



REPUBLIC OF KENYA
IN THE HIGH COURT OF KENYA AT NAIROBI
COMMERCIAL AND ADMIRALTY DIVISION
INCOME TAX APPEAL NO. 3 OF 2013

SECUREX AGENCIES KENYA LTD.....APPELLANT

• **VERSUS -**

KENYA REVENUE AUTHORITY (THROUGH

THE COMMISSIONER OF DOMESTIC TAXES).....RESPONDENT

JUDGMENT

1. In the year 2009 the respondent (hereinafter *KRA*) carried out an in-depth tax audit of the appellant. It found, among other things, that the appellant owed Kshs 18,480,485 as income tax arrears known as *Pay As You Earn (PAYE)*. The basis of the claim was as follows: the appellant (hereinafter *Securex* or *the Company*) provides security services and related equipments to its clients. The company is a tenant on a property in Parklands area, Nairobi known as L.R. 209/92/2. That property is now registered in the names of Kishori Lal Sahni and Usha Kumari Sahni (hereinafter *the landlords*). The two are father and son. Kishori Lal Sahni is a director of Securex.
2. In 2009, the company erected a storied building or new wing on the property at a cost of Kshs 43,517,159. *KRA*'s case was that a provision in the lease permitting the construction was a scheme to draw off profits from the appellant and to confer a benefit on the landlord director. In a word, it was a stratagem contrived to avoid tax. Accordingly, *KRA* raised tax on the construction amount at 30% including penalties under section 72 D of the Income Tax Act. The gross *PAYE* charged was Kshs 18,480,486.
3. The appellant appealed the decision of *KRA* to the Nairobi Area Local Committee (hereinafter *the committee*). On 4th April 2013, the committee dismissed the appeal. It found as follows:

“The committee reviewed the arguments and studied the distributed documentation including the old and new leases and the accounts for the period in question. It concluded that the Income Tax Act needed to be taken as a whole and that it was clear that the construction, and the lease under which it was authorized, could not be regarded as arm’s length negotiation and hence could be used to convey a ‘benefit advantage, or facility? which should be brought to tax under section 5 (2) (b)’”.

4. The appellant being aggrieved by the decision has appealed to the High Court. The grounds of

appeal are three-pronged:

- i. *“The local committee erred in finding that the construction of the building conveyed a benefit, advantage or facility under section 5 (2) (b) of the Income Tax Act and that the transaction could not be regarded as an arm’s length transaction.*
 - ii. *In addition, the Local Committee erred in finding that the Income Tax Act needed to be construed as a whole without giving any legal basis for so holding. In addition, the Local Committee erred in failing to define the term ‘arm’s length’ within the context of specific provisions of the Income Tax Act.*
 - iii. *The local committee erred in finding that the construction of the building conveyed a benefit to the director under section 5 (2) (b) of the Income Tax Act without giving any reasons for so finding. Further, the local committee erred in finding that there was a benefit accruing to the benefit of director as Clause 6 of the lease agreement for 2007 allowed the appellant to erect structures on the leased land. The buildings would become the property of the landlord upon expiration of the lease. Consequently there was no taxable benefit accruing to the benefit of the director.”*
5. The respondent has replied to the appeal by a statement of facts dated 23rd September 2013. In a synopsis, it states that the appellant and the landlord had executed a five year lease from 2003 to 2007 which was replaced by a further five year lease running to 2012. The latter was replaced by yet another twelve years lease commencing 1st April 2012. The latter lease authorized the construction of the structures and provided that the buildings would revert to the two directors (as the landlords) at the end of the lease. The respondent’s case is that construction commenced in 2009, prior to the 12 year lease. Consequently, the building is an asset and benefit to the appellant’s director. Accordingly, the main director, Kishori Lal Sahni, was enjoying a taxable benefit as known under section 3 (2) and 5 (2) (b) of the Act. Fundamentally, KRA was of the view that there were no arm’s length negotiations over the lease.
 6. On 3rd October 2013, directions were granted to dispose of the appeal by written submissions, the pleadings and materials on record. On 10th February 2014, the parties addressed the court briefly on the salient points arising from their written submissions.
 7. I have considered the pleadings, statements of facts, and rival submissions. Under section 78 of the Civil Procedure Act, the appellate court is conferred with wide powers to re-evaluate the evidence and reconsider the decision of the committee. The pith of the appeal is this: did the expenditure of Kshs 43,517,159 to erect the building on the directors’ property confer a benefit to the director? Paraphrased, was KRA entitled to demand PAYE of Kshs 18,480,486? A subsidiary question is whether the director known as Kishori Lal Sahni was an *employee* or held an *office* in the company and thus falling within the chargeable category of section 5 (2) (b) of the Act.
 8. For starters, it is *not* unlawful for a lessee to construct buildings on the landlord’s premises. I have examined the five year lease executed by the parties in 2007. It appears at page 12 of the record of appeal. It is undated. It is material that the lease was executed by Kishori Lal Sahni as the *sole* proprietor of the demised premises. The 2012 lease is executed together with his son Usha Kumari Sahni as *joint* proprietors. It is not clear when those changes took place. At clause 6 of the 2007 lease, it is expressly provided that *“the lessor has at the request of the lessee agreed to permit the lessee to construct an additional wing on the demised premises at the sole cost of the lessee”*.
 9. The construction was subject to statutory and local authority approvals. In consideration of the investment, the landlord was not to increase the rent. The clause further provided as follows:

“It is specifically agreed by the lessee that such additional wing will remain absolute property of the lessor at the expiry of the term hereby created or sooner determination thereof as the case may be. However if the lessor decides to sell the demised premises including the additional wing constructed by the lessee during the term hereby created a fair proportion of the proceeds of sale will be paid to the lessee as compensation. In case of dispute of fair proportion the decision of the single arbitrator appointed by the Chairman of the Association of the surveyors will be final”.
 10. From the materials and bank statements at pages 19 to 48 of the record of appeal, the appellant regularly paid the agreed monthly rent of Kshs 200,000 to the landlord. The landlords have paid

- tax on the income from the rent. It was also submitted by the appellant that “*Securex is a law abiding tax payer and regularly remits to the respondent on a monthly basis an average of Kshs 19,400,000*”. That fact has not been rebutted by KRA.
11. The allegation at paragraph 7 of the statement of facts by KRA that the construction in 2009 was authorized *retrospectively* in the twelve year lease of April 2012 is *incorrect*. A clause allowing the construction had existed in the undated lease for the year 2007. There is however a key submission that was made to the local committee and considered at page 1 of their ruling of 4th April 2013: “*it was noted that the lease presented as evidence was not stamped and registered pursuant to the relevant statutes*”.
 12. I have examined the 2007 lease appearing at page 12 of the record. It bears a stamp of the collector of stamp duty dated 19th April 2013. Clearly, at the time of the appeal to the committee, the document was *unstamped*. Secondly, and more material, the lease is *not* registered at Lands Office or as an entry against the title. The replacement lease dated 14th February 2013 was only received at the Lands Department on 6th April 2013 as is evident from the receipt stamp number 4 - 554 on the face of the lease. The copy presented to Court appearing at page 2 of the appellant’s statement has *not* been *registered* against the title.
 13. The failure to register the leases does *not* invalidate the relationship between the lessor and lessee: but the legal terrain is fundamentally *altered*. The rights and duties in the instruments of lease only form a simple *tenancy* or contract between the parties. An unregistered lease creates a protected tenancy: a periodic tenancy that can be determined by the dates of the rent. Section 32 of the Registration of Titles Act (now repealed) as well as section 36 of the Land Registration Act 2012 support that proposition. But the leases having *not* been *registered* or *noted* against the title, the buildings erected by the lessee on the directors’ property have been conferred on the landlord directors. In a sense then, the directors have received a benefit from the appellant.
 14. There are two other matters that are material. First, the version of the 2007 lease appearing at pages 12 to 19 is undated. It was stamped for stamp duty on 19th April 2013. That was long after its expiry and when the replacement lease appearing at page 1 of the record had taken effect. I cannot thus fault the local committee for its finding or observation that the instruments of leases were not *stamped* or *registered* as required by statute. The admissibility of those documents as evidence before the local committee was thus moot. Secondly, it is common ground that the *director* of the appellant was also its sole *landlord* in the 2007 lease. I picture Mr. Kishori Sahni on one side negotiating the terms of the lease with the company. I also see him in the latest lease with his son Usha on the same side of the table. Since the director is the mind and will of the company, he would occasionally have to leave his seat to go to the opposite side of the table and answer for the company.
 15. I am alive to the notion that a company is a distinct legal entity independent from its members and directors. *Salomon Vs A. Salomon and Company Limited* (1897] AC 22, *Macaura Vs Northern Assurance Company Ltd* [1925] AC 619 (HL), *The Fort Hall Bakery Supply Company Vs Fredrick Muigai Wangoe* [1959] E.A 474. It is thus possible for a controlling shareholder or director to be a company’s servant or agent. *Lee Vs Lee’s Air Farming Limited* [1961] AC 12.
 16. I express serious doubt that Securex and its landlord director were at *arm’s length* in the negotiations over construction of the new wing on the *directors’* land or the terms of the leases. There are two key reasons: first, having invested about Kshs 43,517,159 on the building, I would have expected Securex to negotiate a *longer* term contract and to ensure its leases were *perfected* and *registered* against the title. Strictly speaking, there would have been nothing to stop the landlords from declining to renew the five year lease in 2012; yet the construction was completed in the year 2009. Secondly, there is a more worrying matter: the land was charged to Giro Commercial Bank as far back as the 2007 lease. This is clear from the memorandum of charges and encumbrances noted on the lease at pages 18 and 19 of the appellant’s statement of facts. Notwithstanding freedom of contract, the company was taking a substantial *risk*. The modern concept of an independent board of Securex was tenuous at best in this transaction. It reinforces my view that the company was conferring a benefit or gain on its landlord director.
 17. The Eighth Schedule to the Income Tax Act provides as follows:

“ 2) For the purpose of this schedule –

- a. A reference to a transfer of property includes a reference to a part transfer of property; and
- b. There is a part transfer of property where, on a person making a transfer, any description of property derived from the transferred property remains undisposed of.

3) For the purposes of this schedule two persons are “related persons” if -

a) Either person participates directly or indirectly in the management, control or capital of the business of other; or

b) A third person participates directly or indirectly in the management, control or capital of the business of both”.

Paragraph 9 (2) of the Seventh Schedule provides that property is acquired or transferred by way of bargain at arm’s length only if the consideration is determined as between an independent willing buyer and an independent willing seller. Ground two of the appeal that impugns the local committee for failing to define *arm’s length* within the context of specific provisions of the Act is thus without foundation.

18.The committee had stated that the Income Tax Act must be construed as a whole. The committee may have been too liberal there. As I shall discuss shortly, a tax statute must have clear provisions charging the subject. There is no window for intendment or analogy. But each provision cannot be read in isolation or selectively. In certain cases, the true meaning of a provision in the Act can only be fully understood within the context of the entire statute. For example, and quite relevant here, section 5 (2) (b) of the Act *expounds* on the meaning of the words *gains* and *profits* in section 3 (2) to include a *benefit* and *advantage*. Ground two of the appeal is thus on a quicksand. It is disallowed.

19.I agree with the appellant that KRA has the *onus* to prove that the statute clearly imposes a charge. See Republic Vs Commissioner of Domestic Taxes ex parte Barclays Bank Nairobi, High Court Misc. App. 1223 of 2007 (unreported), Adamson Vs AG [1933] AC 257, T. M. Bell vs Commissioner of Income Tax [1960] E.A. 224. In particular, I accept the proposition that in a taxing statute, there is no room for *intendment*: There must be a clear letter of law charging the subject. Cape Brandy Syndicate Vs Inland Revenue Commissioners [1920] 1 KB 64. Any ambiguity will also be interpreted in favour of the subject. T. M. Bell vs Commissioner of Income Tax, supra at 441, Inland Revenue Commissioners v Ross & Coulter [1948] 1 ALL ER 616 at 625.

20.The respondent in its indepth audit of 2009 stated in a letter dated 29th July 2009 as follows:-

“Though the company operates proper PAYE system, private expenses in relation to cost of building were incurred over the years, hence charged as benefits to the director. The amount has been brought to charge resulting to a total of Kshs 18,480,485 tax arrears as per attached work sheet and is payable to Income tax - PAYE”.

21.The impugned decision of the local committee that I cited earlier brought the taxation under section 5 (2) (b). In the respondent’s statement of facts, there is further reliance on section 3 (2) of the Act. It is thus important to interrogate further those provisions under which the tax has been raised. Section 3 (2) provides as follows:-

“(2) Subject to this Act, income upon which tax is chargeable under this Act is income in respect of-

a) *gains or profits from-*

i) *a business, for whatever period of time carried on;*

ii) *employment or services rendered;.....*

f) Any amounts deemed to be income of a person made under this act by rules made under the Act.”

