REPUBLIC OF KENYA
IN THE TAX APPEALS TRIBUNAL
APPEAL NO 170 OF 2015

NAKUMATT HOLDINGS LIMITED .....APPELLANT

VS

THE COMMISSIONER OF DOMESTIC TAXES.....RESPONDENT

JUDGEMENT

BACKGROUND

1. The Respondent conducted an Audit on the Appellant in May 2011-July 2011 for Corporate Tax and Withholding Tax among other tax heads not subject of this Appeal. The Respondent during the Audit established that the Appellant had a merchant agreement with Cyber Cash Limited. The nature of the agreement is such that Cyber Cash Limited issues smartcards to the Appellant's customers.
2. The Respondent established that through the smartcards issued, the Appellant awards loyalty points on goods purchased to any cardholder and redeemed loyalty points upon presentation by a valid cardholder.
3. The Respondent served the Appellant with notices of additional assessments for Corporation tax and Withholding tax respectively in accordance with the relevant statutes on 16th November 2012 which assessments were confirmed on 16th April 2015 as provided for under Sections 85(1)(c) and 85(3)(b) of the Income Tax Act Cap 470 of the Laws of Kenya.
4. The Appellant being dissatisfied with the decision of the Commissioner of Domestic Tax (CDT) appealed to this Tribunal against the entire

decision. They filed their Memorandum of Appeal on 26th May 2016, which is supported by a Statement of Facts filed on the same date. The Respondent filed its Response thereto dated 19th June 2015.

THE APPEAL

5. The Appellant's prayers are set out in the Memorandum of Appeal as follows:

   i. A declaration that the Appellant is entitled to claim and deduct the full interest on its borrowings that are disputed by the Respondent.

   ii. A declaration that Cybercash Limited is in the business of selling a virtual product and not providing a management service or at all, hence the payments made by the Appellant to Cybercash Limited are not subjected to withholding tax.

   iii. The Respondent's demand for additional taxes dated 20th November 2012 and confirmation of assessment dated 17th April 2015 be struck out in their entirety.

   iv. The Respondent, its employees, agents or other persons purporting to act on its behalf be barred from demanding or taking any further steps towards enforcement or recovery of principal tax, penalties and interest on any of the Respondent's demands stipulated in their notice of assessment dated 20th November 2012 and confirmed vide the letter of 17th April 2015

   v. The costs of this Appeal.

   vi. Any other remedies that the Honorable Tribunal deems just and reasonable.

THE RESPONSE:

6. The Respondent subsequent to being served with the Memorandum of Appeal filed its Statement of Facts on 19th June 2015,

7. The Respondent's Statement of Facts undated and signed by Kamau Kamau on behalf of the Respondent sets out their response on the issue of Interest Restriction and Withholding tax on Management services as follows:-

   i) **Points at issue: Interest Restriction:-**

   The Respondent recommends that bank loan interest expense proportionate to amounts advanced to Cybercash Ltd by the Appellant be disallowed and the assessment that was re-confirmed on the 17th of April 2015 be upheld.

   ii) **Points at issue: Withholding Tax on Management Services: -**

   The Respondent contends that the services offered by the related company Cybercash Ltd be declared in the nature of management services for which the Appellant was required to withhold tax and remit the same to the Respondent. The Respondent prays that the assessment that was reconfirmed on 17th April 2015 be upheld and tax due be rendered payable.

THE HEARING

8. When the Appeal came up for hearing on 9 March 2016 both parties agreed to proceed to full hearing. They both relied on their documents on record. The Appellant filed extensive documentary evidence in reference to the matter involving Cybercash Limited; the Appellant submitted before the Tribunal that the Respondent erred in restricting the interest deductible in the tax computation, which

resulted in an increase of the tax due from them. They argued that Cybercash invoices the Appellant on a monthly basis.

9. The Respondent alleged this was a management/professional service contract as Cybercash recruits customers and awards loyalty points with the main purpose of maintaining and retaining them. The Appellant however maintained that its transaction was a Goods contract one and not for provision of any services as contended by the Respondent.

