Commissioner of Domestic Services v Dutch Flower Group Kenya (Income Tax Appeal E101 of 2020) [2021] KEHC 23 (KLR) (Commercial and Tax) (10 September 2021) (Judgment)

Neutral citation: [2021] KEHC 23 (KLR)

REPUBLIC OF KENYA

IN THE HIGH COURT AT NAIROBI (MILIMANI COMMERCIAL COURTS)

COMMERCIAL AND TAX

INCOME TAX APPEAL E101 OF 2020

A MABEYA, J

SEPTEMBER 10, 2021

BETWEEN

COMMISSIONER OF DOMESTIC SERVICES ..... APPELLANT

AND

DUTCH FLOWER GROUP KENYA ..... RESPONDENT

(Being an appeal from the judgment of the Tax Appeals Tribunaldated 6/8/2020 in Tax Appeals Tribunal Appeal No. 9 of 2018 (consolidated with 84 of 2018))

JUDGMENT

1. On 11/12/2017, the appellant issued its objection decision to the respondent whereby it disallowed input VAT amounting to Kshs.6,085,237.54. The appellant noted that it considered the respondent an agent of Flower Retail Europe B.V (hereinafter 'FRE') therefore in line with the judgment in *Cofftea Agencies Ltd v KRA* , an agent cannot claim the principal's inputs.

2. The respondent appealed against that decision to the Tax Appeals Tribunal ("the Tribunal") which allowed the same vide its judgment of 6/8/2020. The Tribunal made a finding that there was no agent-principal relationship between the respondent and FRE and the respondent was therefore entitled to input VAT refund claimed.

3. Dissatisfied with that decision, the appellant has appealed to this Court on 10 grounds which can be summarized into two as follows: -

    a) That the Tribunal erred in failing to recognize that the service agreement between Flower Retail Europe B.V and the respondent created an agent-principal relationship.

b) That the Tribunal erred in finding that all services, without exception, offered by the respondent could be considered exported services; and that it was not providing horticultural services, which are exempt services under Paragraph 5, Part II of the First Schedule to the VAT Act 2013 and not zero-rated.

4. The respondent opposed the appeal vide its statement of facts dated 6/11/2020. It contended that vide a service agreement with FRE, it was a service provider providing logistical services in the importation of flowers from Kenya to the Netherlands. That the said agreement did not create any agency relationship between the two.

5. It further contended that all costs incurred by it were for the purpose of deriving its income and FRE did not reimburse it on those costs. That as a registered person under the VAT Act, the respondent deals in exported services to FRE and FCH, which are zero rated services under the VAT Act 2013 thereby entitling it to claim input VAT.

6. The Court has considered the contentions of both parties. The first ground was that the Tribunal erred in failing to recognize that the service agreement between FRE and the respondent created an agent-principal relationship. The appellant's position was that, the said agreement created an agency relationship between the two. That the clause on prices and payment was clear that the costs incurred were those of the principal and not the respondent.

7. On the other hand, the respondent's contention was that it was a service provider providing logistical services to FRE for the importation of flowers from Kenya. That FRE paid a service fee to the respondent for the said services plus a markup and that the same was not a reimbursement on the costs incurred.

8. Agency is defined in *Black's Law Dictionary 10th Edn,* as;

> " A relationship that arises, when one person (principal) manifests assent to another (an agent) that the agent will act on the principal's behalf, subject to the principal's control, and the agent manifests assent or otherwise consents to do so. ...".

9. It is clear that what creates an agency relationship is the degree of control that the principal retains in what the agent does on its behalf. In this regard, where parties in a relationship envisage and agree that one will retain some control over another in the latter's conduct or execution of some duty, an agency relationship is created. It matters not what the parties call that relationship. It is the legal effect that arise from their relationship that will count.

10. In the present case, the service agreement dated 10/12/2011 (found at page 460-463 of the Record of Appeal) referred to FRE as the 'Principal' and the respondent as the 'Service-Provider'.

11. It further provides at page 2 thereof that: -

> " - The service-provider's fee ("service fee") for the service shall be determined on a cost-plus base, being the Service-Provider's cost of providing the service (the 'costs') times a percentage of 5% per year.

During the year the Service Fee shall be invoiced on a provisional basis according to year forecast and year expense budget agreed between the Principal and Service Provider at the beginning of the year.At the End of the Financial year the Principal shall evaluate the difference between the total sum invoiced to the Principal based on the provisional Service Fee charged during the year; and the amount that would have been invoiced had the Service Fee been calculated according to actual Costs. The Service

Provider shall issue the Principal with a credit or debit note for the amount of the difference such that the Service Provider's income for the year is corrected to Costs plus an an actual basis plus 5%.For the purpose of the agreement "cost" shall mean the full cost of service in relation to the service as shall be calculated from time to time on the basis of the service provider's books and ledgers.The costs shall be the sum of: direct labour costs including social security and payroll taxes; cost of accommodation and indirect overheads including but not limited to: indirect labour, quality control, travelling cost, assurance and insurance and administration and finance." Emphasis provided.

