IN THE HIGH COURT OF KENYA

AT NAIROBI

MILIMANI LAW COURTS

COMMERCIAL AND TAX DIVISION

CORAM: D.S. MAJANJA J.

TAX APPEAL NO. 4 OF 2016

BETWEEN

TILE AND CARPET CENTRE LIMITED.....APPELLANT

AND

COMMISSIONER OF DOMESTIC TAXES...RESPONDENT

(Being an appeal against the judgment of the Tax Appeals Tribunal made on 5th September 2016 in Nairobi Tax Appeal No. 10 of 2015)

JUDGMENT

Introduction

1. The appellant, Tile and Carpet Centre Limited, is a company incorporated in Kenya and carries on business of selling, amongst others, furnishings, furniture, sanitary wear, ceramic products. It appeals against a decision of the Tax Appeals Tribunal ("the Tribunal") upholding the assessment of the Commissioner of Domestic Taxes ("the Commissioner") dismissing its objection to that assessment. The Tribunal upheld the decision of the Commissioner to disallow Kshs. 2,942,539/= claimed as interest expense under **section 16(1)(a)** of the ***Income Tax Act*** ("the ***ITA***").

Background Facts

2. The facts leading to this appeal are as follows. The Commissioner carried out a tax compliance check on the appellant for the period January 2010 to November 2011. It discovered that in July 2010 and October 2010, the appellant deposited with their advocates Kshs. 15,937,000/= and Kshs. 149,351,250/= towards the purchase of land; LR No. 11895/54. The purchase was being done on behalf of an associated company; Tile and Carpet Development Limited. The deal aborted and the money was credited back to the appellant's account in two instalments; Kshs. 65,288,250/= and Kshs. 100,000,000/= in February and March 2011 respectively.

3. The Commissioner contended that the appellant had sourced the funds from a credit facility and its total borrowings and overdraft for the years 2011 and 2012 was an aggregate sum of Kshs. 770,580,969/= with an accrued interest expense of Kshs. 84,833,487.00.

4. The Commissioner therefore restricted and disallowed interest expense relating to the borrowing to the extent of the amount deposited with the appellant's advocates and by a letter dated 13th November 2013, it raised the additional tax assessment to Kshs. 2,942,539/=.

5. The appellant was aggrieved by the additional assessment and filed an objection under Assessment Number 0305201100056/4. The Commissioner considered the objection and requested additional evidence on whether the appellant had sufficient reserves to fund the alleged purchase. As the appellant failed to furnish the evidence, the Commissioner confirmed the additional assessment by the letter dated 2nd December 2013 thus precipitating the appeal to the Tribunal.

6. By its judgment dated 5th September 2016, the Tribunal upheld the assessment and dismissed the appeal.

Tribunal Judgment

7. The issue for determination framed by the Tribunal was, "whether the Appellant borrowed funds from a commercial bank to finance the purchase of land on behalf of a related company and if so whether part of the interest on those borrowings should be restricted and disallowed for corporation tax purposes to the extent of the monies deposited with the Advocates."

8. After hearing the matter, the Tribunal held that the appellant did not provide crucial documents that would have assisted the Tribunal to ascertain the true purpose of the transfer of money to its advocates such as the agreement of sale and that the loan documents produced did not state the purpose of the loans and were not properly executed.

9. It further held that the evidence presented by the appellant was also contradictory in that it stated that it relied on credit facilities to finance its operations while on the other hand it stated that it had sufficient cash to finance the acquisition of land for a sister company.

10. Since the appellant did not offer documentary evidence to support its case, the Tribunal held and concluded that;

> [29] The Appellant had an obligation to discharge its evidential burden of establishing to the Tribunal that no taxes were absolutely or reasonable payable as demanded in the assessment by the Respondent but it failed and no shift of the burden of proof to the Respondent arose for the Respondent to justify the assessment of the tax liability imposed on the Appellant.
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> [30] The Tribunal finds in the circumstances that the amount of Kshs. 2,942,539/= in terms of interest expense be restricted and disallowed for corporation tax purposes. The Section 16(1)(a) of the Income Tax Act, CAP 470 of the Laws of Kenya is clear and applicable to the circumstances precipitating this Appeal.

