REPUBLIC OF KENYA

IN THE HIGH COURT OF KENYA AT NAIROBI

MILIMANI LAW COURTS

COMMERCIAL & TAX DIVISION

INCOME TAX APPEAL NO.18 OF 2013

PRIMAROSA FLOWERS LIMITED.....APPELLANT

VERSUS

THE COMMISSIONER OF INCOME TAX.....RESPONDENT

(An appeal from the decision of the Income Tax Tribunal dated 17 October 2013 in Income Tax Tribunal Case No. 99/01 of 2012)

JUDGMENT

[1] This is an appeal that was filed herein on **28 November 2013** by **Primarosa Flowers Limited** in respect of the Judgment of the Income Tax Tribunal dated **17 October 2013** in **Income Tax Tribunal (Nairobi) Case No. 99/01 of 2012.** The brief background of the appeal is that the Appellant, a limited liability company incorporated in Kenya and dealing mainly in floricultural products which it exports to Europe and Asia, was subjected to a tax audit by the Respondent, the Commissioner of Income Tax. The audit was for the period March to **May 2011**; and according to the Respondent, the Appellant was found liable to pay a sum of **Kshs. 127,893,431/=** in terms of withholding tax that it had not paid on interest payable to its holding company, **Crest Overseas Holdings Limited**, from which it had received loans in **2002** and in **2010**. The Appellant objected to the assessment and consequently filed an Appeal before the Income Tax Tribunal on **20 March 2012**. The Tribunal rendered its decision on **17 October 2013,** the gist of which was as follows:

> **"In summary, taking into account the incorporation of an offshore company (the Holding Company), arranging for the Holding company to lend funds to the Appellant, crafting the loan agreements (the first and second - although they related to the same principal amounts) so that no interest on the loan was payable on the interest earned which would have compelled the Appellant to deduct the said tax and remit to the Respondent; the subsequent zero rating of the interest payable on the loan although the original to the agreement talked of interest rate at 8% minimum, and notwithstanding the fact that the loan still remained US$ 15 million, the Appellant would be required to pay back US$ 21.6 million, all point to the existence of a transaction whose purpose was either the avoidance [of] tax liability or reduction of tax liability. To the tribunal, looking at the totality of the transactions or arrangements, it became manifestly clear that they were effected with the intention to avoid tax liability or reduce that tax liability. Members were unanimous that this appeal fails and the confirmed assessment upheld."**

[2] Being aggrieved by the decision of the Tribunal, the Appellant lodged the instant appeal herein on the following grounds:

[a] That the Tribunal erred in fact in finding that the predominant purpose behind the granting of the loan by **Crest Overseas Holdings Limited** to the Appellant was a scheme designed to avoid tax or to prevent the Appellant from paying tax to the Respondent;

[b] The Tribunal erred in fact in failing to make a finding that the Respondent exercised the power enshrined in **Section 23** of the Income Tax Act arbitrarily and arrived at an erroneous decision in assessing the Appellant's Tax liability;

[c] The Learned Tribunal erred in law and in fact in making a declaration that the Respondent was justified in exercising its discretion under **Section 23** of the **Income Tax Act** in interpreting the definition of "a transaction designed to avoid a tax obligation";

[d] The Tribunal erred in law and in fact by upholding the assessment of tax by the respondent, despite the observance in the ruling that none of the parties fully addressed the Tribunal as to what are, for instance, the essential elements which would render a transaction to be one intended to achieve a tax avoidance objective;

[e] The Tribunal erred in law and in fact by upholding **Section 23** of the Act, when no evidence was presented by the Respondent that the contract agreement with the holding company was made in anticipation of main benefit which might have been expected to accrue from the transaction in the three years immediately following the completion of the transaction;

[f] The Tribunal erred in fact by observing that the variance between the payment amount of the two loan agreements was not satisfactorily explained, when in fact the total advances as at the date the Respondent conducted the audit stood at **Kshs. 1,618,931,000/=** equivalent to **US$ 21,669,997.00;**

[g] The Tribunal erred in law and in fact in making a declaration that the formation of the Appellant's majority shareholder, **Crest Overseas Holdings Limited** was solely for the purpose of assisting the Appellant to avoid its tax obligations;

[h] The Tribunal erred in fact and in law by upholding the assessment of tax by the Respondent when such liability had not accrued in the first place;

[i] Having conceded that the definition of the word "paid" as provided in **Section 2** of the **Income Tax Act** required the actual payment to have been made, the Tribunal failed to make a finding that indeed no interest payment was ever made by the Appellant to the lender of the loan **(Crest Overseas Holdings Limited)** and, therefore, no withholding tax was payable by the Appellant in its capacity as an agent of the Respondent;

[j] Having accepted the fact that the Respondent did not have any powers under the law during the relevant tax years, to deem the interest payable, the Tribunal erred in fact and in law in failing to find that the Respondent had no legal basis under the law to assess the payment of tax when in fact the Appellant had not repaid the loan interest nor accrued any interest in its books during the relevant tax years;