12. I have quoted the said agreement in extenso so as to capture the full meaning and tenor thereof. It is clear from the aforesaid clause on 'Prices and payment' that FRE exercises a considerable degree of control over the respondent on the issue of costs. That in providing the services contracted, both FRE and the respondent agree at the beginning of the year on a budget.

13. After agreeing on the annual budget, the respondent raises invoices on a provisional basis based on the pre-determined budget and expense with FRE. The invoice contains the actual cost of the service plus a 5% mark up. The cost of the service has also been pre-determined in the agreement itself. The respondent cannot freely incur any cost that is neither set out in the said agreement nor not approved by FRE.

14. The Court's conclusion is that, notwithstanding the wording of the agreement, the net effect is that the respondent is an agent of FRE. A clear agency relationship is created by the said agreement as FRE retains control over the respondent in the nature of the business the two are engaged on. That is the reason why FRE has the right under the agreement 'to inspect the books of the Service Provider at first request' in the event there is doubt as to the cost incurred by the respondent. It is unheard of where an independent entity will have to inspect the books of accounts of another entity to ascertain what costs have been incurred for purposes of re-imbursement.

15. Further, the relationship between the two are such that, all the costs incurred by the respondent are those of FRE. This is so because, the agreement itself spells out that in the event the invoices raised by the respondent provisionally and paid by FRE exceeds the actual cost incurred in any year of operation, FRE is entitled to a credit from the respondent. Why would a consumer of a service control the actual expenses of a service provider if the latter was not its agent or subject to it in the execution of the services contracted? The answer is such control presuppose an agency relationship such that the principal is able to control the costs of execution of the services contracted for.

16. In view of the foregoing, I firmly hold that notwithstanding that the agreement does not expressly state that the respondent is a commission agent of FRE, the net effect of the clauses, set out above, which spells the relationship between the two, the two are in an agency relationship. The income of the respondent is controlled by FRE in that, the two agree at the beginning of the year on a budget on the cost for which FRE pays the same to the respondent plus 5% thereon as the income for the latter.

17. Accordingly, the Tribunal erred in holding that there was no agency relationship between the two. The costs of the respondent in providing the services to FRE are those of the latter. They are either paid in advance by FRE through settlement of the provisional invoices or they are reimbursed in full plus 5% as per the agreement.

18. That being the case, allowing the respondent to claim in put VAT would be to allow it to claim a cost belonging FRE and not itself. The appellant was right in declining the claim. That ground succeeds.

19. The second ground was that the Tribunal erred in finding that all services, without exception, offered by the respondent could be considered exported services and that the respondent was not providing

horticultural services, which are exempt services under Paragraph 5, Part II of the First Schedule to the VAT Act 2013 and not zero-rated.

20. The relevant statutory provisions include Section 7 of the VAT Act which states:

> "(1) Where a registered person supplies goods or services and the supply is zero rated, no tax shall be charged on the supply, but it shall, in all other respects, be treated as a taxable supply.
>
> (2) A supply or importation of goods or services shall be zero-rated under this section if the goods or services are of the description for the time being specified in the Second Schedule."

21. Paragraph 1 of Part A of the Second Schedule of the VAT Act 2013 provides that 'the exportation of goods or taxable services shall be zero rated.' Section 2 of the VAT Act 2013 defines 'service exported out of Kenya' as a 'a service provided for use or consumption outside Kenya'.

22. The appellant's contention was that not all services the respondent offered could be termed as exported services. That the respondent offered horticultural services which are exempt under the law. On the other hand, the respondent contended that its services were consumed by the end users of the flowers in the Netherlands and therefore qualify as an exported service hence zero rated under the second schedule of the VAT Act.

23. The Court has seen the service agreement and what it provides as services for which the respondent was contracted to offer. Most of them are but exported. However, there is one which is doubtful. The fourth service is: -

> " To provide all the suppliers with the correct packaging requirements especially sleeves, flower food, labels etc. These consumables must be to the exact specifications required by the Principal's customers. The service provider will create a Team within Progress to address these tasks called consumables".

24. The foregoing task and or service, although meant to shape the final product to the specification of the final consumer in the Netherlands, the services are directed at and consumed by the suppliers. The services are consumed locally by the supplier of the subject flowers. So that the end product is to the specification of the consumer. The value is not consumed by the person in Netherlands but the supplier locally.

25. In this regard, the complaint by the appellant cannot be said to be without basis. In this regard, not all the services offered by the respondent can be held to be wholly exported.

26. As regards whether the services offered by the respondent are horticultural or not, there is nothing to suggest that they are. The simple definition of horticulture, from which the term horticultural services arise in the second schedule, will show that the services offered by the respondent do not extend there.

27. In view of the foregoing, I find the appeal to be meritorious and I allow the same as prayed. The appellant shall have the costs of the appeal.

It is so decreed.

DATED AND DELIVERED AT NAIROBI THIS 10TH DAY OF SEPTEMBER, 2021.

A. MABEYA, FCI Arb

JUDGE