TaxMatters

KENYA REVENUE AUTHORITY

Tulipe Ushuru, Tujitegemee!

Tax Evasion edition

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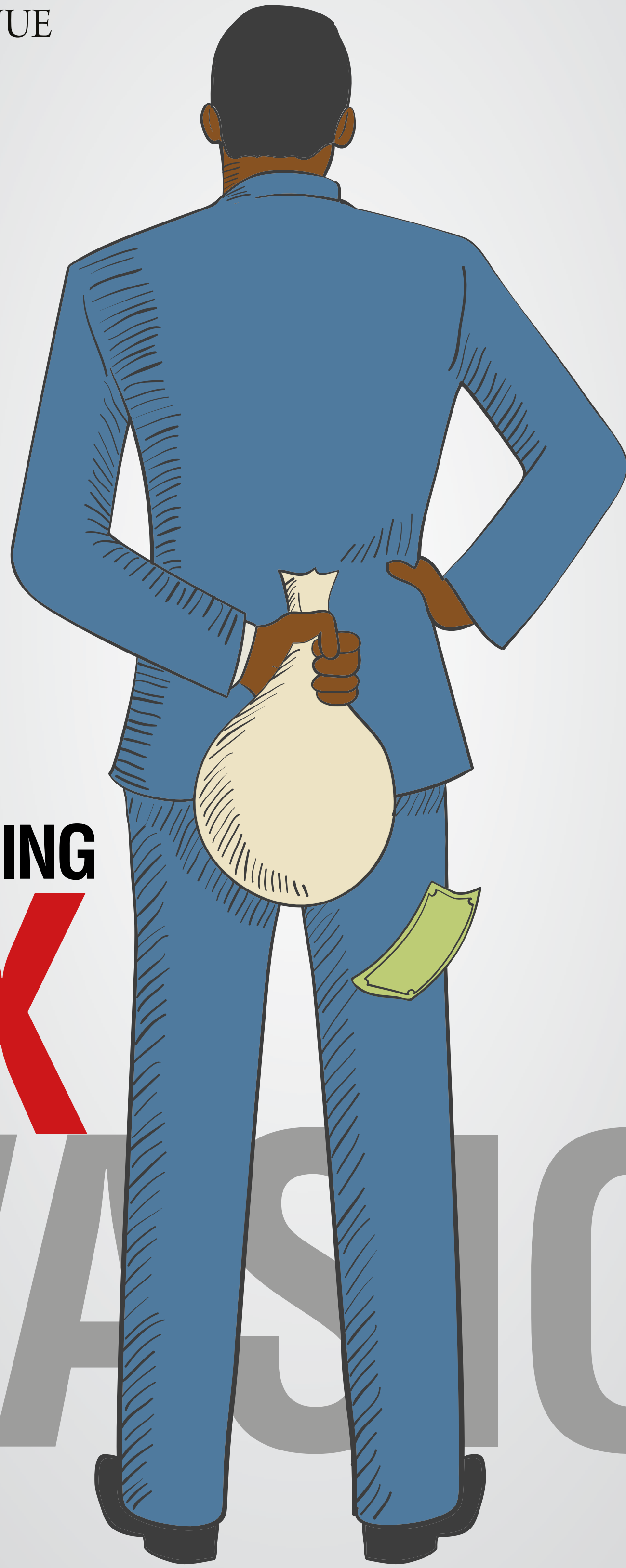

Missing Trader

KRA invest in technology to safeguard transit goods

Trying to beat the tracking system

UNDERSTANDING TAX EVASION

KRA Customs officer verifies goods on transit

Word from the Commissioner General, KRA

Tax authorities the world over are grappling with the dynamics of contemporary tax evasion schemes.

As the world has continued to evolve, so have tax evasion schemes and unfortunately almost growing at the same pace. Perhaps to paraphrase Chinua Achebe, as unscrupulous individuals and organised crime perpetrators have learnt to do business without paying due taxes, tax authorities have no choice but to learn how to catch these criminals without missing.

Over the past few years, financial fraud and tax investigations have revealed sophisticated tax evasion schemes devised by criminals in the supply chain aimed at evading payment of taxes. These tax evasion schemes take a variety of forms and cost the tax payer the absolute value of development funds.

