REPUBLIC OF KENYA

IN THE HIGH COURT OF KENYA AT NAIROBI

INCOME TAX APPEAL NO. 12 OF 2017

SUNMATT LIMITED.....PPELLANT

VERSUS

THE COMMISSIONER OF DOMESTIC TAXES.....RESPONDENT

(From the decision of the Tax Appeals Tribunal in the Nairobi Tribunal Appeal No.6 of 2015 delivered on 9th December 2016)

JUDGMENT

1. The appellant herein SUNMATT LIMITED being aggrieved by the decision of the Tax Appeals Tribunal delivered on 9th December 2016 has appealed to this court on the following grounds -

1. That it was not open to the Tax Appeals Tribunal to find that the Merchant Agreement between the appellant and Cybercash Card Ltd (Cybercash) was not a sale agreement.

2. That the Commissioner of Domestic Taxes and the Tax Appeals Tribunal fundamentally misapprehended the proper nature of the transaction between the appellant and Cybercash and thereby wrongly assessed the payment made to Cybercash as payments for management services and not consideration for the sale of points.

3. That the Commissioner of Domestic Taxes and the Tax Appeals Tribunal misconstrued the provisions of paragraph 2 of the Merchant Agreement entered into between the appellant and Cybercash which provided that "The merchant shall award loyalty points on goods and services to any cardholders or redeem loyalty points upon presentation of a valid card and if necessary evidence of his/her identity" to mean that the appellant does not buy goods from Cybercash.

4. That the Tax Appeals Tribunal failed to take into account the fact that the points awarded to the cardholders on the promise of paragraph 2 of the Merchant Agreement, were actually purchased from Cybercash. Moreover, payment was made for the same as provided for by paragraph 4 of the Merchant Agreement on the basis of points awarded or redeemed. At no particular time was payment made for service offered.

5. That the Tax Appeals Tribunal misapprehended the import of the fact that Cybercash as part of its obligations under the Merchant Agreement, installed its own infrastructure at the premises of the appellant.

6. That while raising its assessment, the Commissioner of Domestic Taxes placed reliance on section 2 of the Income Tax Act which defines management or professional fee as **"….a payment made to a person other than a payment made to an employee by his employer, as consideration for managerial, technical, agency, contractual, profession or consultancy service however calculated…"** The payments made to Cybercash by the appellant, cannot be deemed to be payments for management services for purposes of section 2 of the Income Tax Act since no such service was rendered.

7. That section 35(3) of the Income Tax Act which provides that **"… A person shall, upon payment of an amount to a person resident or having a permanent establishment in Kenya in respect of - (f) management or professional fee or training fees the aggregate value of which is twenty – four thousand shillings or more in a month …."** Will only be applicable if and when a payment is for management service that has been rendered. This is not the case at hand.

8. That in any event, the Tax Appeals Tribunal at paragraph 7 of the Ruling erred by stating that **"….the appellant entered into the agreement with Cybercash Card Limited to install equipment in their shops/premises so that the latter can register and issue loyalty/reward cards to the appellant customers …"** This is false in all material particulars. The Merchant Agreement was entered into for purposes of the sale of loyalty points and not a contract for installation and hire of equipment. It therefore cannot be considered to be a management service for the purposes of section 2, 35(3) (i) and the Third Schedule of the Income Tax Act.

2. Relying on the above grounds of appeal, the appellant requests this court to allow the appeal, set aside the assessments of the Commissioner of Domestic Taxes dated 10th May 2013 and the decision of the Tax Appeals Tribunal dated 9th December 2016, with costs and grant any other or further orders and relief.

3. The appeal proceeded by way of filing written submissions. The appellant through counsel M/s Oraro & Company filed their written submissions on 10th December 2018, while the respondents through counsel Marigi John filed written submissions on 31st July 2019. Thereafter, the appellant's counsel filed a response to the respondent's submissions on 10th September 2019, and parties counsel also highlighted the submissions in court.

4. Ms Onchwari who appeared for the appellant orally submitted that the bone of contention was the finding of the Tax Appeals Tribunal that the appellant was liable to pay withholding tax herein. Counsel highlighted that the appellant entered into a contract with Cybercash Card Ltd for purchase of loyalty points which the appellant intended to reward its customers as part of its marketing strategy – which agreement was described as a Merchant Agreement. Clause 4 of the agreement provided that the merchant (appellant) shall pay Cybercash Ltd Kshs. 3 for every point awarded by the appellant, and in turn Cybercash Ltd shall pay to appellant Kshs.2 for every point redeemed by the appellant. Under clause 9, for purposes of reconciling the payments for the loyalty points the appellant was required to generate a monthly points awarded report and forward same to Cybercash Ltd.

