

VAT issues peculiar to agency arrangements

Background

Agents mainly act on behalf of other parties and are not the providers of the services or suppliers of the goods that they are dealing in. Mostly, they are acting as intermediaries between the suppliers/providers and third parties (we can refer them to consumers).

These agents also charge a service fee either to the providers/suppliers or the consumers or both.

This creates some complexities on the VAT treatment of agency arrangements.



Let's Talk!

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Issues analysed in this publication

1. Agent versus principal
2. Are supplies by agents taxable?
3. What is the taxable value?
4. Incidental costs and disbursements?
5. Claiming of input VAT

1. Agent versus principal?

The characterisation as an agent or principal has a significant implication on what taxes are applicable to you, the amount of those taxes and when those taxes are payable. By taxes, we mean the major taxes – Income Tax, Value Added Tax (VAT) and Customs Duty. Unfortunately, none of our tax laws have extensively defined these terms (agent and principal) for clarity on their application and implication to taxpayers.

From an Income Tax perspective, the profits to be attributed to an agent or principal varies. A party is classified as an agent or principal depending on the functions performed, risks assumed and assets employed. The returns (profits) that are expected to be earned by a commissionaire agent are not similar to those that are to be earned by a distributor or entrepreneur. In this publication we will be focusing on agency from a VAT perspective.

1.1 Definition on an agent in Kenyan Tax Laws

The term agent has not been defined in the VAT Act. East Africa Customs Management Act has defined an agent specifically with respect to an aircraft, vehicle or vessel. This definition is unsuitable for purposes of other common types of agency arrangements like travel agency, distribution agents, insurance agents, property agents, etc.

There are no applicable definitions in our other domestic tax laws. Therefore, we have to rely on other sources for an appropriate definition of agents.

The Black Laws Dictionary defines an agent as:

- *A person authorized by another to act for him, one intrusted with another's business*
- *A business representative, whose function is to bring about, modify, affect, accept performance of, or terminate contractual obligations between principal and third persons.*

1.2 Factors to consider in determining an agent

The following are some of the key issues to determine if a person is acting as an intermediary:

- i. Both the person and the service provider or supplier have agreed that the person will act as their intermediary (agent). There is need to demonstrate this, normally by holding commercial documentary evidence, for example an agreement or contract.
- ii. Does the person routinely fully disclose the name of the principal they are acting for?
- iii. Does the person receive payment on behalf of the service provider and what is the time taken to remit the same to the principal?

- iv. Is the person taking any significant commercial risk in relation to the services arranged e.g. compensating the consumers?
- v. Does the person alter the nature or value of any of the supplies made between their principal and third parties?

1.3 Tax case on agency

HMRC vs Med Hotels Ltd (Med)

This a tax dispute in the U.K which went all the way to Supreme Court provides guidance on the circumstances under which a person is to be treated as an agent for VAT purposes.

The issue in contention was whether Med acted as an agent for hotel accommodation or was in fact supplying accommodation services (principal).

Some facts of the case

- Med entered into agreements with hoteliers to market their hotels on its website.
- Potential customers (holiday-makers) booked for holidays through completing a form on Med's website.
- The holiday maker would then make the full payment to Med. Med would thereon, pay the hoteliers a lower sum pursuant to an invoice issued when the holiday is ended.
- HMRC (the U.K tax authority) argued that Med booked a room in a hotel for the net sum, which it paid to the hotelier when the holiday

had ended, and Med supplied the room to its customer in return for the gross sum, which it received in advance of the holiday. Therefore, VAT should be paid on the gross sum.

- Med's analysis of the position was that, through Med's agency, the hotelier supplied a hotel room to a customer for the gross sum, and that Med was entitled to the difference between the gross sum and the net sum as a commission from the hotelier for acting as his agent.

The Ruling

The Supreme Court ruled that Med was acting as an agent of the hoteliers.

VAT implication of the ruling

The taxpayer (Med) would have been required to account for VAT on the gross sum invoiced to persons booking their holidays through its website.

Of course this would have a significant implication on the business of the agent, over and above the VAT and late payment penalties for the years assessed by the tax authority.

This tax case goes to a great length to demonstrate the factors to be considered in determining whether a person is acting as an agent or a principal for VAT purposes.

2. Are supplies by agents taxable?

Agency services in general have not been listed as zero rated or exempt services in the VAT Act. However, some forms of agency could qualify as exempt or zero-rated.

2.1 Definition of taxable supply

Section 2 of VAT Act defines taxable supply as:

*a supply, other than an exempt supply, **made in Kenya** by a person **in the course or furtherance of a business carried on by the person**, including a supply made in connection with the commencement or termination of a business.*

To ascertain whether the service provided by an agent has met the above condition and whether the service should be subject to VAT will require an analysis of other related fundamental principles.

2.2 Export of service

Paragraph 13(1)(b) of VAT Regulations 2017 defines exported services as:

..... when the taxable supply involves the services being provided to a recipient outside Kenya for use, consumption, or enjoyment outside Kenya.

2.3. An Example of a travel agency service

Assume a travel agent is selling a tour package to a British tourist planning to visit Kenya and Tanzania. The total cost of the package is Kshs 150,000 which includes Hotel accommodation in Mombasa Hotel for 40,000, Hotel in Serengeti Tanzania 60,000 and tour van hire of 30,000 and agency commission of 20,000. The agent has also incurred significant telephone charges calling the client in Britain, totalling Kshs 3,000. What cost elements should the travel agent charge VAT on?