For example, in Kenya, our investigations indicate that we have continued to lose billions to tax evasion schemes every year. In the last financial year, we successfully intercepted spirituous illicit products with an estimated tax loss of Kshs. 1.2 billion that were destined for local consumption. We have profiled 1,309 individuals and companies with tax-loss estimated at approximately Kshs. 259 billion. These entities are earmarked for further investigations and legal action for non-compliance.

Tax crimes have been cited as major obstacles for developing countries in mobilizing domestic resources needed to finance development in a sustainable way. To mitigate against these crimes, tax authorities and government agencies dealing in financial investigations have heightened efforts to outsmart the tax cheats.

Globally, these schemes are recognised as economic crimes. As a result, organisations such as the Organisation for Economic Co-operation and Development (OECD) have come up with best practice to deal with the criminal acts, mainly through reforms in tax laws and anti-money laundering provisions. The OECD is actively mobilising global support to ensure that tax evasion is criminalized. This, for good reason given that tax crimes, money laundering and other financial crimes threaten the strategic, political and economic interests of both developed and developing countries. These acts undermine citizens' confidence in the tax system.

Locally, KRA has domesticated OECD's Ten Global Principles for Fighting Tax Crime, including the legal, institutional, administrative, and operational aspects necessary for putting in place an efficient system for fighting tax crimes through specific provisions under the Tax and Custom Laws.

KRA investigates potential violations of revenue loss and related financial crimes with a view to demanding unpaid taxes and prosecuting the key players where criminal culpability is established. This, in turn, builds the public confidence in the government's ability to get their citizens to pay their fair share of taxes and the net result is an increase in voluntary tax compliance.

To enhance voluntary compliance, where it is clear the purpose of the transactions was to undermine the tax system, KRA endeavours to investigate, prosecute and publicize our actions. This gives compliant taxpayers the confidence that we don't tolerate unfair business practises.

"This publication outlines the activities that KRA is undertaking in dealing with these crimes to ensure that the objectives of enhancing tax compliance are achieved."

We are therefore scaling up our stakeholder engagement efforts by launching this quaterly journal to facilitate effective communication on tax crimes. We hope to use this as a tool to engage stakeholders in the public and private sector, academia and professional fraternity to raise awareness on contemporary tax evasion schemes. We are optimistic that it will also provide much needed feedback and encourage tax crime whistleblowing.

This publication outlines the activities that KRA is undertaking in dealing with tax crimes to ensure that the objectives of enhancing tax compliance are achieved.

In this inaugural issue, we take a deep dive into contemporary tax evasion schemes particularly the infamous "Missing Trader" scheme. We also highlight our expertise in exposing tax evasion schemes – which are oftentimes very intricate involving multiple players – by looking at case studies of schemes that we have disrupted in the past. It is our hope this will not only act as cautionary tale and a deterrent against tax evasion, but will also prove to those who are compliant that KRA stands for equitable taxation for all.

Githii Mburu
Commissioner General, Kenya Revenue Authority

Missing Trader

A few years ago, the Kenya Revenue Authority (KRA) commenced an investigation to unearth an elaborate tax evasion scheme.

The scheme had been designed as a Value Added Tax (VAT) racket and involved the generation of fictitious tax invoices from ghost traders. KRA had noticed a rather suspicious trend where a number of taxpayers suddenly had a huge drop in VAT liability despite the increase in their trading activities without any particular variations in outputs.

This trend was internally noted and picked by our surveillance system as it continued to grow month on month raising further suspicion as the amounts involved were significant. The missing trader fraud by then had begun to feature as a VAT vice in India and a few European countries thus heightening KRA's attention.

Initial investigations confirmed that the scheme had been established by unscrupulous individuals to reduce tax liability without incurring costs on the taxable inputs as required of them to qualify for deduction of input VAT and costs for income tax computation.

For example, around April 2018, KRA charged two suspects in court for tax evasion amounting to Kshs. 7 billion. The two were arrested after it was found out that they had registered more than nine business names and are believed to have made fictitious invoicing in excess of Kshs.15,369,511,856. The two were suspected to have defrauded or aided in defrauding the government approximately Kshs.2,459,121,896 in Value Added Tax and a further Kshs.4,610,853,556.80 in income taxes.