10. The Appellant admitted that Cybercash redeemed the awarded loyalty points at a cost of Kenya Shillings One (Kshs 1/=) while the Appellant retained Kenya Shillings Two (Kshs 2/=) as stated in the Merchant Agreement. The Appellant also confirmed that Cybercash installed equipment and software at the Appellant's outlets thus incurring cost.

11. It was the Appellant's argument that the sale of points by Cybercash Limited to the Appellant did not constitute a Management Service. The Appellant relied on paragraph 3 and 4 of the Contract between themselves and Cybercash Limited to fortify their position. These paragraphs state;

> ***inter alia; Paragraph 3.... 'the merchant shall decide the manner in which to award and redeem the points and shall at all-time keep Cybercash Limited informed on this'*** where as ***Paragraph 4*** **inter alia provides...** ***'the payment made by the Appellant to Cybercash Limited would be payment for every point awarded'***

12. Finally, the Appellant maintained that the Respondent's argument was a shallow representation of the business that was carried out by an independent entity.

ISSUES FOR DETERMINATION

13. Upon discerning the issues for determination, the Tribunal decided to summarize them into two namely: -

    i. Whether the services offered by Cybercash Limited to the Appellant are in the nature of management services for which the Appellant should have remitted withholding tax.

    ii. Whether bank interest expenses incurred by the Appellant can be restricted/ disallowed in proportion to the Appellant's loan advances to related parties including Cybercash Limited over total bank loans for income tax purposes.

ANALYSIS

14. On the issue of the loyalty points awarded to customers who shopped at the Appellant's establishment, the Respondent contended before the Tribunal that, the relationship between the Appellant and Cybercash Limited qualified to be classified as management services as defined under Section 35(1) of the ITA. According to the Respondent, Cybercash helped to provide functions, *inter alia*, maintained the record of data of points awarded after purchase by the Appellant from them and the points redeemed at the point of sale at the Appellant's facility during a given period as provided for in the Merchant Agreement through reconciliation of the records. They also managed data of the Appellant's customers in terms of who qualified to redeem the loyalty points and equivalent item/goods from the Appellant, and that the consideration of Kshs 1 per point was for this kind of service, which the Respondent equated to management services.

15. There were substantial arguments by both sides. However, whichever way one approaches the matter, the question is always whether the relevant provision of the statute, upon its true construction, applies to the facts. Lord Nicholls of Birkenhead stated in **MacNiven (Inspector of Taxes) V Wesmoreland Investment Ltd [2001] UKL 6 at [2001] STC 237 at {8}, [2003]1 AC 3118**: *"The paramount question always is one of interpretation of the particular statutory provision and its application to the facts of the case."*

16. The Respondent defended their action for demanding taxes from the Appellant for management service fee as provided for under Section 35(1) of the ITA stating that as Cybercash Limited was in the business of management of loyalty points on behalf of the Appellant this created a contractual relationship. That the product sold by Cybercash Limited, which comprised of loyalty smart card scheme is a virtual good.

17. The Tribunal in its analysis having considered the relevant statutory provisions and case law holds that the issue for consideration was whether the relationship between the Appellant and Cybercash Limited may be termed as master and servant or define the rights and duties of the parties. The Tribunal proceeded to consider what the term *"a contract of service meant"*.

18. A contract of service as encapsulated in the case of **Ready Mixed Concrete (South East) Ltd V Minister of Pensions and National Insurance;** and Two more cases reported in ***[1968]1ALL ER 433*** stated that a contract of service exists if the following conditions are fulfilled:

i. The servant agrees that in consideration of a wage or other remuneration he will provide his own work and skill in the performance of some services to the master.

ii. He agrees, expressly or impliedly, that in the performance of that service he will be subjected to the other's control in sufficient degree to make that other master.

iii. The other provisions of the contract are consistent with its being a contract of service.

