



IN THE COURT OF APPEAL

AT MALINDI

(CORAM: VISRAM, KARANJA & KOOME, J.J.A)

CIVIL APPEAL NO. 10 OF 2018

BETWEEN

COMMISSIONER OF DOMESTIC TAXES.....APPELLANT

AND

OCEAN FREIGHT (EAST AFRICA) LIMITED.....RESPONDENT

*(An appeal from the ruling of the High Court of Kenya at Mombasa (Otieno, J.) dated 12<sup>th</sup> May, 2017 in*

*Income Tax Appeal No. 97 of 2010)*

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JUDGMENT OF THE COURT

1. The appeal herein revolves around the application of *Sections 15(1), (2)(a)* and *16(1)(a)* of the *Income Tax Act* in determining the taxable income of a person. The relevant portions of *Section 15* read in part as follows:

“15.

*(1) For the purpose of ascertaining the total income of any person for a year of income there shall, subject to section 16 of this Act, be deducted all expenditure incurred in such year of income which is expenditure wholly and exclusively incurred by him in the production of that income,...*

*(2) Without prejudice to sub-section (1) of this section, in computing for a year of income the gains or profits chargeable to tax under section 3(2)(a) of this Act, the following amounts shall be deducted:*

*(a) bad debts incurred in the production of such gains or profits which the Commissioner considers to have become bad, and doubtful debts so incurred to the extent that they are estimated to the satisfaction of the Commissioner to have become bad, during such year of income...”*

2. On the other hand, *Section 16 (1) (a)* provides:

“16

*1) Save as otherwise expressly provided, for the purposes of ascertaining the total income of a person for any year of income, no deduction shall be allowed in respect of—*

*(a) any expenditure or loss which is not wholly and exclusively incurred by him in the production of the income; ...”*

3. The aforementioned provisions came into consideration following an audit carried out by the **Commissioner of Domestic Taxes** (the appellant) on **Ocean Freight (East Africa) Limited** (the respondent)'s account for the period running from 2002 to 2006 (audit period). Of relevance is that pursuant to an agency agreement between the respondent and Mediterranean Shipping Company S.A (MSC) which carries out shipping business, the respondent acted as MSC's agent in Kenya.

4. It is on the basis of the said audit that the appellant vide a letter dated 21<sup>st</sup> February, 2008 demanded for payment of Kshs. 51,319,757 as corporation tax arrears for the audit period. Additionally, by another letter of even date the appellant also demanded from the respondent as an agent of MSC, a sum of Kshs. 53,417,116 as tax arrears for non-resident income earned during the audit period by MSC.

5. By a letter dated 21<sup>st</sup> April, 2008 under the hand of her auditor and tax agent, Deloitte & Touche, the respondent objected to the corporation tax demand. The objection was on the grounds that the appellant had failed to take into account the respondent's deductible expenses under **Section 15** of the **Income Tax Act**. Specifically, the appellant had not factored in that the salaries and emoluments of two of the respondent's employees who also acted as directors, namely, Captains Tommaso Castellano and Fiorenzo Castellano (the Castellanos) were deductible expenses as against the respondent's income.

6. Similarly, the appellant failed to take into account that outstanding and written off freight were bad debts within the meaning of **Section 15(2) (a)** and subject to deduction from the respondent's taxable income. The appellant did not agree with the objection raised and communicated as much to the respondent.

7. This prompted the respondent to refer the dispute to the Income Tax Local Committee (Committee). After considering representations made by each party, the Committee rendered its decision as contained in a letter dated 12<sup>th</sup> April, 2010 in the following manner:

***“At a meeting held on 9<sup>th</sup> April, 2010, the Income Tax Local Committee made the following decision in your case:***

***1) That the bad debts arising out of the unpaid freight charges were debts of Mediterranean Shipping Company (MSC) and they were therefore not allowable against the income of your company.***

***2) That the two directors of the company i.e. Messrs Tommaso Castellano and Fiorenzo Castellano were employees of MSC and therefore the expenses incurred on their behalf were not allowable against the income of your company.”***

8. Unrelenting, the respondent lodged an appeal in the High Court against the Committee's decision which was allowed by a ruling dated 12<sup>th</sup> May, 2017. In setting aside the Committee's decision the learned Judge (Otieno, J.) held:

***“To this court, the critical consideration is not whether or not the two persons were employees of the appellant. What would matter is whether or not the Appellant did incur expenditure on them towards the generation of its income for the tax period in question. I so say noting that what section 15(1) requires for an expenditure to be allowable is that the expenditure need to be wholly and exclusively incurred by the tax payer in the production of the income. To that extent, the Local Tax Committee needed to address its mind as to whether or not that was the case. It did not. Instead it employed much energy and gave undue prominence to consideration whether or not the two were employees and on the question of the work permits.***

***To this court those were extraneous and irrelevant consideration.***

...