The Appeal

11. The appellant is aggrieved by the judgment and has set out its grounds of appeal in the memorandum of appeal dated 25th October 2016. Its counsel, Mr Wakwaya filed written submissions which he highlighted at the hearing. The respondent supported the assessment by the Commissioner and the decision of the Tribunal. Its counsel, Ms Naeku, filed written submissions opposing the appeal and which she highlighted at the hearing.

Appellant's Submissions

12. The thrust of the appellant's case is the Tribunal failed to consider the evidence placed before it by the appellant and therefore reached an erroneous decision. It considered the main question to be whether the money deposited with the advocates was from the overdraft facility and whether it was intended to purchase property for and/or finance the operations of a sister/subsidiary company.

13. The appellant submitted that the issue in contention is whether the funds deposited with their advocates were intended to purchase the property for the associated company and whether the funds were derived from the overdraft facility. The appellant's contention is that the funds were not derived from the overdraft facility but from retained earnings. It also submitted that the intended use of funds was not to purchase property for its sister company but for itself.

14. Counsel for the appellant submitted that evidence of retained earnings was furnished before the Tribunal was not challenged or refuted by the Commissioner. He further submitted that the Commissioner did not challenge the appellant contention that the property could not be purchased from retained earnings. On the basis of the evidence provided, the appellant submitted that it had established on the balance of probabilities that the funds used to purchase the property were from retained earnings and not from the overdraft facility. As a result, counsel contended that the burden had shifted to the Commissioner to show otherwise and it failed to do so.

15. As regards the intended use of funds deposited with the advocates, the appellant submitted that the Commissioner did not provide any shred of evidence on how it came to the conclusion that the funds were used to purchase property for a sister company. On the contrary, the appellant stated that it provided a letter dated 19th November 2013 from its advocates showing that the intended purchase by Tile and Carpet Limited did not materialise and the property was never transferred to the company. The appellant's noted that this correspondence was never challenged and when the appellant was requested to provide further documentation as proof of intended use of the funds, it provided the material to show that the funds were to be utilized for the purchase of the property for the appellant and not a sister company.

16. The appellant complained that despite the explanation, the Tribunal dwelt on an extraneous matter concerning the sale agreement that had not been produced disregarding the fact that the Commissioner had requested for and the appellant had produced a letter and other documentation whose authenticity was not challenged.

17. From the totality of the evidence on record, counsel for the appellant submitted that the appeal should be allowed as the Tribunal failed to consider all the evidence before it to reach the correct conclusions.

Respondent's Submissions

18. The thrust of the Commissioner's case is that the appellant used money it had borrowed from its bankers to lend to its sister or associated company. It stated that part of the interest, which the appellant absorbed, was attributable to the funds lent out and not in the production of its own income. In the circumstances the Commissioner was right to apportion the interest claimed and disallow the proportion that related to the funds lend to the sister company.

19. In answer to the appellant's contention that it used the money deposited with its advocate which came from retained earnings, the Commissioner submitted that the availability of retained earnings in the appellant's book of account does not translate in liquidity. The Commissioner argued that the appellant had over Kshs. 1,000,000,000/= in retained earning but this did not prevent it from borrowing to

finance other activities.

20. The Commissioner also argued that the funds deposited with the appellant's advocate were not available to it as working capital which was contrary to the main purpose that the appellant obtained the loan. In the circumstances, it submitted that the interest accrued from the loan borrowed as working capital should be brought to charges in accordance with **section 16(1)(a)** of the ***ITA***.

21. As regards the true purpose of the borrowed funds, the Commissioner submitted that the appellant had produced a Memorandum of Understanding between itself and Bookman Properties that was neither signed nor dated. That it failed to produce evidence showing the true purpose of the borrowed funds either through a sale agreement between a vendor and purchaser or an initial understanding with its advocates.

22. It submitted that the appellant was advancing funds to a sister company while it was maintaining huge credit facilities with banks and incurring large interest expense. It could not prove that it had sufficient retained earnings to finance additional investments and that the amounts deposited with the advocates was not available as working capital. The Commissioner maintained that the borrowed funds were obtained for the purpose of purchasing of property for its sister company which did not materialise and the funds returned and that at all times the money was not available for working capital.