19. The Tribunal finds that the Kenya shilling One (Kshs.1) which Cybercash was paid by the Appellant amounted to a wage or remuneration for the work aforesaid being a service and accordingly attracts withholding tax being a management service as provided for under section 35(1) of the ITA. Therefore, a contract obliges one party to work for the other, accepting his control. The element of virtual goods that the Appellant advanced was incidental to the main purpose of the contract when looked at in totality with the other features or elements in the circumstances. Cybercash Limited was under an obligation to provide services to the Appellant in terms of managing the awarding and redeeming of loyalty points. This point was well articulated in the signed Merchant Agreement between the Appellant and Cybercash Limited under Clause 3 thereof that provided;

> *"The merchant (Appellant) shall decide the manner in which to award and redeem the points and shall at all-time keep Cybercash Limited informed of this"*

20. The Tribunal further finds that the ultimate authority over Cybercash Limited in the performance of its work resided with the Appellant in this case, as they were subject to the latter's orders and directions. The Tribunal finds that most important part of the work/service performed by Cybercash Limited consisted in the management of the data points earned by the individual customers, installing equipment and software and servicing them.

21. It is the task of the Tribunal to ascertain the legal nature of any transaction to which it is sought to attach a tax or a tax consequence and if that emerges from a series or combination of transactions, intended to operate as such, it is that series or combination which may be regarded.

22. The Tribunal, while deliberating the matters in issues, was not confined to examining transactions between the Appellant and Cybercash in isolation which were mainly related to the awarding and redeeming of the loyalty points to the customers but also to look at matters as a whole including, transmitting of data amongst other ancillary services such as screening, reviewing the applications for completeness of information of smart cardholders.

23. Accordingly, it is clear that the Tribunal must interpret the statute in question purposively, unless demonstrated that is not the intention of Parliament. The Appellant on this issue, failed to convince the Tribunal to deviate from that established principle of law. The Tribunal shall not allow itself to be distracted by any peripheral explanations that are not at all convincing in order to take a different path. This is well captured in the famous case of **Astall and another v Revenue and**

Customs Commissioners [2009] EWCA Civ 1010 where it was held; *"....applying a purposive interpretation involves two distinct steps: first, identifying the purpose of the relevant provision. In doing this, the court should assume that the provision had some purpose and parliament did not legislate without a purpose. But the purpose must be discernible from the statute: the court must not infer one without a proper foundation for doing so. The second stage is to consider whether the transaction against the actual facts which occurred fulfills the statutory conditions..."*

24. It is important to note that although the Appellant had the final power to decide the manner in which to award and redeem the point, the Tribunal is not blind to the fact that once the Appellant made the decision, Cybercash remained to run and manage the decision taken by the Appellant. In other words, Cybercash managed the records relating to the points transacted during any relevant month.

25. Secondly, Cybercash, having undertaken the assignment given to them by the Appellant of managing the awarding and redeeming of the points, qualified to be paid the Kenya shilling One (Kshs.1/=) as their consideration. If this was not the position, then one would be left wondering, why Cybercash was paid Kenya shilling One (Kshs.1/=) , if not for the management services they were rendering on behalf of the Appellant. These services were paid for and it was on the basis of the payments that the Respondent was demanding payment of withholding tax under Section 35 of ITA.

26. The Tribunal is satisfied that there is sufficient evidence to demonstrate, as provided by the Appellant, that Cybercash was

responsible for installing equipment and software at the Appellants outlets for the purpose of running the system of awarding and redeeming the points. The Tribunal would wish at this juncture to make reference on the following paragraphs 27 of the Appellant's Statement of Facts which state;

27(a); *"The Appellant agrees to pay Cybercash Limited Kshs 3/= inclusive of VAT which is to be paid at the prevailing rate for every point awarded...."*

27(c); *The Appellant also prepares a point redeemed report at the end of every month and forward the same for settlement by Cybercash Limited at Kshs 2/= inclusive of VAT for every point redeemed...* and "

27(e) of the "Cybercash would, at its cost, install the equipment and software to the Appellant"

27. This action by Cybercash to install equipment and software goes to confirm that there existed a working contractual relationship with the Appellant thus substantiating the argument by the Respondent that there existed a management service contract between the two parties. Cybercash received payment for the issuance of points, setting up and managing the program. From the foregoing, the Appellant's argument is unsustainable as they failed to demonstrate that the Respondent applied the wrong test by demanding withholding tax together with penalties and interest as provided for under Section 35(3) of ITA Cap 470. The Appellant under Section 35(3) ITA has a mandate to deduct withholding tax and it was their duty to so do and remit the deducted withholding tax to the Respondent. The Respondent on this issue has

not acted outside its mandate to demand for the outstanding withholding tax on management fees in the circumstances.