Through the two suspects, KRA had effectively stumbled on some of the Missing Trader schemers after more than a year of undercover investigations. The investigations provided links to approximately 66 missing traders and over 2,000 beneficiaries of the scheme.

In this scheme customised heavily for local application, the traders had been claiming non-existent input on purchases, using fictitious invoices, thereby evading payments of billions of shillings in taxes.

Fictitious invoices had been generated to depict business transactions but there was hardly any corresponding actual supply or movement of goods and services. The invoices had been generated and sold at a fee by the missing traders to existing companies purposely for use in inflating the cost of sales thereby reducing tax payable.

The major companies that have benefited from the missing traders syndicate were noted to be from various sectors including: construction, importers of hardware and household goods, scrap metal dealers and importers of electronic items including mobile phones and household electronics.

Some of the companies identified in the missing trader scheme were found to be actual importers of various goods but had under-declared the imports in order to pay less import duty and VAT. In order to claim Input VAT, the companies had resorted to buying invoices to inflate purchases; effectively minimizing their VAT obligations.

In yet another missing trader case, KRA identified a trader who had allegedly procured steel worth more than Kshs. 4.8 billion on cash basis. Curiously, this trader could not avail his cash books when requested to avail the same for perusal. The trader had nonetheless proceeded to claim input VAT occasioning national revenue loss as there was no evidence of exchange of goods or services in respect of input VAT claimed.

On this front, initial findings reveal that the government has lost in excess of Kshs.65 billion in terms of VAT alone over the last four years.

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Kshs.2,459,121,896

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Customs officers verify a suspected cargo at ICD, Nairobi

CASE STUDY:
Using fake invoices to evade taxes

Mr John who is a contractor has benefited from a construction project initiated by the Government of Country X. He has won a Kshs.40 billion-tender to construct a tarmac road but unfortunately, he had to part with a tidy sum of Kshs.5 billion to some 'fat cats' in Government to secure the deal. Mr John therefore will need to claim the Kshs.5 billion as a cost. If not, his income tax liability will be high since his margins will appear huge; now that he can't claim the 5 billion kickback as an expense for tax purposes.

In the analogue era, Mr John could have recovered some of this inflated cost through some simple tax-evasion trickery. But with introduction of iTax the party is spoilt. As part of his inputs, Mr John buys quarry stones, sand, ballast, and boulders from unregistered traders. With a manual tax system, all he needed to do was to generate fake invoices showing that the inputs were worth Kshs.5 billion (for the cash he paid in kickbacks). This would result in reduced Value Added Tax (VAT), as well as Corporation Tax.

With the advancement in taxation systems, however, even the informal traders from whom Mr John purchases building materials had to be registered for VAT for him to claim the inputs. They needed to have Electronic Tax Register (ETR) machines, to enable the Kenya Revenue Authority (KRA) to identify their sales as those from VAT registered suppliers, at that time.

It was nearly impossible for him to beat the digital

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Kshs.65 billion

Popularly known as the "Missing Trader Scheme," the Authority estimate that fake invoices worth Kshs.65 billion have been issued since 2015, with the peak being in 2016 when Kshs.32 billion worth of fake invoices were generated.

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system. To succeed, he would need to register those traders supplying him with the construction materials as companies. Then preferably using stolen identities, he would also need to register them for VAT. The use of stolen identities here is important so as to conceal the ownership trail.

In some cases the owners of the companies as listed at the Registrar of Companies are different from those on iTax. The ghost traders could then generate ETR invoices matching his fictitious purchases of Kshs. 20 billion . This enabled him to declare lower taxes by claiming VAT on inputs and also expenses that were otherwise non-existent.

The events leading up to Mr John defrauding the taxpayers through a scheme in which traders are assumed to have supplied goods are not hypothetical. This has happened in Kenya, not once, but several times. They involve multiple companies, including multinational corporations that have even been involved in Government contracts.

Kenya Revenue Authority's (KRA) Investigations have in the past unravelled a Kshs. 30 billion tax evasion scheme. This money could finance a sizeable portion of the Government's budget. Popularly known as the "Missing Trader Scheme", the Authority estimates that fake invoices worth Kshs.65 billion have been issued since 2015, with the peak being in 2016 when Kshs.32 billion worth of fake invoices were generated.