***I do find that there was availed sufficient evidence that the two Castellanos were employed at a known monthly salary, as was proved by the letters of employment, duly acknowledged by the Respondents in their statement of facts, those expenses were due as allowable expenditure by the appellant and the Local Tax Committee had no right, and infact failed in its duty to consider and find the same to be allowable expenditure. In coming to this conclusion, I have given due regard to section 16 of the Act and I am in doubt that salaries to an employee is not outlawed.”***

9. The learned Judge went on to state that:

***“The upshot is that I find that the Local Tax Committee was plainly and wholly wrong when it came to the conclusion that the bad debts were not allowable merely because the Appellant was forbidden from giving credit. I find that, incoming to that conclusion, the committee did misapprehend the provision of the agency agreement and thereby came to a wrong and unsupported conclusion.”***

10. This time around it was the appellant who was displeased with the High Court's decision and preferred the appeal before us which basically challenges the entire decision.

11. Ms. Odundo, learned counsel for the appellant, whilst remaining steadfast that the Castellanos were employees of MSC as opposed to the respondent, argued that there was overwhelming evidence on record to that effect. She made emphasis on the Castellanos contracts of employment dated 30<sup>th</sup> May, 1990 and 15<sup>th</sup> March, 1996 as well as work permits which clearly indicated that they worked for MSC. She posited that if indeed the respondent's allegations were true then the said permits should have reflected the same in their subsequent renewals during the audit period.

12. Counsel went further to claim that letters dated 15<sup>th</sup> December, 2000 under the hand of the respondent purporting to employ the Castellanos were not letters of employment. Rather, they were letters seconding the Castellanos to the respondent as the local agents of MSC. According to the appellant, in the absence of an agreement to the contrary, the idea of secondment presupposed that the Castellanos remained the employees of MSC during the period of secondment. By extension that MSC would continue paying their salaries. In that regard, reliance was placed on two decisions by the industrial court of Malaysia. The first being ***Bank Simpanan National Finance Bhd & Anor. vs. Omar Hashim*** [2002]1 ILR 272 wherein the court expressed:

***“The ordinary dictionary meaning of secondment as a temporary transfer has on the face of it the connotation that the employee is subject to recall by his employer. So he is not a permanent employee of the other.”***

13. The other was **Comex Services Asia Pacific Region, Miri v Grame Ashley Power [1987] 2 ILR 34** wherein the court in reinforcing the idea of a temporary transfer stated:

***“Therefore so long as the contract is not terminated, a new contract is not made and the employee continues to be in the employment of the original employer. Even if the employer orders the employee to do certain work for another person, the employee still continues to be in his employment.”***

14. Besides, the agency agreement did not provide for the salaries of the Castellanos as expenditure to be borne by the respondent. There was also no evidence that the respondent was paying P.A.Y.E in respect of the Castellanos.

15. Making reference to a decision by the Bangalore Income Tax Appellate Tribunal in **Flughafen Zurich Ag, Bangalore vs Ddit International Taxation [TS-96-ITAT-2017] (Bang)**, it was the appellant’s position that the Castellanos salaries could not properly speaking amount to expenses which are deductible from the respondent’s income as envisioned under **Section 15** of the **Income Tax**.

16. In counsel’s opinion the learned Judge misdirected himself in holding that the question of whether the Castellanos were employees of the respondent was not pertinent to the matter before it.

17. Ms. Odundo faulted the learned Judge for misinterpreting the provisions of **Section 15(2)** of the **Income Tax** to the effect that bad debts need not be irrecoverable and that it is enough if their recovery is doubtful. She urged that the determination of whether a debt qualifies as a bad debt or doubtful debt is at the discretion of the appellant. In her view, the learned Judge usurped the appellant’s discretion.