28. In respect of Interest Restriction imposed on an alleged loan advanced to Cybercash Limited, the Appellant opposed the handling of this issue by the Respondent. They argued before the Tribunal that the Respondent was misinterpreting Section 15(3)(a) of the ITA. The Tribunal requested for additional information and documents from the Appellant vide letter dated 18th April 2016 pursuant to Section 17 of the Tax Appeals Tribunal Act, 2013. The additional information sought related to the extract of Cybercash account in the Appellant's Books of Accounts produced along with the copies of invoices. Unfortunately, the documents provided by the Appellant vide their letter dated 4th May 2016 and received by the Tribunal on 6th May 2016, did not include the extract of Cybercash account and credit notes from Cybercash to the Appellant towards the points redeemed with a few additional copies of invoices relating to points awarded which the Tribunal had requested for.

29. The documents availed did not reflect the method followed by the Appellant to account for the points awarded and the points redeemed. This approach of releasing selective information to the Tribunal raises doubts about the sincerity in relation to the claims made by the Appellant. Further pages 83 to 150 of the additional documents are repetition of pages 18 to 81. In the absence of the abstract of Cybercash account from the Appellant's books of accounts, the Tribunal was compelled to depend on the available evidence to arrive at a decision relating to the disallowance of interest.

30. Accordingly, the Tribunal observed that the management agreement stipulated that both parties settle their dues by 5th of the subsequent month. Accordingly, the dues at the end of any particular month only related to the transactions (amount towards points awarded and points redeemed) during that particular month.

31. In the absence of information to the contrary, the Tribunal finds that the Cybercash account in the Appellant's books of accounts had credits towards the points awarded at Kshs.3 per point and debits towards the points awarded at Kshs.2 per point and a cheque drawn towards settlement of the net due. This finding confirms that the Appellant and Cybercash did adhere to the terms of Clause 5 of the Merchant Agreement.

32. The Tribunal analyzed the monthly abstract of the points awarded, redeemed and the balance availed by the Appellant, for the period February 2006 to February 2009 (except for July 2006 and August 2006, which were not availed), and found that the abstract reflected that in all cases the net position remained that the Appellant owed an amount to Cybercash. The Only exception was during two months, that is, August 2007 and July 2008. Hence, Cybercash had to appear as a creditor in the books of accounts maintained by the Appellant.

33. The Tribunal finds that the only possibility of Cybercash appearing as a debtor in Appellant's books was when there were excess payments made by the Appellant to Cybercash, which justifiably confirmed the arguments of the Respondent.

34. The Tribunal also finds that the excess payments made by the Appellant could not be attributed to any direct trade benefit to the Appellant, as

the Appellant only derived its trade benefit from the amounts paid to Cybercash for the points awarded by the Appellant to its customers. The excess payments made by the Appellant to Cybercash therefore in the circumstances could only be considered to be a loan from the Appellant to Cybercash.

35. In view of the above, the Tribunal is in agreement with the Respondent's disallowance of proportionate interest from the interest paid by the Appellant to the extent of the amounts lent by the Appellant to Cybercash.

TRIBUNAL DECISION

36. The Tribunal having considered the Pleadings and submissions by the parties herein finds that the Appeal lacks merit and the same is hereby dismissed.

37. The Tribunal affirms the decision of the Commissioner in confirming the Assessment dated 16th April, 2015.

38. The Tribunal orders that each party shall bear its costs.

DATED and DELIVERED at NAIROBI this 6th day of December 2016

In the presence of:-

VINCENT MUTAHI .....for the Appellant

FIONA KERUBO KIYUKA .....for the Respondent

.....
GEOFFREY KATSOLEH
CHAIRPERSON

.....
LILIAN RENEE OMONDI
MEMBER

.....
GABRIEL KITENGA
MEMBER

.....
FRANCIS K. KIVULLI
MEMBER

.....
PONANGIPALLI V.R. RAO
MEMBER