



REPUBLIC OF KENYA

IN THE HIGH COURT OF KENYA

AT MOMBASA

INCOME TAX APPEAL NO. 97 OF 2010

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

VERSUS

COMMISSIONER OF DOMESTIC TAXES.....RESPONDENT

RULING

1. This appeal arises out of the decision of the Income Tax Local Committee decisions made on the 12/4/2010. In that decision the committee held and found that:-

“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 tax of the Appellant.

That the two directors of the company i.e. Messrs Tomna so Castelino were employees of MSC and therefore expenses incurred on their behalf were not allowable against the income tax of the appellant”.

2. Aggrieved by the decision, the Appellant filed this appeal and posed four (4) questions for determination by the court. The four questions are expressed to be:-

(a) Whether Captain Tommaso Castellano and Captain Fiorenzo Castellano are Directors and employees of the Appellant?

(b) Whether the salaries and emoluments paid by the Appellant to Captain Tommaso Castellano and Captain Fiorenzo Castellano are allowable expenses against the income of the Appellant?

(c) Whether the outstanding freight and written off freight are operational expenses incurred by the Appellant in the ordinary course of business allowable expenses against the income of the Appellant?

(d) Whether the Income Tax Local Committee erred in law and fact in deciding firstly 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 the Appellant, and secondly that the two Directors Captain Tommaso Castellano and Fiorenzo Castellano were employees of Mediterranean Shipping Company and therefore expenses incurred on their behalf were not allowable against the income of the Company?

Facts of the case

3. By a tax assessment dated the 21/2/2018, the Respondent assessed tax due and payable by the Appellant to be Kshs.51,319,757/=. On the 20/3/2008 the Appellant through its tax advisors objected to the assessment on the grounds; among others that:-

i) Two persons; Tomaso Castellino and Florenzo Castellino were employees of the Appellant and therefore expenses met on them were allowable expenses for purposes of taxation.

ii) That the company incurred bad debts being unpaid freight charges.

It is the decision on that objection that has given rise to this appeal.

4. In response to the Appeal the Respondent did file a statement of facts and a witness statement by one RAPHAEL MWANGEKA.

5. In those two documents the Respondent take the position that the two named individuals are not employees of the Appellant and that the unpaid freight are not allowable expenses of the Appellant but could be for the Mediterranean Shipping Company S A. The provisions of section 16 of Income Tax Act were cited to restrict and outlaw allowing the two items.

6. Pursuant to directions by the court made on the 26/7/2016 parties did file written submissions. The Appellants submissions are dated 28/11/2016 to and filed on 29/11/2016. The Respondent did file not only submissions dated 26/10/2016 and filed on 27/10/2016 but also reply to the appellants' submissions dated 14/2/2017 and filed on 16/2/2017.

7. I have had the benefit of not only reading the assessment and its reasoning, but I have equally read the letter of objection, the reasons advance for the finding by the Local Tax Committee as submitted by the parties in the submissions filed.

8. There are only two issues that isolate themselves for determination by the court in this appeal. The issues are namely:-

i) Whether Tommasso Castellino and Florenzo Castellino employees of the appellant whose salaries and other emoluments were expenses of the Appellant as envisaged under section 15(i) of the Income Tax Act?

ii) Whether the unpaid debts due to the Appellant qualified for being allowed as expenses of the Appellant?

9. Depending on the evidence presented by the parties, the determination of these issues will determine the propriety of the decision of the Local Tax Committee and therefore whether or not as a first appellate court there is a justification to interfere with the determination of the committee arrived at the trial.

10. The jurisdiction of this court as a first appellate court is now well settled. It is that the court proceeds by way of a retrial and is obligated to reassess and re-appraise all the evidence adduced and to come to own conclusion while being cognizant of the fact that it can only interfere with findings of facts if the same is based on no evidence at all or is arrived at in perversion of the evidence tendered. See *Mwangi vs Wambugu [1984] KLR 453*.

11. Although there are enumerated four(4) grounds of Appeal, in truth and reality, the same can be seen as only two grounds. This is because grounds 1 & 4 relate to one issue of whether or not the two named Castellinos' were employees of the Appellant while grounds 2 & 3 are on the question whether or not the bad debts were deductible or allowable as expenses of the Appellant under section 15(1) of the Act.