5. Counsel further submitted that after the respondent conducted an audit on 01/03/12, they raised a withholding tax demand for Kshs.1,122,303/= on the false premise that the payments to Cybercash Ltd were management fees for management services allegedly performed for the appellant by Cybercash Ltd. An objection was made by the appellant, and the respondent amended the tax assessment to Kshs.965,862/= which was the genesis of this appeal, as the Tax Appeals Tribunal upheld the said assessment.

6. Counsel contended that it was not true that Cybercash Ltd rendered management services to the appellant as alleged by the respondent, and that the transaction in question was a sale of loyalty points. In this regard, counsel relied on section 2 of the Income Tax Act which defined management fees but did not define management services, the relevant part of which provides as follows –

> *"… management or professional fee" means a payment made to a person, other than a payment made to an employee by his employer, as a consideration for managerial, technical, agency, contractual, professional or consultancy service however calculated …"*

7. Counsel relied also on the minority reasoning and findings of Visram J. A in the case of **Stanbic Bank Ltd – vs – Kenya Revenue Authority [2009]eKLR** and the Oxford English Dictionary on the definition of a manager and stated that Cybercash Ltd could only have been taken to render management services if it had control or administered the appellant's business, which in the present case it did not. According to counsel, though as per the agreement every transaction was to go through an electronic point of sale provided or approved by Cybercash Ltd, that did not render the transaction a management service.

8. Finally, counsel urged that the principle of sanctity of contact entered into between the parties which was an agreement for sale, should be honoured and relied on paragraph 12 to 60 of the book Chitty on Contracts – and said that it was not open to the court to revise the terms of a written contract between parties. Counsel also relied on the case of **Ephraim Kubai – vs – Kenya Breweries Ltd [2011]eKLR** and stated that the fact that the payment from the appellant to Cybercash Ltd were reflected as marketing fees did not affect the clear contractual terms of the written agreement between the parties.

9. Mr. Marigi for the respondent in response submitted that upon scrutiny the respondent found that the monthly payment arrangement herein could only be described as management fees under section 2 of the Income Tax Act, as Cybercash Ltd were not employees of the appellant.

10. Counsel submitted that though the appellant appealed the respondent's tax assessment to the Tax Appeals Tribunal and presented two witnesses, the Tribunal found that there was no supply of virtual goods by Cybercash and as such the relationship between the appellant and Cybercash Ltd was for provision of management services.

11. With regard to the provisions of the written contract herein, counsel pointed out that paragraph 6 of the Merchant Agreement provided that the merchant (appellant) was to seek authorization from Cybercash, and the merchant was also bound to honour all cards issued by Cybercash. According to counsel, since the words used were that the merchant "shall" comply with, that meant that Cybercash was in control or managing the transactions.

12. Counsel relied on the majority (two judges) opinion in the case of **Stanbic Bank Ltd** (supra) especially the reasoning of Nyamu J. A, with regard to what constituted technical service, which in counsel's view applied in the present case.

13. Though counsel agreed that court are to give effect to the intention of the parties to a written contract; counsel stated that in the present case, since the appellant's witnesses were not able to explain what constituted virtual goods, the contract was a management contract, and emphasized that Article 2(1) and 10 of the Constitution of Kenya 2010 requires that taxes must be paid.

14. Counsel added that since there was no legal definition of virtual goods in Kenya - the court has to be very careful on this issue as the court might be legislating through the bench, and added that even developed countries did not recognize virtual goods, but only intellectual property.

15. Counsel concluded by stating that the court should properly interpret and apply the provisions of section 2 of the Income Tax Act, as Cybercash Ltd was not an employee of the appellant but was providing technical services.

16. In response, Ms Onchwari stated that the appellant was not circumventing payment of taxes and added that the fact that the payments

were made monthly did not prove provision of management services.

17. Counsel also stated that the invoices were credit sales and distinguished the case of **Stanbic Bank Ltd** as what was in issue therein was not whether it was sale of goods or management services, but the distinction between management services and technical services, and that was the reason why the appellant relied on the reasoning of Visram J. A.

18. Counsel concluded by stating that there was no issue of intellectual property herein as alleged by the respondent, and maintained that virtual goods were recognized in law as stated in the English case of **Loyalty Management UK Ltd – vs – HM Revenue & Customs [2007]EWCA Civ.965.**

19. I have considered the appeal, documents filed and the submissions of counsel both oral and written. I have perused the proceedings of the Tax Appeals Tribunal and the judgment. In my view the issues herein are what the Tribunal found to be issues.

20. The first issue is whether what the appellant received from Cybercash Ltd was a virtual good. The written contract dated 25th September 2005 did not use the words "virtual" or "goods". It did not refer to written law or any International Convention that has a reference to virtual goods. None of the two contestants herein has stated that there is any reference to those two words. None of the parties has suggested that there in any legal definition of virtual goods in Kenya. Arguments have however been made both in the Tax Appeals Tribunal and in this court that the goods sold were virtual good, which the respondent has contested.