[k] Having satisfied itself that indeed the law on deemed interest did not exist during the relevant tax years, the Tribunal erred in fact and in law in failing to find that in those circumstances, it was not open for the Respondent to deem that the Appellant paid or should have repaid the loan interest;

[l] The Tribunal erred in fact in failing to make a finding that if indeed the Appellant was an agent for the Respondent in the collection of withholding tax, there was no conceivable benefit that

would have been enjoyed by the Appellant in failing to remit what it had not collected in the form of withholding tax;

[m] By satisfying itself that the subject matter of the assessment were two Loan Agreements submitted by the Appellant to the Respondent, the Tribunal failed to appreciate the submissions made on behalf of the Appellant relating to the discretion to waive interest on the said loans and the sequence of events prior to the filing of the said Loan Agreements and in particular the confirmation by the Appellant's Auditors that the loans had been granted grace periods and were interest free;

[n] That in view of the circumstances set out herein above, the Tribunal totally misdirected itself in delivering a contradictory Judgment in favour of the Respondent.

[3] Thus, the Appellant prayed for Orders that this Appeal be allowed and a Declaration made to the effect that the Appellant properly made appropriate tax declarations and that the alleged liability to pay withholding tax did not arise; and that the Orders made by the Tribunal on **17 October 2013** be set aside; and the costs of the Appeal be granted to the Appellant. With the leave of the Court, granted on **5 December 2014**, two Supplementary Grounds of Appeal were filed on **26 February 2015** thus:

[a] Having held that the power to deem interest was conferred on the Respondent after the tax years in question and that the Respondent, for want of powers under the Act could not charge and enforce payment of withholding tax under the concept of **"deeming",** it was not open for the Tribunal to confirm the assessment raised by the Respondent when, in fact, the said assessment was based on the concept of deeming;

[b] Having held that the power to deem interest was conferred on the Respondent after the tax years in question and that the Respondent, for want of powers under the Act could not charge and enforce payment of withholding tax under the concept of **"deeming",** it was not open for the Tribunal to confirm the assessment raised by the Respondent when, in fact, the assessment was in respect of tax years before the Finance Act, 2011 during which period the Respondent did not have power to deem interest.

[4] Respondent's Statement of Facts filed on **21 January 2014** is to the effect that the Respondent conducted a tax audit of the Appellant during the period **March 2011 to May 2011** and observed that, on **25 October 2002**, the Appellant contracted to receive a loan from **Crest Overseas Holdings Limited** amounting to **US$ 15 Million** for the purpose of meeting its expansion and capital requirements; and that **vide Clause 5** of the Loan Agreement, the Appellant was expected to pay interest at the rate of 8% per annum quarterly. It was further agreed by the parties that the Lender had the option to convert the entire or part of the loan capital by issuing non-cumulative redeemable shares.

[5] It was further established by the Respondent that, up to the date of the audit, there had been no interest paid in connection with the loan, nor had any such interest been provided for in the Appellant's financial statement; and therefore no withholding tax on interest had been remitted to the Authority. The Respondent further noted that, though the loan agreement was for **US$ 15 Million**, the total advances to the Appellant as at the date of the audit, according to the financial statements, stood at **Kshs. 1,618,931,000/=,** equivalent to **US$ 21,660,997.00,** notwithstanding that the Appellant had repaid some **545,000 Euros** between **May 2007 and July 2008** and issued non-cumulative shares of **Kshs. 240 million**.

[6] Thus, taking into account all the foregoing, including the fact that the Appellant had no Transfer Pricing Policy in place at the time, the Respondent assessed and calculated withholding tax on the interest element at **Kshs. 75,557,009/=** and penalties and interest thereon at **Kshs. 53,316,422/=;** and a Notice of Assessment was subsequently sent to the Appellant on **24 November 2011** in the total sum of **Kshs. 127,893,431/=.** The Respondent's Statement of Facts further shows that the Appellant objected to the Assessment by a letter dated **28 November 2011** and submitted further documentation to support its contention that interest was neither paid nor accrued in the accounts; and that having taken those

representations into account, the Respondent confirmed the assessment vide its letter dated **9 February 2012.**

[7] Being aggrieved by the Respondent's decision, the Appellant filed and served Notice of Appeal and thereafter lodged its Memorandum of Appeal on **20 March 2012**; which appeal was resolved in favour of the Respondent. The Respondent's argument was that the failure by the Appellant to either pay or accrue interest on the loan was a deliberate scheme to avoid payment of withholding tax. Hence, the Respondent's contention, that withholding tax was payable on interest and that the same ought to have been accrued in the Appellant's financial statements pursuant to **Sections 23 and 35** of the **Income Tax Act** as well as the General Accounting Practices and the International Accounting Standards, was upheld by the Tribunal.