18. Moreover, a bad debt only becomes a deductible expense if it is wholly and exclusively incurred in the normal course of business. To bolster that line of argument we were referred to the persuasive decision of the High Court in **Republic vs. Commissioner for Income Tax & another Ex-Parte Stockman Rozen (K) Limited [2015] eKLR** where Odunga, J. held:

***“ ... taxable income is that income that has accrued minus allowable deductions and that the said deductions from the accrued income must be those that are allowable under sections 15(1) and (2) of the Act which includes bad debts at section 15(2)(a). However, for these to be deductible (i) they must be bad or have become bad, (ii) must have been incurred in the production of gains or profits and (iii) must be estimated to the satisfaction of the commissioner to have been bad.”***

19. It was postulated that the obligations of the respondent and MSC were expressly set out in the agency agreement. The said agreement is categorical that the respondent should not offer any credit without a written approval from MSC. As such, any debts accruing as a result of their business could only be incurred by MSC as the principal. It followed therefore, that the respondent could not claim bad debts as a deductible to its taxable income.

20. Ms. Odundo further submitted that the learned Judge did not consider all the issues before him, namely, that he failed to address the demand for tax on non-resident income of Kshs.53 417,116. As far as she was concerned, the demands of corporate tax and tax on non-resident income as reflected in the appellant’s letters dated 21st February, 2008 ought to be paid.

21. On his part, Mr. Odera began by stating that it was common ground that the Castellanos were initially the employees of MSC. However, as from 1<sup>st</sup> January, 2001 they both became the respondent’s employees as evidenced by the letters of employment dated 15<sup>th</sup> December, 2000. Further, the annual returns and financial statements relating to the audit period which were availed to the appellant confirmed that the two were directors and employees of the respondent. Therefore, the respondent was entitled to treat their salaries as expenses which are deductible from its taxable income.

22. Mr. Odera submitted that the Committee arrived at an erroneous conclusion that the Castellanos were not the respondent’s employees because it paid regard to documents that pre-dated audit period.

23. Addressing us on deduction of bad debts, counsel referred to the definition given to a bad debt under the **Black’s Law Dictionary** thus,

***‘ a debt that is uncollectable and that may be deductible for tax purposes.’***

On the strength of that definition, we were told that debtors failed to pay freight charges to the respondent hence she had to make payment to the principal and thereafter, pursue the debtors. She did file suit to recover the debts but was unsuccessful; she was forced to write off the debts as bad debts and as a result, was entitled to deduct the same from her taxable income in line with **Section 15(2)** of the **Income Tax Act**.

24. As for the appellant’s discretion to determine what amounts to a bad debt, counsel’s response was that this particular discretion was conferred by an amendment to **Section 15 (2)** of the **Income Tax Act** by **Section 20** of the **Finance Act No. 9 of 2007**. The said amendment came into force on 1<sup>st</sup> January, 2008 and was therefore not applicable to this matter. Also distinguishing the case of **Republic vs. Commissioner for Income Tax & another Ex-Parte Stockman Rozen (K) Limited (supra)** from this case, Mr. Odera asserted that it was decided in the year 2014 and in line with the amendment to **Section 15(2)** of the **Income Tax Act**. All in all, the High Court’s decision was sound and incapable of reproach.

25. We have considered the record, submissions by counsel and the law. It is discernible from the provisions of **Section 15** and **16** of the

**Income Tax Act** which we have set out herein above that before any expenditure can be deducted from a person's taxable income it ought to have been exclusively incurred in the production of the said income. Did the Castellanos salaries meet the foregoing criteria?

26. In our view, the starting point would be to consider whether the Castellanos were employees of the respondent for purposes of establishing whether their salaries were wholly and exclusively incurred for production of the respondent's income.

27. The discussion on the test of determining an employer/employee relationship by learned authors of *Halsbury's Laws of England Vol I 26, 4<sup>th</sup> Edition at paragraph 3* is instructive:

***“There is no single test for determining whether a person is an employee, the test that used to be considered sufficient, that is to say the control test, can no longer be considered sufficient, especially in the case of the employment of highly skilled individuals, and is now only one of the particular factors which may assist a court or tribunal in deciding the point. The question whether the person was integrated into the enterprise or remained apart from and independent of it has been suggested as an appropriate test, but is likewise only one of the relevant factors, for the modern approach is to balance all of those factors in deciding on the overall classification of the individual. The factors relevant in a particular case may include, in addition to control and integration: the method of payment; any obligation to work only for that employer, stipulations as to hours; overtime, holidays etc; arrangements for payment of income tax and national insurance contribution; ...”.***