Since 2015, about 66 individuals have colluded with several companies, from construction, electronics, textile to iron and steel, to evade taxes by registering fictitious firms that have impersonated a genuine firms by trying to meet all the paper requirements of a "supply" for tax purposes. Approximately 2,700 companies have also fraudulently claimed input VAT and 30 per cent in cost of sales for Corporation Tax through the Missing Trader Scheme.

The biggest loss is through foregone VAT which has so far exceeded Kshs.10 billion. Assuming that there was no single purchase in all the fictitious invoices, Corporation Tax foregone is estimated at Kshs.19.7 billion. Ninety-six of the 2,700 companies had made fake transactions of about Kshs.46 billion with a VAT liability of Kshs.7.4 billion. In this scheme, the traders are described as "missing" because they are using wrong identity to register phony companies and other business entities and supplying non-existent missing products. In this scheme, the traders are described as "missing" because they are using the wrong identity to register phoney companies and other business entities and supplying non-existent (missing) products.

This therefore means that the (phony) traders supplying the purported goods and services are actually missing. The "missing trader" scheme has been carried out before in many other countries that digitised their tax systems especially in Europe and Asia.

To date, four of the six manufacturers of invoices have been charged in court. Among those arrested is one whose documents were used to issue invoices worth Sh11.6 billion. Another one who was arrested in Western Kenya had registered 12 business names and issued invoices valued at Kshs.15.3 billion. Two other accomplices sneaked out of the country, and efforts are being made to have them arrested to face justice. Three other traders, who are said to have issued invoices worth Kshs. 22.5 billion, are still at large and suspected to have sneaked out of the country. One was recently intercepted at the airport and arrested. Efforts are at an advanced stage to have the others arrested and brought back to Kenya for legal action. There are more than 16 cases under the tax appeals tribunal involving the revenue value of over Kshs. 1.2 billion. As far as the beneficiaries are concerned, 63 of them have been arraigned in court. More than 200 other cases are still under investigation.

Kshs. 30 billion

Kenya Revenue Authority (KRA) Investigation and Enforcement officers have in the past unravelled a Kshs.30 billion tax evasion scheme. This money could finance a sizeable portion of the Government's budget.

KRA officials destroy illicit bottled water worth Kshs. 5 Million at Wilson Airport.

Assorted contraband goods and counterfeits go up in flames during a multi-agency destruction exercise in Garissa.

A section of non-intrusive scanners at ICD, Nairobi.

KRA invests in technology to safeguard transit goods

Cases of dumping have for a long time posed a challenge to Kenya Revenue Authority (KRA) Customs and Border Control Department, which has reported billions in estimated loss of revenue. With the increase in revenue targets, KRA has intensified measures to curb revenue leakages and improve revenue collections.

Consequently, this has led to the introduction of Real Time Transit Monitoring systems to curb the vice. Investment in manpower and technology have been implemented to monitor transit goods with Regional Electronic Cargo Tracking System (RECTS) becoming the new frontier in addition to the Electronic Cargo Tracking System (ECTS).

The RECTS solution comprises of satellites, a monitoring/ command centre and electronic seals fitted on cargo trucks to give the precise location of goods at any time. It covers trade routes that originate from the Kenyan ports and Free Zones within Kenya, via the country's main transportation trade routes to the neighbouring countries.

RECTS has been succesfull in ensuring high tech comprehensive monitoring of transit cargo with less manpower and greater precision. the use of scanners have also been initiated as a control measure. The neighbouring EAC countries are quickly adopting scannersas a non-intrusive tool of enforcement and trade facilitation.

Previously, transit escort vehicles and ECTS were used to monitor transit cargo from the Port of Mombasa to the exit borders. This process was time consuming, unreliable, costly and prone to manipulation. With the success of RECTS, the opportunities for cargo dumping and diversion into the local market will be curtailed, however, the perpetrators of fraud are always devising new ways to beat/circumvent the systems and controls in place.

For a long time now, schemers of transit goods dumping and cargo diversion have always tried to devise new ways of beating the system. They are always coming up with new ways to divert transit cargo into the local market. The dumping/cargo diversion schemes have denied the country much needed revenue amounting to billions of shillings.

Demand for high value consumer goods, varied valuation and tax rates among the EAC partner states and restrictions by regulatory bodies are motivation for most of the cargo diversion schemes. Foodstuffs such as milk

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H.E President Uhuru Kenyatta being taken through on how the RECTS tracking device works, during a visit at the Scanner Command Centre, Times Tower Nairobi.