[8] Pursuant to the directions issued herein on **5 December 2014**, the parties filed their respective written submissions in respect of the Appeal. In its written submissions filed on **23 February 2016,** the Appellant reiterated its submissions before the Tribunal and added that as a legal person, it had the unfettered power to enter into whatever agreements it deemed fit with its holding company, **Crest Overseas Holding Company Ltd,** in so far as there is no legal bar to its doing so. That at the time of the subject transactions, there was no provision under the Income Tax Act prohibiting interest free loans between related parties. Thus it was the submission of the Appellant that it would be unlawful, unreasonable and even unconstitutional for the Respondent to seek to charge tax on the said loans.

[9] It was further the submission of the Appellant that while the law was amended in **2011** to address the lacuna aforementioned, vide the **Finance Act, 2011,** that amendment did not have retrospective effect; and therefore that the Respondent has no justification whatsoever for seeking to apply the new law to antecedent transactions. It was also the contention of the Appellant that the transactions between it and **Crest Overseas Holdings Ltd** were not the sort of transactions contemplated under **Section 23** of the **Income Tax Act**; and therefore that the invocation of **Section 23** by the Respondent is totally unjustified, as no benefit whatsoever had been shown to accrue to the Appellant from the transactions. According to the Appellant, it was in fact the net loser from a tax advantage point of view.

[10] It was further the submission of the Appellant that there was no variance in the amounts set out in the loan agreements. It argued that the amount of advances in its financial statements as at the time of the audit was **US$ 21,600,000**; and that the alleged variance was therefore satisfactorily explained to the Tribunal by the Appellant. However, it was submitted, the Tribunal wholly disregarded the argument made by the Appellant on that point, and thereby ended up reaching the wrong conclusion in basing its decision on this alleged variance which, according to the Appellant, did not exist.

[11] With regard to the definition of the word **"paid"** as provided for in **Section 2** of the **Income Tax Act,** the Appellant's submission was that it was a requirement that actual payment be made for withholding tax to be charged; and since it is not in dispute that no actual payment of interest was ever made by the Appellant to its financier, it would follow that no withholding tax was payable by the Holding Company. Accordingly, it was posited that the Tribunal's holding that withholding tax was payable by the Appellant was not only contradictory, but was also not consistent with its determination that the definition of the word **"paid"** in **Section 2** of the **Income Tax Act** required the actual payment to be made before liability for withholding tax could arise.

[12] It was also the Appellant's argument that the Tribunal confused and conflated the issue of the transactions as being transactions that fell under **Section 23** with the issue of liability under **Section 35** of the Income Tax Act, yet **Section 23** does not itself result in liability. According to the Appellant, what **Section 23** does is that it provides an avenue for the Commissioner of Income Tax to adjust the transactions based on other sections in the **Income Tax Act** that impose liability. That, the Tribunal having ruled that the Respondent had no power to deem interest in this case, it would follow that **Section 35** of the Act would not be applicable either. In effect, it was argued, the Tribunal had no valid or reasonable basis for upholding the confirmed assessment, there being no statutory basis for the tax charge. Hence, it was submitted that, in the circumstance, the Tribunal totally misdirected itself in delivering a contradictory Judgment in favour of the Respondent.

[13] The Respondent's written submissions filed on **21 October 2016** were to the effect that, under **Section 35(1)(e)** of the **Income Tax Act**, as read together with **Paragraph 3(e)(i)** of the **Third Schedule** to the Act, interest payments made to a non-resident person is subject to withholding tax at the rate of 15%; and that since the loan agreement between the Appellant and its Holding Company provided for interest to be paid on a reducing balance at the rate of 8% per annum, **Section 35** is applicable to the transaction. Reliance was placed on the definition of **"paid"** in **Section 2** of the Act, in which **"paid"** is defined as including **"distributed, credited, dealt with or deemed to have been paid in the interest of or on behalf of a person."** Thus, it was postulated that, since the payment of interest was provided for in the agreement, the Respondent was in order to deem it to have been paid.

[14] The Respondent further submitted that **General Accounting Practices and International Accounting Standards** require that interest liability be provided for in the financial statements when the liability to pay the same crystallizes; yet the Appellant failed to provide for interest liability on the loans in its income statement. That it was for this reason that the Commissioner, as mandated by **Section 23** of the Act, came to the conclusion that the reason for the omission was for the avoidance or reduction of liability to tax; contending that the financial statements did not represent a true and fair view of the transactions. According to the Respondent, the failure either to pay or accrue interest on the loan was a deliberate scheme to avoid payment of withholding tax; and that since the Appellant was in a loss position, failure to charge the interest was a tax avoidance scheme to ensure that the incidence of withholding tax did not arise.