21. What the appellant received from Cybercash Ltd is in the contract. The contract is written in simple clear terms. Under clause (1) of the contract the appellant was to receive cardholders of Cybercash Card Ltd as customers, to whom the appellant under clause (2) was to award loyalty points or redeem loyalty points. Under clause (4) the appellant was to pay Cybercash Ltd Kshs.3 for every loyalty point awarded (by the appellant), and later Cybercash was to repay the appellant Kshs.2 for every loyalty point redeemed by the appellant. Under clause 11 Cybercash was to supply equipment to the appellant premises for facilitation of the points award and redeeming process. Under clause 9 the appellant was to prepare and submit to Cybercash Ltd a monthly points award report with the settlement cheques.

22. The appellant's counsel has argued that Cybercash Ltd supplied virtual goods to the appellant in this contractual arrangement and has relied on the case of In **Loyalty Management UK Ltd – vs – HM Revenue & Customes [2007] EWCA Civ 965 – the English and Wales Court of Appeal**. The respondent says no virtual goods were supplied and that the arrangement was a management contract.

23. I note that in the above cited English case the terms "virtual goods" do not appear to have been defined. The appellant however maintains that the terms of clause (4) of the agreement herein which tended to be an agreement for the purchase of reward points shows that it was an agreement for sale of virtual/goods. In my view, even though the agreement was a sale and purchase arrangement, it was not an agreement for sale of virtual goods as such was not mentioned anywhere in the signed agreement, and there is no law in Kenya providing that a sale and purchase of reward points amounts to sale of virtual goods. I find however that as per the agreement Cybercash Ltd was to sell award points which were to be awarded by the appellant, and paid for at the price of Kshs.3/= and when redeemed by the same appellant, the same Cybercash Ltd pays back Kshs.2/- to the appellant thus retaining a net of Kshs.1/=.

24. In saying this I rely on the provisions of sections 2 of Sale of Goods Act (Cap.32), which does not close the definition of goods. The definition of goods is open and provides as follows –

> *"goods" includes all chattels personal other than things in action and money and all emblements, industrial growing crops and things attached to or farming part of the land which are agreed to be severed before sale or under a contract of sale.*

25. In my view therefore if the appellant and Cybercash agreed in writing to sale and purchase of loyalty points which are, physical and ascertainable, one cannot say that such goods are not recognized in Kenya, unless the parties themselves are in dispute, which is not the case herein. The finding of the Tribunal therefore that the appellant did not buy goods from Cybercash was an error.

26. With regard to the issue as to whether the services offered by Cybercash Ltd to the appellant were management services, in my view they were not. Section 2 of the Income Tax Act has been relied upon by both appellant's counsel and the respondent's counsel with respect to payments of management or professional fee. The relevant part of the section provides as follows –

> *"management or professional fee" means payment made to a person, other than a payment made to an employee by his employer, as consideration for managerial, technical, agency, contractual, professional or consultancy services however calculated"*

27. Management services herein would only arise if control or administration of the activities, of the appellant was by somebody who was engaged to do so and was not an employee. Indeed Cybercash was not an employee of the appellant. There is no dispute about that. What they were providing under the terms of the signed agreement was clear. Cybercash issued cards to prospective customers of the appellant; they provided equipment to the appellant to facilitate the process of effecting the issuance of loyalty points awards and award redeeming activities by the appellant; while Cybercash were to approve any changes. There is no clause in the agreement that shows that Cybercash ran the equipment, or supervised the operations of the loyalty points award issuance and redeeming system. They received payment for points awarded by the appellant and refunded part of the amount for the redeemed points. In my view, Cybercash only played a facilitating role, but did not control or administer the appellant's operations of the award and redeeming systems. The installation of the infrastructure by Cybercash was only to enable the appellant award and redeem loyalty points not to enable Cybercash perform the services of the appellant. The services were thus not in the nature of management services. On this also, in my view the Tax Appeals Tribunal erred.

28. I now turn to the issue whether withholding tax is applicable herein? Since the liability to pay withholding tax arises only from payments for management or professional services which I have found that there were no such services rendered herein, I hold that withholding tax is not payable herein.

29. I must state here that both the appellant and Cybercash Ltd are liable to pay lawful taxes on their incomes and activities, but the appellant in my view is not liable to pay the withholding taxes herein assessed.

30. I thus allow the appeal, set aside the Commissioner (respondent) assessment and the Tax Appeals Tribunal decision herein. Like in the Tax Appeals Tribunal, parties will bear their respective costs of the appeal.

Dated and delivered at Nairobi this 6th February 2020.

GEORGE DULU

JUDGE

In the presence of -

Court Assistant …….

For the plaintiff…….

For the respondent……..