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powder, spaghetti and cooking oil are some of the high demand goods being diverted into the country.

With the increase in trade volumes, there has been need to introduce appropriate trade facilitation measures during the transportation process and at the border post to ease the process of cargo movement. The ratification of the World Trade Organisation (WTO) agreement on trade facilitation also requires that we implement measures to ensure faster movement of goods in transit. One of the most common trade facilitation measures is the electronic tracking of imported cargo transiting through Kenya. Research on the use of electronic cargo tracking system concluded that the use of the radio frequency identification system has benefits such as increased accountability of goods in transit, reduced level of diversion of transit cargo, reduced time taken to clear cargo at the border points, reduced cost of doing business and enhanced competiveness of Mombasa Port in the region.

Reported cases of transit cargo being diverted into the country occasioned loss of taxes estimated at Kshs.12 billion annually hence necessitating the introduction of real time cargo tracking system to minimise and deter tax evasion through diversion of transit goods.

However, investigations have established that the assumption that transit goods diversion has reduced due to the use of technology such as Regional Electronic Cargo System (RECTS) & Electronic Cargo Tracking System (ECTS) is not entirely conclusive. This is going by the recent interceptions made at the border points of transit cargo being diverted back to the country upon reaching destination's entry points of non-EAC member like the Democratic Republic of Congo and South Sudan.

The finding therefore increased the understanding of the importance of information sharing amongst different Revenue Authorities in East Africa Countries as stipulated under section 10 of EACCM Act 2004.

The investigations always aim to detect, deter and disrupt tax fraud schemes used to circumvent and manipulate the systems and controls in place to combat illicit trade. In this way, KRA is able to address the emerging trends in transit diversion in light of the newly deployed systems.

Lately KRA has intercepted transit consignments being dumped/diverted back into the country through the Kenya borders since clearing agents have devised new ways of dumping and diverting cargo to defeat the newly deployed real-time monitoring systems.Diversion has reduced due to the use of technology such as Regional Electronic Cargo System (RECTS) is not entirely conclusive.

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Kshs.12 billion

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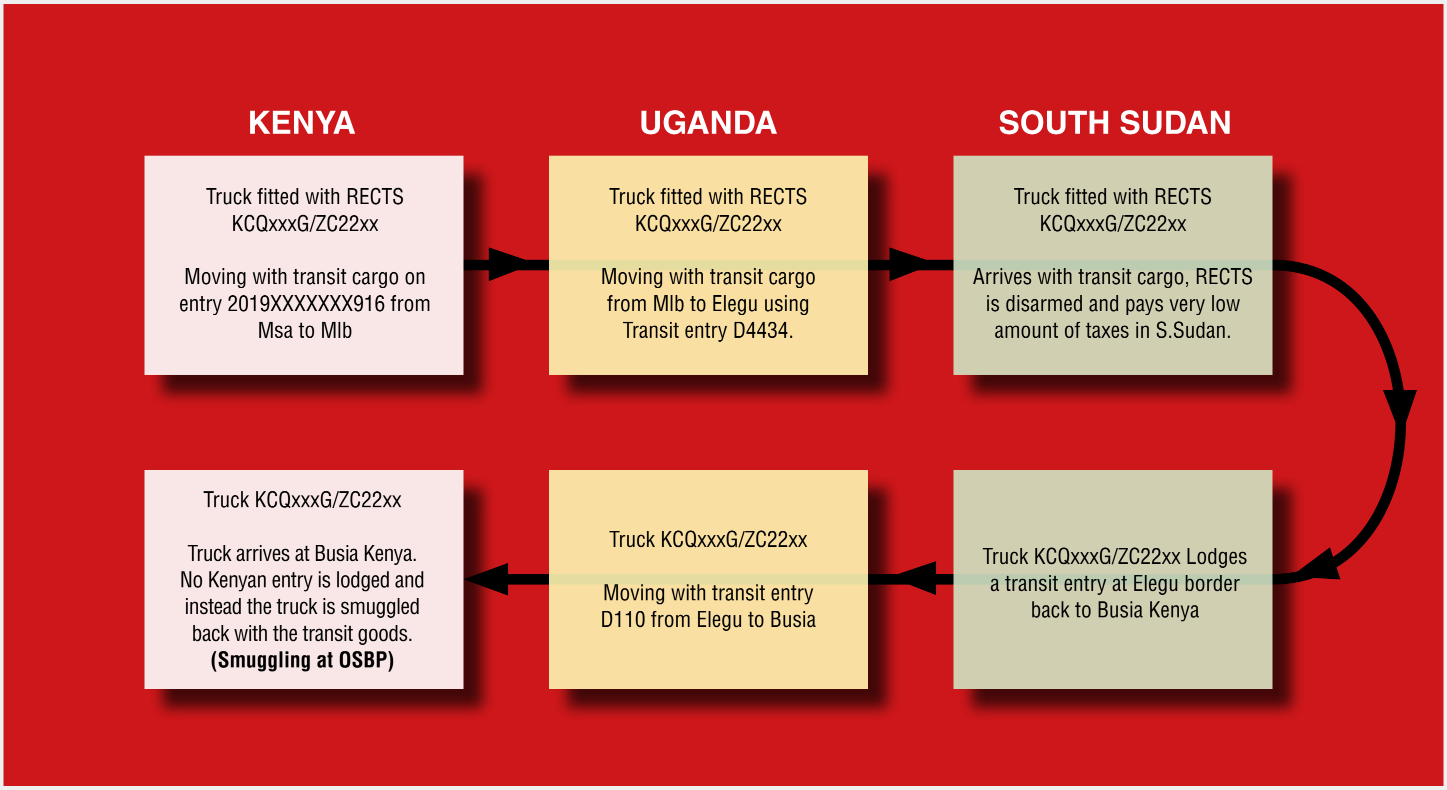
Trying to beat the tracking system