23. In conclusion counsel for the Commissioner submitted that the appellant had not discharged the burden of proof under **section 56(1)** of the ***Tax Procedures Act*** which provides that the taxpayer bears the burden of proving that a tax decision is incorrect. Relying on ***Oceanfreight (EA) Limited v Commissioner of Domestic Taxes*** **[2018] eKLR** and ***Sheria Sacco Limited v Commissioner of Domestic Taxes*** **ML HC ITA No. 36B of 2017 [2019] eKLR**, the Commissioner submitted that the appellant did not discharge its burden hence the appeal should be dismissed.

Determination

24. In considering this appeal, this court is guided by **section 56** of the ***Tax Procedures Act*** which provides as follows:

> 56.(1) In any proceedings under this Part, the burden shall be on the taxpayer to prove that a tax decision is incorrect.
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> (2) An appeal to the High Court or to the Court of Appeal shall be on a question of law only.
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> (3) In an appeal by a taxpayer to the Tribunal, High Court or Court of Appeal in relation to an appealable decision, the taxpayer shall rely on the grounds stated in the objection to which the decision relates unless the Tribunal or Court allows the person to add new grounds. [Emphasis mine]

25. Before I consider the basis of this appeal, it is worth dealing with the limitation of this court in so far as the court's jurisdiction is limited to, "*a question of law only.''* In ***Attorney General v David Marakau*** **[1960] EA 484** the court held that a decision is erroneous in law if it is one to which no court could reasonably come to which is the same thing as a decision of fact in which there was no evidence to support. Recently, the Supreme Court, in reference to appeals in election petitions under **section 85A** of the ***Elections Act***, the Supreme Court dealt with what constitutes matters of law in ***Gatirau Peter Munya vs Dickson Mwenda Kithinji & 2 others*** (Supra) as follows:

> [81] Now with specific reference to Section 85A of the Elections Act, it emerges that the phrase "matters of law only," means a question or an issue involving:
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> a. the interpretation, or construction of a provision of the Constitution, an Act of Parliament, Subsidiary Legislation, or any legal doctrine, in an election petition in the High Court, concerning membership of the National Assembly, the Senate, or the office of County Governor;
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> b. the application of a provision of the Constitution, an Act of Parliament, Subsidiary Legislation, or any legal doctrine, to a set of facts or evidence on record, by the trial Judge in an election petition in the High Court concerning membership of the National Assembly, the Senate, or the office of County Governor;
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> c. the conclusions arrived at by the trial Judge in an election petition in the High Court concerning membership of the National Assembly, the Senate, or the office of County Governor, where the appellant claims that such conclusions were based on "no evidence", or that the conclusions were not supported by the established facts or evidence on record, or that the conclusions were "so perverse", or so illegal, that no reasonable tribunal would arrive at the same; it is not enough for the appellant to contend that the trial Judge would probably have arrived at a different conclusion on the basis of the evidence.

26. The matter was further elucidated by the Court of Appeal in ***John Munuve Mati v Returning Officer Mwingi North Constituency & 2 others*** **[2018] eKLR** where it stated that "*matters of law*" means:

> [T]he interpretation or construction of the Constitution, statute or regulations made thereunder or their application to the sets of facts established by the trial Court. As far as facts are concerned, our engagement with them is limited to background and context and to satisfy ourselves, when the issue is raised, whether the conclusions of the trial judge are based on the evidence on record or whether they are so perverse that no reasonable tribunal would have arrived at them. We cannot be drawn into considerations of the credibility of witnesses or which witnesses are more believable than others; by law that is the province of the trial court." [Emphasis mine]

27. These decisions do not suggest that the appellate court should not consider the evidence on record at all. Where the issue is misapprehension of evidence, leading to a perverse decision or ignoring material evidence or basing a decision of extraneous evidence

amount to points of law that may be taken up on appeal.

28. This case concerns the application of **sections 16(1)(a)** of the ***ITA*** which provides as follows:

> 16.(1) Save as otherwise expressly provided, for purposes of ascertaining the total income of a person for a year of income, no deduction shall be allowed in respect of –
>
> (a) Expenditure or loss which is not wholly or exclusively incurred by him in the production of the income;

29. There is no dispute about the interpretation or construction of **section 16(1)(a)** of the ***ITA***. What is in issue is its application to the facts and evidence available to the Commissioner and the Tribunal to reach the conclusion disallowing the interest expense on account on the money deposited by the appellant with its advocates.

