-resident, which accrued in or was derived from Kenya.**
- (2) Subject to this Act, income upon which tax is chargeable under this Act is income in respect of-**
 - a) gains or profits from—**
 - (i) any business, for whatever period of time carried on;**
 - (ii) any employment or services rendered;**

(iii) any right granted to any other person for use or occupation of property;

The court further noted that a reading of Section 10(1) of the ITA deems the income from demurrage charges on containers to be income accrued in or derived from Kenya.

Of key note was that the Finance Act, 2018 introduced amendments that made specific provisions to demurrage. Section 2 of the said Act defined demurrage as: -

“Demurrage charges” means the penalty paid for exceeding the period allowed for taking delivery of goods, or returning of any equipment used for the transportation of goods.”

Further, Section 10 of the Finance Act was made to specifically include demurrage charges in the category of income which accrued in or was derived from Kenya. Section 35 was also amended to expressly provide for Withholding Tax (WHT) on demurrage at the rate of 20%.

In relation to these amendments, the shipping agents referred the Court to the budget statement made by the Minister for Finance in support of the proposal to widen the scope of taxation in the shipping industry. The statement specifically read as follows in part: -

“...Under the current legislative framework, payments for such services which represent income from Kenya are not subject to tax. This creates an unfair playing field for residents of Kenya whose income from similar sources are subject to tax. I therefore, propose to amend the Income Tax Act to subject payments for demurrage charges made to non-residents persons to Withholding Tax rate of twenty percent”

The Shipping Agents contended that this was an admission by the Government that there was no legal framework to charge demurrage as income as at the time of the making of the Budget Statement. KRA however argued that the averments thereto were merely fortified to an existing legislative framework and could well be over-legislation. Moreover, that the Minister's words cannot bind them.

In its finding, the Court observed that a plain reading of the above statement inferred that there was no legislative framework subjecting demurrage to tax. However, that based on the provisions of the Kenya Revenue Authority Act, the Commissioner of Domestic Taxes was appointed and authorized under the supervision of the Minister to be an agent of the Government for the collection and receipt of all revenue.

It was the finding of the High Court that in the current case, the party to the dispute was the Commissioner of Domestic Taxes and not the Minister. That whereas the Minister could exercise general supervision over KRA, the Commissioner of Domestic Taxes took a different view of the matter from that of the Minister. As such, the Commissioner being the Party before the Court had not made any admissions and the Court could as such not admit the Budget Statement as a concession by the Commissioner. To that end, it was the finding of the Court that demurrage charges on containers was chargeable to income tax even under the statutory regime that existed prior to the amendments under the Finance Act 2018.

4. SHOULD DEMURRAGE BE FOUND TO BE TAXABLE IN KENYA, THEN WHO HAD THE OBLIGATION TO WITHHOLD THE TAX; THE CONSIGNEE OR THE SHIPPING AGENT?

Lastly under demurrage, was the issue of who had the obligation to Withhold tax on demurrage under Section 35 of the Income Tax Act.

In arriving at its decision, the Court made reliance to the provisions of Section 4(1) of the Income Tax (Withholding Tax) Rules 2001 which stipulates as follows: -

A person who makes a payment of, or on account of, any income which is subject to Withholding Tax shall deduct tax therefrom in the amount specified-

(a) Under Paragraphs 3 and 5 of Head B of the Third Schedule; and

(b) Where the Government of Kenya has double taxation agreement with the Government of another country in the terms of that agreement:

Provided that the rates of tax under this sub-rule shall not exceed the rates specified under Paragraph (a)

The High Court noted that a reading of Section 35(1) of the ITA together with Rules (2) and 4(1) of the Income Tax (Withholding Tax) Rules stipulated that the person who bears the responsibility to withhold tax is the one who makes the payment of the income.

It was the Shipping Agents' argument thus that in this respect the consignee was the one supposed to Withhold the Tax. KRA however argued that it was the Shipping Agents who should do so before remitting the income to its principal. That the consignee paid the demurrage based on the local invoices raised by the Shipping Agent and so Section 35 (1) (c) of the ITA would not apply to the consignee as the obligation to withhold tax would be on the Shipping Agent before repatriating the money to the parent company.

However, upon further investigation of the invoices, the Court noted that the invoices were in the names of the Shipping Lines and as such though the monies were payable to the Agents, the monies belonged to the shipping Lines.

Moreover, Section 8 of the Merchant Shipping Act recognizes the Agents as Licensed under the Act and as such the monies that they collect they do so on behalf of the principal. Consequently, the payment made by the Consignee is a payment to the shipping line who are non- resident. To this end the argument by KRA could not stand.

With this kind of transaction, the Judge noted that it was only practical to expect the consignee to Withhold Tax. However, based on the provisions of Rule (4)(1) of the WHT Rules which notes as follows: -

A person who makes payment of, or on account of, any income which is subject to Withholding Tax shall deduct therefrom in the amount specified: -

(a) Under Paragraph 3 and 5 of Head B of the Third Schedule; and

***(b) Where the Government of Kenya has a double taxation Agreement with the Government of another country, in terms of the Agreement
Provided that the rates of tax under this sub-rule shall not exceed the rates specified under Paragraph (a)***

In regard to the meaning of ‘**on account of**’ as highlighted above. Whereas KRA held the

position that the said Section sought to bring to charge the remittance by a person on behalf of another provided the transaction fell within the ambit of Section 35(1)(c), the Shipping Agents noted that the same referred to as ‘**in respect of**’

In making a decision on the same, the court referred itself back to the purpose and object of WHT on a non- resident noting that the same was to ensure that taxes are paid on income accrued and derived from Kenya by the non- resident and the failure to withheld will lead to the loss of the tax. Based on this finding, the Court noted that the Shipping Agents thus had an obligation to ensure that the tax that ought to be withheld was indeed withheld before being remitted to the non- resident principal.

In light of the foregoing, the Court held that the Shipping Agents had an obligation to Withhold Tax on demurrage charges on containers and remit the same to the Kenya Revenue Authority. Currently the matters are at the Court of Appeal awaiting the superior Court’s determination on the same.

We note that the determination of the High Court in this case was in contrast to the determination of the Tax Appeals Tribunal in the case of **Maersk Case**. For our next analysis, we shall discuss the Tribunal’s distinguishing analysis and reliance of Law in the Maersk case.

Let’s talk

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