Section 5 (2) on the other hand provides as follows:

“5 (2) For the purposes of Section 3 (2) (a) (ii), “gain or profits” includes –

b. Save as otherwise expressly provided in this section, the value of a benefit, advantage, or facility of whatsoever nature the aggregate value whereof is not less than thirty six thousand shillings, granted in respect of employment or services rendered”.

22. The PAYE rules are made under section 130 of the Act. They apply to weekly wages, monthly wages, annual salaries, bonuses, commissions, director’s fees and all cash emoluments. If I find the director has received a benefit from his office or employment, the appellant will be liable, by dint of section 37 of the Act, to deduct PAYE from the director or employee and remit the tax to the respondent.

23. When you unpack the respondent’s case, it boils down to the following: The director(s) own the land; the property was developed by the appellant at a cost of 43,517,159; it belongs to the landlord to whom it will revert at the end of the lease; and, the director is enjoying a benefit over the property which would not have accrued if he was not both the director and landlord. The key issue is whether the director is an employee or holds an office in the company. I stated earlier that it is trite that a registered corporation is a distinct legal entity from its directors and shareholders. Section 3 (2) of the Act is the general charging section. That is why section 3 (2) (f) deals with any other amounts deemed to be income under the Act. Of immediate relevance is that the section does not directly mention *benefits*. It deals primarily with *gains* and *profits* from business or employment.

24. Section 5 (2) (b) on the other hand expounds on the meaning of section 3 (2). Section 5 (2) (b) provides that the gains and profits referred in section 3 (2) *include the value of a benefit, advantage, or facility of whatever nature the value of which exceeds thirty six thousands granted in respect of employment or services rendered*. In order then to ground the PAYE tax demand, it has to be established that the director was an *employee* or rendered services. I have already stated that the construction on the premises and the absence of a registered lease conferred a benefit on the director. The reasons for that finding by the local committee may not have been explained in the manner the courts hand down decisions. But the committee stated it had reviewed the arguments by the parties, documents, the old and new leases and accounts for the relevant period and found they conferred a benefit on the director.

25. The terms *office* or *employee* are not defined in the Income Tax Act. The Act defines an *employer* as follows:

“ ‘employer’ includes any resident person responsible for the payment of, or on account of, emoluments to an employee, and an agent, manager or other representative so responsible in Kenya on behalf of a non-resident employer”.

26. The Employment Act defines an employee as a person employed for wages or a salary and includes an apprentice and indentured learner. A director is defined by the Income Tax Act as a member of the board of directors of a body corporate including a single director. It also includes members of the corporation where those members run the affairs of the company. A director holds an office and position in the company. The director may have a service contract. The Income Tax Act defines a contract of service as follows:

“Contract of service” means an agreement, whether oral or in writing, whether expressed or implied, to employ or to serve as an employee for any period of time and includes a contract of apprenticeship or indentured leadership under which the employer has the power of selection and dismissal of the employee, pays his wages or salary and exercises general or specific control over work done by him; and for the purpose of this definition an

officer in the public service shall be deemed to be employed under a contract of service”.

27. It is then incumbent to interrogate the nature of the directorship. Is it *ad hoc* or a full time service for example? Is the director employed on a service contract? *Halsbury’s Laws of England 4th edition (reissue) Vol. 23 (1) para 617* states the following:

“Office; position of directors, trustees etc. ‘Office’ is not defined in the Income Tax Acts, but the characteristics of an office as distinct from a profession or vocation are relevant to the law of income tax. An office may be described sufficiently as a subsisting, permanent and substantive position which has an existence independent of the persons who fill it, which goes on and is filled in succession by successive holders. A director of a company holds an office. So does a medical specialist holding a part-time hospital appointment, and the registrar of a company, the auditor of a company, and a trustee or executor”.

See also *Edwards Vs Clinch* [1982] AC 845, 56 TC 367 (Ch1) for the proposition that occasional appointments do not constitute an office. Accordingly, an inspector appointed from time to time to hold occasional public inquiries was held not to be a holder of an office. It is perfectly possible for a controlling shareholder or director to be a company’s employee or agent. *Lee Vs Lee’s Air Farming Limited* [1961] AC 12.