30. The Commissioner disallowed the interest attributable to funds lent to its associated company to buy land as the same was not wholly and exclusively incurred by the appellant in production of its income within **section 16** of the ***ITA***. The decision was based on two grounds; First, that the appellant deposited money with its advocate to facilitate the purchase of a property for its associated company and second, that while the appellant was maintaining huge credit facilities with the banks and incurring large interest expense, it was lending its sister company money from the borrowing and that the money was not available to it for generating its income.

31. At the hearing before the Tribunal, the appellant was given the opportunity to furnish additional documents to support its case. On 21st March 2016, the appellant furnished the following documents:

> 1. Loan agreements for short and long term loans as reported in the appellant's audited accounts and balance sheet as at 31st March 2011.
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> 2. Correspondence either through electronic mail or otherwise exchanged between the appellant and their lawyer as regards the monies that were deposited with the lawyers.
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> 3. Support documentation showing deposit of monies with lawyers and subsequent refund to the appellant.
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> 4. Copies of the profit and loss account of the appellant as at 31st March 2011.
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> 5. Copies of the respondent's letter of 21st October 2013.

32. It is these documents that warrant examination to determine whether the decision of the Tribunal was reasonable and not perverse within the meaning of **section 56(2)** of the ***Tax Procedures Act***.

33. The appellant produced letters from its banker, I & M Bank Limited ("the Bank") confirming that the appellant had credit facilities with it. In the letter dated 19th January 2011, the appellant acknowledged that as at 18th January 2011 it was indebted to the Bank as follows;

Overdraft	Kshs. 117,738,259.07 DR
Term Loan 3	Kshs. 65,000,000,14
Term Loan 4	Kshs. 41,666,666.83
Term Loan 5	Kshs. 66,666,666,68
Term Loan 6	Kshs. 241,666,666.68
Letter of Credit	USD 1,132,418.83
Letter of Credit	Euro 174,680.87
Letters of Guarantee	Kshs. 1,510,698.00

34. The letter dated 20th June 2010 shows that Term Loan 5 was for the purchase of three plots under LR Nos. 15447, 14448 and 15450 Mainland North, Mombasa construction of a go-down and showrooms for use by the appellant. The letter dated 21st October 2010 shows that Term Loan 6 was to finance capital expenditure and working capital requirements for the borrower's water tanks manufacturing unit. The letter dated 10th March 2009 was for Term Loan 3 and 4 to finance purchase of property LR Nos. 104426/49, 10425/50 and 10426/51 – Mavoko Municipality and expansion of existing manufacturing plants of rotational moulding and purchase of a new plant to manufacture PVC flooring respectively.

35. The correspondence produced by the appellant comprised the following documents; A letter dated 19th November 2013 regarding the purchase of LR No. 11895/42 – Nairobi from *Harit Sheth Advocates* to the appellant stating that the intended purchase by the appellant did

not materialise and the property was never transferred to the Company. It confirmed that the money deposited by it was transferred back to the appellant. The appellant produced an undated and unsigned Memorandum of Understanding between Brookman Properties Limited, Apex Business Park Limited and Tile and Carpet Developments Limited. The nature of the MOU was that Brookman was the owner of LR No. 11895/45 and proposed to sell shares in the company to Apex Business Parks Limited and Tiles and Carpet Developments Limited for Kshs. 287,500,000/=. In a letter dated 6th October 2010 referenced, *"Completion Statement"* from *Harit Sheth Advocates* stated the amount of Kshs. 273,592,500/= being the purchase price, stamp duty, professional fees, VAT etc and added that, *"The above amount is being advanced by way of a loan to Bookman Properties Limited by Apex Parks Limited and Tile and Carpet Developments Limited in equal shares namely Kshs. 136,796,250/=."* A similar "Completion Statement" addressed to Apex Business Parks Limited calling for Kshs. 28,807,500/= and stating that, *"Each party is required to pay 50% namely Kshs. 14,403,750/= being contribution towards share purchase."*

36. In addition, the appellant attached evidence of forwarding the amount to *Harit Sheth Advocates* which included the instruction to the Bank to transmit the money to the advocates, copies of the cheques accompanying the instructions and the bank statement confirming that the money was refunded in the appellant's account.

37. At Pages 51, 52 and 53 of the record of appeal, the appellant attached the following documents from its Consolidated annual report and financial statement for the year ended 31st March 2011; Schedule of Trading and Manufacturing Account, Schedule of Other Operating Income and Expenditure and Schedule of Other Operating Income and Expenditure.