There are number of issues that should be addressed with respect to the above:

- a) What is taxable supply?
- b) Is the entire package cost and telephone cost subject to VAT?
- c) Is the commission portion with respect to the hotel accommodation in Tanzania subject to 16% VAT or is an exported service?

Finance Act 2016 exempts tour operators

Section 25 of the Finance Act 2016 provided an exemption for tour services as follows:

25. The services of tour operators, excluding in-house supplies

VAT treatment of the supply in 2.3 above

Travel agency services provided by travel agents are services of tour operators. Therefore, they will be VAT exempt as long as they are not classifiable as in-house supplies. VAT exemption has other implications like claiming of input VAT. So can the travel agent above explore the possibility of zero rating some portion of its supply?

The traveller will enjoy some portion of the services provided outside Kenya. Therefore, a portion of this package should be treated as an exported service and zero-rated for VAT.

The VAT treatment of the telephone cost component will be addressed under sections 3 and 4 of this publication.

However, the VAT treatment of agency arrangements cannot definitively be determined without analyzing the peculiar and fundamental issues relating to nature and conduct of these arrangements that we have analysed in this publication.

Is the travel agent acting as an intermediary or a principal?

It is important for the travel agent to demonstrate that it is acting as an intermediary of the service supplier and it is not in fact providing accommodation and car hire services. If the travel agent is deemed to be acting as a principal with respect to the above services, then this supply might not be treated as an exempt supply.

3. What is the taxable value?

There is a need to determine what components of a supply or costs incurred in providing a service by an agent should be subjected to VAT.

Section 13(5) of the VAT Act states:

*In calculating the value of any services for the purposes of subsection (1), there shall be included any **incidental costs** incurred by the supplier of the services in the course of making the supply to the client:*

*Provided that, if the Commissioner is satisfied that the supplier has merely made a **disbursement** to a third party as an **agent** of his client, then such disbursement shall be excluded from the taxable value.*

Two issues should be analysed in determining the taxable value:

- a) is the person acting as an agent or principal; and
- b) are some of the costs incurred incidental costs or disbursements?

In the example in 2.3, would the telephone calling costs of Kshs 3,000 be considered incidental costs and part of the taxable supply or disbursements? We analyse the key considerations in next section (4).

4. Are components of the supply incidental costs or disbursements?

The VAT Act does not define disbursements.

The Black Laws Dictionary defines disbursements as:

- *Money paid out or expended for which one is entitled to a credit upon rendering an account of his doings.*

If these costs have been incurred by suppliers in the course of making their own supply to their clients, then they have to be included in the value of those supplies when VAT is calculated.

However, if a person merely pay amounts to third parties as the agent of your client and debit your client with the precise amounts paid out, then you may be able to treat them as disbursements for VAT purposes, and exclude these amounts when calculating any VAT due on the main supply to their client.

The treatment of a component of a supply will depend on the specific arrangement and how the related documentation is done.

4.1. General factors to consider on disbursements

A payment may be treatment as a disbursement if the following conditions are met:

- ✓ you acted as the agent of your client when you paid the third party;
- ✓ your client actually received and used the goods or services provided by the third party (this condition usually prevents the agent's own travelling and subsistence expenses, phone bills, postage, and other costs being treated as disbursements for VAT purposes);
- ✓ your client was responsible for paying the third party (examples include estate duty and stamp duty payable by your client on a contract to be made by the client);
- ✓ your client authorised you to make the payment on their behalf
- ✓ your client knew that the goods or services you paid for would be provided by a third party;
- ✓ the payment is separately itemised when invoicing your client
- ✓ only the exact amount paid to the third party is recovered; and
- ✓ the goods or services, which you paid for, are clearly additional to the supplies which you make to your client on your own account.

The above conditions must be met before you treat a payment as a disbursement for VAT purposes.

5. Claiming of input VAT

Generally, it's only advantageous to treat a payment as a disbursement for VAT purposes where no VAT is chargeable on the supply by the third party, or where your customer is not entitled to reclaim it as input tax.

If you treat a payment for a standard-rated supply as a disbursement for VAT purposes, you cannot reclaim input tax on the supply because it hasn't been made to you. Your customer may also be prevented from doing so because the client doesn't hold a valid VAT invoice.

If you treat a payment as a disbursement for VAT purposes then you must keep evidence (such as an order form or a copy invoice), to allow you to show that you were entitled to exclude the payment from the value of your own supply to your principal or client. You must also be able to show that you didn't reclaim input tax on the supply by the third party.

There is a need to evaluate the implication and potential leakage relating to input VAT for all parties to the agency arrangement before structuring the arrangement.

6. Summary of important issues

There are number of important factors to consider to manage the VAT implication of agency arrangements. Considerations on the financial implication especially tax leakages that will arise to parties involved should be considered in structuring the agency arrangement.

Firstly, there is need for a contractual document supporting the agent to act as an agent. The contract can either be with the consumer or supplier/provider or both.

Secondly, the documentation issued to the customer/third party should disclose the principal.

Thirdly, the risks assumed by the agent should not be those that should be assumed by a principal. For example, handling of compensation claims.

Lastly, the conduct, execution of the agency arrangement and supporting documentation should be in conformity with the principles discussed and the VAT Act and Regulations.

7. Way forward

The documentation and execution of the agency arrangement is the most critical matter in determining the VAT treatment of the transaction. There might be a need for agents and the service providers or supplier of goods to review their arrangements and the related contractual documentation to fully manage the VAT risks and/or take advantage any opportunities that they might have not exploited.

Due to the lack of extensive guidelines on this peculiar complex matter by KRA, it is advisable that businesses undertaking agency activities to seek further clarification and ruling on the matter either individually or through their respective associations.

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