Countries outside EAC partnership are emerging as high risk in relation to transit cargo. It has been observed that the transit cargo heading to South Sudan and Democratic Republic of Congo (DRC) for instance is under-declared and lower taxes paid to the respective revenue authorities due to one reason or another.

Since some of these countries are not members of the EAC, they are outside the scope of KRA's real time cargo tracking systems. KRA has investigated several cases where goods imported from overseas are declared to be transiting to South Sudan via Malaba and Busia One Stop Border Posts (OSBP). The transporting vehicles were fitted with RECTS to ensure they do not divert from the gazetted transit route from Mombasa all the way to Elegu (Uganda & South Sudan border). The goods are transited as required to final destination. Once at Elegu, Customs declarations were made with minimal Customs values and taxes paid to South Sudan Government. Immediately, transit entries were lodged at the Elegu border on Uganda Revenue Authority (URA) ASYCUDA system, declaring the goods to be transiting from South Sudan through Uganda and back into Kenya. A case study of full cycle intercepted consignment is as shown below through a flow chart illustration of how dumping/diversion was propagated for transit milk powder.



The unscrupulous clearing agents collude with the traders and other key players to ensure that rotation messages at the Kenyan exit border are captured at the very instance that the truck carrying transit goods exits the One Stop Border post (OSBP). They complete the process by ensuring the certificate of exports (C.O.E) are issued and the bonds cancelled almost immediately. The scheme is such that they even obtain the landing certificate (Customs declarations) at the destination (South Sudan & Democratic Republic of Congo) country. They later use these documents as defence in the event of inquiries into transit diversion cases.

The above illustration exposes the government to several risks among them loss of revenue, substandard goods (illicit trade), security risk (prohibited items may be smuggled) and unhealthy local competition.

All incoming trucks from partner states were initially considered to be low risk due to the fact that they can only be carrying EAC originating goods or are empty after delivery. This risk profiling status made it easy for the system and controls to be overrun. After investigations, the culpable individuals have faced criminal sanctions as the taxes lost are pursued for recovery. After investigations, the culpable individuals faced criminal sanctions as the taxes lost are pursued for recovery. After investigations, the culpable individuals faced criminal sanctions as the taxes lost are pursued for recovery.

Meanwhile system and process enhancements continue in the light of the observations from the results of investigations.

UNDERSTANDING TAX EVASION

FIND OUT MORE

If you'd like additional information on Tax compliance in Kenya, please contact KRA through email: callcentre@kra.go.ke

KENYA REVENUE AUTHORITY

Tulipe Ushuru, Tujitegemee!