38. The letter dated 31st October 2013 from the respondent to the appellant was merely reiterating its position in the matter.

39. I have reviewed the evidence furnished by the appellant in light of its burden to show that the tax decision was wrong. On whether the appellant furnished sufficient evidence to demonstrate the purpose of the loan, I find that the letter from the Bank confirmed that it had credit facilities. Each letter of offer, in my view, constitutes an agreement as it is signed by the appellant's directors. In that respect the Tribunal was wrong to come to the conclusion that the documents were insufficient or that they did not show the purpose of the facility. As I have illustrated above, each letter of offer shows the purpose of each loan facility. It is worth noting that none of the letters mention LR No. 11895/42 – Mavoko Municipality. It is therefore clear that the facilities were not taken for the purpose of financing purchase of that property or at any rate LR No. 11895/42 – Mavoko Municipality.

40. I note that the letter from *Harit Sheth Advocates* dated 19th March 2013 was written to the appellant in 2013, two years after money was refunded in March 2011. It states that, *"the intendent purchase by Tile and Carpet Centre Limited did not materialise and the Property was never transferred to the Company."* The other documents, whose contents I have summarised tell a different story. The nature of the transaction evidenced by the MOU was that Tile and Carpet Developments Limited and another company were purchasing shares in Brookman Properties Limited which was purchasing LR No. 11895/42 from Knebworth Investments Limited which owned that property. The documents evidencing the transaction had nothing to do with the appellant and the advocates letter coming years later did not clarify the matter at all. This is why the Tribunal was asking for other documents like a sale agreement which would have confirmed what the letter from the advocates was saying. In this respect the Commissioner and Tribunal came to the correct conclusion that the money deposited with the advocates was not for the purpose of purchasing property for the appellant.

41. I have also looked at the cheques supporting the RTGS transfer of Kshs. 149,351,250/- and Kshs. 15,937,500/- on 19th October 2010 and 29th July 2010 respectively were drawn on the appellant's account at the Bank being account number **0172991201**. The evidence that the money was received was evidenced by Bank statements showing that *Harit Sheth Advocate* refunded the money in two instalments to account no. 0010**0172991201**. According to the statement the account type is titled, ***"OVERDRAFT ACCOUNT KES."*** This is the same account that the appellant drew the cheques that supported the transfer of money to its advocates. This money did not come from its reserves or retained earnings, it came from the overdraft account.

42. The above evidence displaces the argument that the amount deposited from the advocates came from the retained earnings. Even if the appellant had sufficient reserves, the evidence shows that the money came from the overdraft account and was refunded to the overdraft account. I read and re-read the record of appeal and the documents annexed which I have set out above and they do not show retained earnings were available as cash for investment. Nothing would have been easier than to provide a statement of account to show that the appellant was sitting on substantial cash reserve. The Commissioner and the Tribunal were right to conclude that if the appellant was cash rich, it would not have taken out facilities to the extent that it was heavily indebted.

Conclusion

43. From the totality of the evidence, I do not think the conclusions of the Commissioner and the Tribunal could not be supported by the evidence or were perverse. The appellant did not discharge its burden to show that the tax decision was wrong. There was sufficient evidence to show that the purpose of the borrowing was not, *"wholly and exclusively incurred"* by the appellant for the production of income. That money came from the overdraft account; it was deposited with its advocate for the benefit of another company hence it was not available for the appellant for its working capital during that period. The Commissioner was entitled to disallow the interest expense under **section 16(1)(a)** of the ***ITA***.

Disposition

44. For the reasons I have stated, I dismiss the appeal with costs to the respondent.

DATED and **DELIVERED** at **NAIROBI** this **31st day of MARCH 2020.**

D. S. MAJANJA

JUDGE

ORDER

In view of the declaration of measures restricting court operations due to the COVID-19 pandemic and in light of the directions issued by his Lordship, the Chief Justice on 15th March 2020, this ruling has been delivered to the parties online with their consent. They have waived compliance with **Order 21 rule 1** of the ***Civil Procedure Rules*** which requires that all judgments and rulings be pronounced in open court.

D. S. MAJANJA

JUDGE

Court Assistant: Mr M. Onyango.

Mr Wakwaya instructed by Rachier and Amollo Advocates for the appellant.

Ms Naeku, Advocate instructed by the Commissioner of Domestic Taxes.