[15] In response to the Respondent's written submissions, the Appellant filed, with leave, the Supplementary Submissions dated **20 February 2017**, contending that the issue of discrepancy in the amount of the loan outstanding as at the date of the tax audit by Kenya Revenue Authority was a non-issue. According to the Appellant, the amount at the time was **Kshs. 1,618,931,000/=**, equivalent to **US$ 21,660,997.00** which was captured in the Appellant's financial statements. Counsel further submitted that **Section 35(1)(e)** of the **Income Tax Act** together with **Paragraph 3(e)(i)** of the **Third Schedule** refer to situations in which the withholding tax is actually paid as the words used in that context are "**upon payment";** and that the said provisions are therefore not applicable to the instant case. In support of his submissions, Counsel relied on the cases of **Commissioner of Domestic Taxes vs. Tsavo Power Company Limited: High Court Income Tax Appeal No. 10 of 2007; Photo Production Limited vs. Securicor Transport Limited [1980] AC 827, 848** and **Republic vs. Kenya Revenue Authority ex parte Bata Shoe Company (Kenya) Limited [2014] eKLR**.

[16] The written submissions were highlighted herein on **6 March 2017, 14 March 2017** and **29 May 2017.** Counsel for the Appellant, **Mr. Kashindi**, highlighted the Appellants submissions and stressed the Appellant's contention that the parties had the freedom to vary the rate of interest as well as the option to convert the entire loan into equity, as set out in **Clause 6(b)** of the Loan Agreement at Page 27 of the Appellant's Record. Counsel further submitted that, due to liquidity and cash flow issues, no interest was actually paid, as the liability was not due until **October 2017**; and that this fact is not in dispute. According to Counsel, since no interest was paid, there cannot be accrued interest in the Appellant's books of account for the tax period. He urged the Court to note that the deeming provision introduced by the **Finance Act, 2011** was not applicable to the tax period, which was the period from **2007** to **2010**.

[17] On his part, **Mr. Ontweka**, Counsel for the Respondent, submitted that this was a case in which the Respondent carried out a tax audit of the Appellant and found that it had engaged in a scheme to avoid the payment of tax on interest due to its financier; and that in those circumstances, the Respondent was empowered by **Section 35**, as read with **Section 23** of the **Income Tax Act**, to carry out an assessment and charge tax as found to be appropriate. He also relied on the definition of the word **"paid"** in **Section 2** of the Act. Counsel further argued that, in so doing, the Respondent relied on International Accounting Standards, which require that transactions be recorded as accrued and not when due; and therefore that the Appellant ought not to have entered into arrangements for a loan with delayed repayment clauses in the first place.

[18] Mr. Ontweka further argued that had this been a transaction between parties who had no relationship between them, interest would have been charged once the loan was disbursed; and therefore

the holding by the Tribunal that this was a tax avoidance transaction should be upheld by this Court. Counsel further submitted that the Appellant's contention that the loan is not yet due should not be entertained because to do so would be tantamount to ousting the Respondent's obligation under **Section 23** of the Income Tax; and that this state of affairs would be an infringement of **Articles 201** and **202** of the **Constitution**, which provide for equity in the payment of tax.

[19] Regarding the authorities relied on by the Appellant, it was the submission of **Mr. Ontweka** that, being High Court decisions, they are not binding on this Court. He instead urged the Court to rely on the Court of Appeal decisions of **Kenya Commercial Bank vs. Kenya Revenue Authority, Civil Appeal No. 184 of 2009** and **Stanbic Bank vs. Kenya Revenue Authority [2009] eKLR** in connection with the interpretation of **Section 35** of the **Income Tax Act**. In the premises, the Respondent urged for the dismissal of the Appeal with costs.

[20] In his concluding remarks, Counsel for Appellant submitted that the payment of income tax is a matter of law and has to be expressly provide for. He argued that there was no obligation in law at the time to require that the interest payable be spread over the loan period; and that the Court cannot rely simply on the wishes of the Kenya Revenue Authority as to the mode of payment. Counsel argued that the applicability of the International Accounting Standards, has to be anchored in law for the purposes of tax imposition. He relied on **the Bata Shoe Case (supra)** in support of this argument. He also relied on **Republic vs. Kenya Revenue Authority ex parte Fintel Ltd** in connection with the definition of the word "**paid**" in **Section 2** of the **Income Tax Act**; and otherwise submitted that the authorities relied on by the Respondent are distinguishable for the reason that there was actual payment of interest in those cases.

[21] This being a first appeal as it were, the Court is under duty to re-evaluate the evidence presented before the Tribunal and make its own findings thereon; a principle well set in ***Selle -v- Associated Motor Boat Co. [1968] EA 123***as follows:

> ***"An appeal to this Court from a trial by the High Court is by way of retrial and the principles upon which this court acts in such an appeal are well settled. Briefly put they are that this court must reconsider the evidence, evaluate it itself and draw its own conclusions though it should always bear in mind that it had neither seen nor heard the witnesses and should make due allowance in this respect. In particular this court is not bound necessarily to follow the trial judge's findings of fact if it appears either that he has clearly failed on some point to take account of particular circumstances or possibilities materially to estimate the evidence or if the impression based on the demeanour of a witness is inconsistent with the evidence in the case generally (Abdul Hameed Saif -v- Ali Mohamed Shalan [1955],22 EACA 270)"*** *See also* ***Jivanji -v- Sanyo Electrical Company Ltd. [2003] KLR 425 at page 431."***