12. I will therefore seek to determine the appeal by seeking to answer the two broad questions.

Whether or not Tomnaso and Florenzo Castellino were employees of the Appellant?

13. There was before the committee and in the Record of Appeal at pages 143 and 144 letters dated 15/12/2000 offering employment to the two. The said letters show that the offers were duly accepted by the two. There are also tax Returns for the period 2001 to 2006. The same are at pages 71 to 126 of the Record of Appeal. Those returns in totality and in particular at pages 77,86, 95, 105, 115 and 124 have entries that the two were indeed directors of the Appellant. Equally exhibited are the receipts for submission of the returns.

14. Incoming to the conclusion that it did, the committee did put reliance on the fact that the work permits upto 2007 showed that the two were Representative of Ms. Mediteranean Shipping Company. That position was supported by Ms. Odundo Advocate who made a submissions that the Returns and Letters of employment were irrelevant and that to allow salaries and other emoluments would be in violation of section 16 of the Income Tax Act. To Ms. Odundo the two could only be regarded as employees of the Appellant had there been an agreement for secondment and evidence of such secondment. For that submissions the Respondent went to great length to establish what amount to employment for being dependant upon the level of control. However, in her duty to court Ms. Odundo did well to quote to court the decision in Commissioner of **Domestic Taxes vs Kenya Malting Ltd [2013] eKLR** in which a decision by the Supreme Court of India **in South Africa, Builders Ltd vs Commissioner of Income Tax Appeals**, was cited for the proposition that 'provided that expenditure is voluntarily incurred, it matters not that it is a third party that benefited thereby'. Also cited was the decision in **Everret Aviation Ltd vs Kenya Revenue Authority [2013] eKLR** in which it was held that it is the duty of an employer to deduct and account for the taxes so deducted in the manner allowed by the law.

15. 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.

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

As was well said by Kimondo J, in **Everret Aviation Ltd** [supra] even non-permanent employees, provided they earn income, are bound to pay PAYE. For them to pay PAYE, the employer is duty bound to deduct the tax from the earnings and it would be a contradiction in terms to expect an employer to meet its obligations under section 37 of the Act without first providing for the income as its expenditure to run its business.

17. 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.

18. I find, as a first appellate court, proceeding by way of a retrial, that on the evidence availed the expenditure meet on the two Castellanos were those by the Appellant for the generation of its income for the year of income. The two grounds of appeal (1 & 4) succeeds and the appeal is allowed and the decision of the Local Tax Committee is set aside.

Are bad or doubtful debts written off, allowable?

19. Section 15(2) a provides:-

“ 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 and the Commissioner may prescribe such guidelines as may be appropriate for the purposes of determining bad debts under this subparagraph;**
- (b) amounts to be deducted under the Second Schedule in respect of that year of Income**
- (bb) amounts to be deducted under the Ninth Schedule in respect of that year of income**
- (r) an amount to one-third of the total gains and and profits from employment of an individual who is not a citizen of Kenya”.**

20. In this appeal, the appellant contended that the debts provided are disclosed as bad and or doubtful debts which it sought to apply to reduce its tax obligation.

21. To the contrary, the Respondent took the position, which was accepted by the Local Tax Committee that the debts were due to the Mediteranean Shipping Company S. A , and relied on the Agency Agreement for the position that the Appellant as the agent was forbidden from offering any credit and not to release any bills of landing prior to payment.

22. The agreement is to be found at pages 33 to 59 of the Respondent’s statement of facts. 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 Landing 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”.

23. That provision in the agency agreement simply say that if the agent/ Appeallant 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.

24. 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. I do find that the bad debts, need not be irrecoverable, as the statute says, it is enough that the recovery is doubtful.

25. 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 unsupportable conclusion.

26. The upshot is that the appeal succeeds in whole and the decision of the Local Tax Committee is hereby wholly set aside and in its place substituted an order allowing the objection presented by the

Appellant to the Local Tax Committee.

27. I award the costs of this appeal to the Appellant.

Dated and delivered at **Mombasa** this **12th** day of **May 2017**.

HON. P.J.O. OTIENO

JUDGE