28. The question that begs an answer is whether Kishori Lal Sahni was a full time director or manager or employee of the appellant. The Courts have laid useful guidelines out of that maze. In *Eaton Vs. Robert Eaton Ltd* [1988] IRLR 83, the following tests were proposed-

- a. *“Did the director have a descriptive title like marketing director, managing director or sales director?”*
- b. *Was there an express contract of employment, or if not, was there a board minute or memorandum constituting an agreement to employ the director as an employee?*
- c. *Was remuneration paid by way of salary or director’s fees?*
- d. *Was remuneration fixed in advance or paid on an ad hoc basis?*
- e. *Was remuneration by way of entitlement or, in effect gratuitous (in other words, was the director in a position to sue for it)?*
- f. *Did the director merely act in his own capacity as a director or, was he under control of the board of directors in respect of the management of his work?”*

29. In *David Randu Vs. Malinde Water & Sewage Co Ltd* Mombasa, Industrial Court, Cause 110 of 2012 [2013] eKLR, Makau J applied that test. From a commercial perspective, the appointment of a director for a particular purpose is an office even though *ad hoc*. See *Taylor Vs Provan* [1975] AC 194. The appellant has not contested the fact in KRA’s letter of 15th September 2010 (page 61 of the appellant’s statement) that Kishori Lal Sahni was “*running operations of the company*” as the main director. The reference to *main* director appears in the respondent’s letter of 30th November 2009 at page 57 of the appellant’s documents. The decision of the local committee did not deal with those matters.

30. But I would return to the letter from KRA to the appellant dated 15th September 2010. Regarding VAT it stated as follows-

“During the audit, it was established that the company was paying expenses for a premise [sic] that belongs to the director and claimed the input thereon. There was no agreement provided to the audit team explaining as to [sic] why the company was financing a director’s investment. The amount spent on construction of the extended building included VAT input which was claimed through the monthly VAT returns. In view of the fact that the property belongs to the directors and the same director is running operation of the company from the same premises.....”

31. Regarding PAYE, the respondent stated further in the same letter-

“The ownership of the property remained that of the landlord who is a director. In the circumstances the cost of construction was not passed to the director either through billing or debit in the director’s account. This is deemed to be drawing of company’s resources in furtherance of director’s personal gains.”

32. The submissions by the appellant that the absence of an equivalent Schedule E of the UK Income Tax Act makes the definition of *office* irrelevant is thus prosaic. The term employee as defined in the Kenyan Income Tax Act brings the director of the appellant well within its ambit. He was running the operations of the company at the suit premises as the main director. The building constructed on his mortgaged land was clearly a substantial benefit or gain from the office or employment by the company.
33. The local committee itself did not come out confidently on that score. It stated that since the construction and lease negotiation were not at arm’s length, *“it could be used to convey a ‘benefit, advantage or facility? which should be brought to tax under section 5 (2) (b)”*. I have no hesitation in finding that the benefit or gain was taxable as PAYE as clearly provided by section 5 (2) (b) as read together with section 3 (2) of the Act. Granted the facts of this case, I find no ambiguity in the charging sections. It follows that under section 37, the appellant was under a duty to collect the amount raised in the tax demand. Accordingly, the decision of the local committee cannot be impeached.
34. The impugned decision did not make a finding that the appellant was *avoiding* tax. That matter arose from the respondent’s statement of facts and submissions in this appeal. Like I said, it is not contested the appellant remits approximately 19,400,000 in monthly taxes to the respondent. The allegation of tax avoidance is without any firm evidential basis and I refuse to accept it.
35. In the result, grounds one and three of the appeal are also devoid of merit. The entire appeal is accordingly dismissed. Costs follow the event and are at the discretion of the court. The appellant had paid the disputed tax of Kshs 18,480,485 before lodging this appeal. It is common ground that the appellant has been paying an average of Kshs 19,400,000 in taxes per month. I have also found no evidence of a scheme to avoid or evade taxation in this matter. In the interests of justice, it would not be right to condemn the appellant to costs for pursuing this appeal. Granted those circumstances, the order that commends itself to me to grant is that is that each party shall bear its own costs.

It is so ordered.

DATED, SIGNED and DELIVERED at NAIROBI this 11th day of March 2014.

GEORGE KANYI KIMONDO

JUDGE

Judgment read in open court in the presence of-

Mrs E. Opiyo for the appellant instructed by Kaplan & Stratton Advocates.

Ms R. Ngugi for the respondent instructed by Rosalie Ngugi Advocate.

Mr. C. Odhiambo, Court clerk.