[22] Accordingly, from the Statements of Facts filed herein by the parties, there is no dispute that the Appellant is a limited liability company incorporated in Kenya; or that it carries on the business of growing and exporting flowers. It is also not in dispute that 99.9% of the Appellant's share capital is owned by **Crest Overseas Holdings Limited (herein after, Crest Holdings)**, a Holding Company incorporated and based in the **British Virgin Islands**. The parties are in agreement that **Crest Holdings** advanced the Appellant a loan amounting to **US$ 15,000,000** vide an agreement dated **25 October 2002** for the purpose of meeting its expansion and working capital requirements. A copy of the Agreement **(the First Agreement)** was included in the Appellant's Bundle of Documents, at pages 25 to 32 thereof. The loan was to be repaid with interest at 8% per annum over a period of ten years in quarterly instalments together with interest.

[23] There is no disputation that on the **27 April 2010**, the Appellant entered into another Loan Agreement with **Crest Holdings**, a copy whereof is to be found at pages 40 to 46 of the Appellant's Bundle of Documents. That Agreement (**the Second Agreement)**, shows that the Appellant agreed to pay back the sum of **US$ 21,600,000**(which was to include the initial **US$ 15,000,000**) to **Crest Holdings** by **25 October 2017**. It is common ground that this **Second Agreement** made no provision for interest; and that, in consequence thereof, the Appellant did not accrue interest in its books, nor did it claim interest as

an expense in its financial statements or returns of income lodged with the Respondent.

[24] That **Kenya Revenue Authority** ("**the Authority**") carried out routine tax audit of the Appellant's business in **2011** is also not in dispute. The audit was undertaken between **March and May 2011** in respect of the Appellant's **2007-2010** years of income; and it revealed that:

> **[a]** Up to the date of the audit, there had been no interest, relating to the loans, that had been provided for in the Appellant's financial statements, nor was any withholding tax on interest remitted to the Authority;
>
> **[b]** Though the amount stated in the Loan Agreement dated **25 October 2002** was **US$ 15,000,000**, the Appellant's financial statements as at the time of audit showed that the total advances stood at **Kshs. 1,618,931,000,** equivalent to **US$ 21,660,997.00**; and that the Appellant had within the audit period repaid **Euros 545,000** to the Holding Company through **Uniworld Ltd**. (see **Appendix 2** of the Appellant's Statement of Facts at page 34).
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> **[c]** That the Appellant had no Transfer Pricing Policy in place as is the legal requirement for any borrowing from foreign related companies.

[25] Thus, there is no disputation that the Authority assessed the Appellant's fiscal situation and calculated withholding tax on the interest element at **Kshs. 75,577,009/=** and penalties on interest at **Kshs. 53,316,422/=,** making a total of **Kshs. 127,893,431/=;** and the Appellant was accordingly notified of the assessment on **24 November 2011** per **Annexure B** at page 68 of the Appellant's Statement of Facts. The parties are in agreement that it was on account of that assessment that the Appellant approached the Tribunal on **26 March 2012** pursuant to **Rule 4** of the **Income Tax (Tribunal) Rules**, seeking the reversal of the assessment. The Tribunal heard the matter and rendered its decision on **17 October 2013**, dismissing the Appeal. Given the foregoing agreed facts, and having taken into account the submissions made herein by the parties as well as the Statements of Facts filed herein, the issues for determination can be safely reduced to the following:

> **[a]** Whether the loan transactions between the Appellant and Crest Holding fell under what was contemplated under **Section 23** of the **Income Tax Act**; and
>
> **[b]** Whether, under **Section 35** of the **Income Tax Act**, it was open to the Authority to assess and charge tax solely on the basis of the adjustments made in line with **Section 23** of the **Income Tax Act**.
>
> **[a] <u>On whether the subject loan transactions fell under what was contemplated under Section 23 of the Income Tax Act</u>:**

[26] First and foremost, it is trite law that for the Authority to purport to charge or collect tax, the imposition thereof must be expressly sanctioned by law. In this connection **Article 210(1)** of the **Constitution** is explicit that:

> **"No tax or licensing fee may be imposed, waived or varied except as provided by legislation."**

Thus, in **Halsbury's Laws of England 4th Edition Vo. 23 paragraph 22** it is the opinion of the learned authors thereof that:

> **"...it is a general principle of fiscal legislation that to be liable to tax the subject must fall clearly within the words of the charge imposing the tax, otherwise he goes free; and that it is for the Crown to establish that the charge prima facie extends to the subject matter sought to be charged; whether this strict rule of construction still applies is questionable in view of the very wide deeming provisions enacted to prevent varying forms of tax avoidance. However this may be, if the subject is within the scope and terms of the charge, he cannot escape**

unless he can bring himself fairly within an express exemption conferred by the statute."