28. Applying the above principles to the circumstances of this case we are not satisfied that there was cogent evidence to demonstrate that the Castellanos were employed by the respondent. In our view, apart from the letters dated 15<sup>th</sup> December, 2000 more evidence was required to establish their employment by the respondent. More so, taking into account that the application for renewal of the Castellanos working permits indicated that they were employees of MSC a fact which was admitted by the respondent. There was also no documentary evidence e.g. payslips tendered to show that the respondent paid their salaries or remitted P.A.Y.E on their behalf. Consequently, we find that the learned Judge erred in finding that the salaries in question were deductible under **Section 15** of the **Income Tax Act**.

29. As for the bad debts, we cannot help but note that the exercise of the appellant's discretion under **Section 15 (2) (a)** of the **Income Tax Act** to determine what amounts to a bad debt was not in issue. It is clear from the Committee's decision that unpaid freight charges were not considered as bad debts for the reason that the Committee believed that they were incurred by MSC and not the respondent.

30. In determining whether or not the unpaid freight charges were debts incurred by the respondent, the learned Judge looked into the terms of the agency agreement and rightly so. He observed as follows:

***“It would serve a lot of good to quote the relevant clauses for clarity purposes. Those clauses are 3.37 and 3.38 which provide:-***

***“The Agents will not offer credit to any shipper or consignee without the express written approval of the Principals. No Bills of Lading are to be issued prior to receipt of all funds for payment for those Bills. No documents for release of import cargo are to be issued prior to receipt of all funds in relation to that cargo.***

***The Agents shall indemnify the Principals at all time from and against all claims, losses, damages and expenses which the Principals may incur as the direct result or indirect results of the Agents' lack of due diligence or breach of this agreement by them. The Agents will take out satisfactory and appropriate transport intermediaries' agency insurance. The preferred mutual agency for this purpose is listed in schedule B.’***

***That provision in the agency agreement simply say that if the agent/ Appellant allowed any credits, it would be its duty to indemnify the principal for any loss thereby occurring. I understand indemnifying a financial loss to mean financial expense which to this court would be an expense met in the cause of business.***

***To this court such indemnity would be an expense that is wholly and exclusively incurred in the earning of income for the year of income...***

***The upshot is that I find that the Local Tax Committee was plainly and wholly wrong when it came to the conclusion that the bad debts were not allowable merely because the Appellant was forbidden from giving credit. I find that, in coming to that conclusion, the committee did misapprehend the provision of the agency agreement and thereby came to a wrong and unsupportable conclusion.”***

We concur with the above exposition by the learned Judge of the relevant clauses of the agency agreement. There was no contention that there were freight charges which were not paid and which the respondent was not able to recover from the debtors, yet the respondent was supposed to indemnify MSC for the loss. We are not persuaded that such were not bad debts as found by the Local Tax committee and as submitted by learned counsel for the appellant. On the contrary, we find that they were bad debts which ought to have been considered when computing the tax payable. The issue as to whether the commissioner had discretion or not to allow the bad debts in this case is neither here nor there because it was not addressed by the Local Tax Committee. The issue here is whether the said Committee was right in its finding that the bad debts could not be taken into account because the respondent was not authorised by MSC to give credit to her customers. The learned Judge found the Committee had misapprehended the Agency agreement on that issue. We find that the learned Judge cannot be faulted for so finding.

31. Last but not least, despite the respondent objecting to the demand for non-resident income tax, the said objection neither formed part of the dispute referred to the Committee nor was it considered in the appeal to the High Court. That is as much as we are prepared to say on this issue.

32. In the end, the appeal herein succeeds in part to the extent that we set aside the learned Judge's finding that the Castellanos' salaries were deductible from the respondent's taxable income. We however find the bad debts arising out of the unpaid freight charges were allowable against the income tax of the respondent.

33. As this Appeal has succeeded in part, the order on costs that commends itself to us is that each party shall bear its own costs of both the appeal herein and in the High Court.

**Dated and delivered at Malindi this 27<sup>th</sup> day of September, 2018**

**ALNASHIR VISRAM**

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**JUDGE OF APPEAL**

**W. KARANJA**

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**JUDGE OF APPEAL**

**M.K.KOOME**

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**JUDGE OF APPEAL**

I certify that this is a true copy of the original.

**DEPUTY REGISTRAR**