[27] It is in this regard that **Section 23** of the **Income Tax Act** bestows on the Commissioner the authority to carry out an audit and charge tax where appropriate. That provision states as follows:

> **(1) Where the Commissioner is of the opinion that the main purpose or one of the main purposes for which a transaction was effected (whether before or after the passing of this Act) was the avoidance or reduction of liability to tax for a year of income or that the main benefit which might have been expected to accrue from that transaction in the three years immediately following the completion thereof was the avoidance or reduction of liability to tax, he may, if he determines it to be just and reasonable, direct that such adjustments shall be made as respects liability to tax as he considers appropriate to counteract the avoidance or reduction of liability to tax which could otherwise be effected by the transaction.**
>
> **(2) Without prejudice to the generality of the powers conferred by subsection (1), those powers shall extend--**
>
> > **(a) to the charging to tax of persons who, but for the adjustments, would not be charged to the same extent;**
> >
> > **(b) to the charging of a greater amount of tax than would be charged but for the adjustments.**
>
> **(3) A direction of the Commissioner under this section shall specify the transaction or transactions giving rise to the direction and the adjustments as respects liability to tax which the Commissioner considers appropriate."**

[28] In its letter dated **23 December 2011 (at page 71** of the documents attached to the Appellant's Statement of Facts), the Respondent required the Appellant to pay tax on interest in the sum of **Kshs. 127,893,431/=** for the period **2007** to **2010;** and by the email dated **24 November 2011**, the assessment was again forwarded to the Appellant for settlement. Granted that this impost was made after a tax audit exercise, the Respondent was obliged to explain, and did explain to the Appellant the grounds upon which the assessment was made, as well as the legal provisions therefor. A copy of the Details of Payment pertaining to the sum of **Kshs. 127,893,431** is to be found at page 68 of the documents attached to the Appellant's Statement of Facts. It is further evident that the Respondent also involved the Appellant by way of due process, and took into consideration the representations made by it in response to the assessment. The Appellant's detailed responses are to be found at pages 69 to 70 and 227 to 231 of the documents attached to its Statement of Facts; and after reviewing the response, the Respondent communicated its final decision vide the letter dated **9 February 2012** (page 72-73 of the Appellant's Bundle) confirming the assessment. Clearly therefore, the Respondent had the requisite jurisdiction to make the impost.

[29] As to the basis for the impost, the Respondent placed reliance on **Clause 5** of the Loan Agreement dated **25 October 2002**. That Clause provides thus:

> **"The Borrower shall pay interest on so much of the Loan as shall from time to time be owing by the Borrower to the Lender at the rate of (eight per cent per annum) 8% per annum minimum or at such other rate or rates per annum as mutually agreed between the parties. <u>Provided Always That</u> all payments of interest hereunder shall be made without any set- off or counterclaim and free and clear of any deduction for or on account of any present or future taxes of any nature now or hereafter imposed."**

[30] In addition to the aforestated Clause, **Clause 6(a)** of the **First Agreement** provided for a moratorium period for the repayment of both the principal sum and the interest due thereon up to **30 June 2005**; after which the Loan would be repaid over a period of ten years in equal quarterly instalments. In the premises, it was expected that, pursuant to **Section 35(1)** of the **Income Tax Act**, the Appellant would pay

withholding tax on the interest component paid on a quarterly basis over the ten year period that it had been afforded by **Crest Holdings** to repay the loan. In this connection, **Section 35(1)** provides that:

> **"A person shall, upon payment of an amount to a non resident person not having a permanent establishment in Kenya in respect of--**
>
> **(a) a management or professional fee...**
>
> **(b) a royalty;**
>
> **(c) interest, including interest arising from a discount upon final redemption of a bond, loan, claim, obligation or other evidence of indebtedness measured as the original issue discount...;**
>
> **(d) ...**
>
> **(e) Interest**
>
> **which is chargeable to tax, deduct therefrom tax at the appropriate non-resident rate." (Emphasis supplied)**

[31] Needless to say that the interest in issue herein was due to a non-resident person and was therefore, on the face of it, subject to withholding tax at the rate of 15% in terms of **Section 35(1)(e)** of the Act as read with **Paragraph 3(3)(i)** of the **Third Schedule** to the Act**.** The Court of Appeal, had the opportunity to restate the law in this regard in the case of **Kenya Commercial Bank Limited vs. Kenya Revenue Authority: Civil Appeal No. 184 of 2009**, thus:

> **"By section 35(1) a person upon payment of a non resident person not having a permanent establishment in Kenya in respect of interest which is chargeable to tax is required to deduct withholding tax at the appropriate non-resident rate...From the provisions of the Act, we have come to the conclusion that payment for interest and incidental expenses on Nostro accounts to the correspondent bank is indeed taxable income to the correspondent bank for services rendered to the Appellant for foreign exchange transactions..."**

[32] Thus, given the wording of **Section 35(1)** of the **Income Tax Act**, and the employment of the words **"upon payment"** and **"deduct therefrom"** it is paramount that the Court be satisfied that payment of interest was, in fact, made. It is the contention of the Appellant that, because of liquidity challenges, it was unable to make repayments as had been envisaged by the terms of **the First Agreement**; and that this necessitated the execution of the Loan Agreement dated **27 April 2010** whereby the interest component was waived and the period of repayment of the principal extended to **25 October 2017**. This was captured in **Clause 2.2** of the **Second Agreement** thus:

> **"The parties confirm that all the conditions precedent have been complied with and the loan was disbursed and drawn down by the Borrower on the 25th of October 2002 (now past)."**

[33] Granted that it is common ground that no payment was ever made in respect of the two Agreements, the question to pose is whether the Appellant is, in the circumstances, under obligation to pay withholding tax pursuant to **Section 35** of the **Income Tax Act.**Whereas it was the contention of the Respondent that the Appellant was under duty to accrue the interest in its books and pay withholding tax, the Appellant's argument was that withholding tax was not due, as no interest had been paid by it; and that in any event the same was waived by **Crest Holdings**. It was thus the Appellant's contention that if any interest was due, the same was not chargeable until **25 October 2017** when the loan amount was due for repayment; and that whereas it had the option, under **Clause 2.5** of the Second Agreement to make periodic payments to the Lender, it was unable to do so due to liquidity challenges.

[34] The Respondent relied heavily on the definition of the word **"paid"** in **Section 2** of the **Income Tax**

Act, which reads:

> **"paid includes distributed, credited, dealt with or deemed to have been paid in the interest of or on behalf of a person."**

It was accordingly postulated by Counsel for the Respondent that, since interest was required to be paid by virtue of **Clause 5** of the **First Agreement**, it ought to be deemed, by dint of the **Section 2** definition above, to have been paid; and added that, the General Accounting Practices and International Accounting Standards also require that interest liability be provided for in the financial statements when the liability to pay the same crystallized. Thus, according to the Respondent, the Appellant is liable to tax under **Sections 23** and **35** of the **Income Tax Act**. It was further the assertion of the Respondent that the Appellant's financial statements do not represent a true or fair view as the loans from **Crest Holdings** were not interest free; and that the failure to either pay or accrue interest on the loan was a deliberate scheme by the Appellant to avoid payment of withholding tax.

[35] The Tribunal was in agreement with the Respondent. Consequently it made a determination that:

> **"...taking into account the incorporation of an offshore company (the Holding company), arranging for the Holding company to lend funds to the Appellant, crafting the loan agreements (the first and second - although they related to the same principal amounts) so that no interest on the loan was payable and as a consequence no withholding tax would become payable on the interest earned which would have compelled the Appellant to deduct the said tax and remit to the Respondent; the subsequent zero rating of the interest payable on the loan although the original loan agreement talked of interest rate at 8%,minimum, and notwithstanding the fact that the loan still remained US$ 15 million, the Appellant would be required to pay back US$ 21.6 million, all point to the existence of a transaction whose purpose was either the avoidance of tax liability or reduction of tax liability. To the tribunal, looking at the totality of the transactions or arrangements, it became manifestly clear that they were effected with the intention to avoid tax liability or reduce that tax liability."**

[36] What, then, is the import of the above-stated definition of the word **"paid"** especially the words **"deemed to have been paid"** for the purposes of **Sections 23** and **35** of the **Income Tax Act**? In connection with the construction of tax law, I find instructive the words of **Lord Simonds** in **Russell vs. Scott [1948] 2 AllER1** that:

> **"...there is a maxim of income tax law which, though it may sometimes be over-stressed, yet ought not to be forgotten. It is that the subject is not to be taxed unless the words of the taxing statute unambiguously impose the tax on him."**

[37] Similarly, in **Republic vs. Kenya Revenue Authority, *ex parte* Bata Shoe Company (Kenya) Limited [2014] eKLR**, in which **Korir, J** had occasion to grapple with a similar question, he quoted the case of **Palm Oil Research and Development Board of Malaysia & Another vs. Premium Vegetable Oils SDN BHD [2004] 2 CLJ 265** to the following effect, which I find helpful:

> **"The correct approach to be adopted by a court when interpreting a taxing statute is that set out in the advice of the Privy Council delivered by Lord Donovan in Mangin v Inland Revenue Commissioner [1971] AC 739:**
>
> **First, the words are to be given their ordinary meaning. They are not to be given some other meaning simply because their object is to frustrate legitimate tax avoidance devices...moral precepts are not applicable to the interpretation of revenue statutes. Secondly, ... one has to look merely at what is clearly said. There is no room for any intendment. There is no equity about a tax. There is no presumption so to tax. Nothing is to be read in, nothing is to be implied. One can only look fairly at the language used...Thirdly, the object of the construction of a statute being to ascertain the will of the legislature, it may be presumed that neither injustice nor absurdity was intended. If therefore a literal interpretation would**

produce such a result, and the language admits of an interpretation which would avoid it, then such an interpretation may be adopted. Fourthly, the history of an enactment and the reasons which led to its being passed may be used as an aid in its construction...Hence, the governing principle is this. When construing a taxing or other statute, the sole function of the court is to discover the true intention of Parliament. In that process, the court is under a duty to adopt an approach that produces neither injustice nor absurdity; in other words, an approach that promotes the purpose or object underlying the particular statute albeit that such purpose or object is not expressly set out therein."

[38] With the foregoing principles in mind, I have carefully considered the provisions of **Sections 23** and **35** of the **Income TaxAct** as well as the definition of the word **"paid"** in **Section 2** thereof. The plain meaning of **Section 35** is that withholding tax is payable by non-residents but that such tax can only be withheld upon payment. It is further my understanding that this is notwithstanding the **Section 2** definition of the word **"paid"** which includes the phrase **"deemed to have been paid in the interest or on behalf of a person."** I find succour in this posturing from the case of **Republic vs. Kenya Revenue Authority ex-parte Fintel: High Court Misc. Application No. 1768 of 2004** wherein it was held that:

"..."paid" in section 2 of the Income Tax Act assumes its ordinary meaning and the use of the words "include" is merely illustrative of the kinds of activities that constitute payment. I agree with counsel for the applicant that payment implies "delivery of money or some other valuable thing." The ordinary meaning can also be gleaned from the Concise Oxford English Dictionary, 2011, where the word pay means, "give (a sum of money) thus owed" which in ordinary meaning suggests actual payment. Thus, "distributes, credited, dealt with or deemed to have been paid in the interest or on behalf of a person" should be interpreted *ejusdem generis* with the word "paid. My view is reinforced by a consideration of the provisions of section 35(5) of the Income Tax Act which provides how the provisions of sections 35(1) and (3) are to be effected. First, section 35(1) requires a person making the payments to "deduct tax therefrom at an appropriate rate." Second, section 35(5) provides how the deduction is to be made and how this is to be done. Deduction implies subtracting from what is due and being paid to another person and therefore these provisions negative any intention by the legislature to ascribe a meaning other than the plain and obvious meaning to "paid" and "upon payment" in section 2 and 35 of the Income Tax Act. If these provisions are applied to the circumstances of this case, then it is difficult to see how withholding tax can be deducted from a provision in the profit and loss account, in the manner contemplated without any payment being made to the payee."

[39] I note that, in support of its arguments, the Respondent relied on **Republic vs. Kenya Revenue Authority ex parte Cimbria (E.A.) Limited**, in which the Authority had carried out an assessment and, in a similar fashion, demanded withholding tax from the *ex-parte* applicant, **Cimbria (E.A.) Limited.** The Applicant unsuccessfully challenged that decision on Judicial Review on the ground that the Respondent had not proved that any payments of interest had been actually made to the parent company. It is however manifest from the Judgment that the Court was satisfied that the interest was deemed to have been paid on the basis of the entries in the financial statements; and that **Cimbria** had claimed in their profit and loss account interest payable to its non-resident shareholder. Hence, the Court observed thus:

"If indeed Cimbria's parent company was credited with interest as alleged, then 'paid' included the word 'credited' because it was a benefit to Cimbria and the interest would be deemed to have been paid and withholding tax is therefore due upon the crediting. Even if no payment was made by Cimbria to the parent company but interest was received, Cimbria would be holding it or would have received a benefit, on behalf of the parent company and that would still fall under the meaning of the word 'paid' - meaning 'on behalf of a person' or Cimbria will be deemed to have been paid on behalf of the parent company...It would be immaterial whether interest was paid or the whole sums received was retained by the Applicant. The Applicant was under a duty to deduct tax from any payment made to it for any income that is specified under Section 35 of the Act and even if it used the whole sum for

its benefit, the same tax would be due and payable."

[40] In the instant matter, there was no dispute that interest had not been paid during the period under review; and neither was any posting made in that connection in the Appellant's books of account. Clearly therefore, the **Cimbria Case** is distinguishable. Similarly in **Stanbic Bank Kenya Ltd vs Kenya Revenue Authority: Civil Appeal No. 77 of 2008**, it was found as a fact that the Bank had actually paid fees for the online services to a non-resident person, but was purporting that the services paid for were for provision of news and information and that the payments made constituted subscription for publications and therefore not taxable. The majority decision of the Court of Appeal was that withholding tax was payable, thus affirming that withholding tax can only be due upon payment. Indeed, the Court proceeded to emphasize that:

> **"Tax law entails strict application and ... there is no question of the exercise of discretion by the Court when dealing with matters pertaining thereto..." (Per Aganyanya, JA)**

[41] In the premises, it is my finding that, given the facts of this case, and in particular the agreed fact that no interest was paid during the period of assessment, the Appellant's liability to pay withholding tax had not arisen, granted that the loan was not due for repayment until **October 2017**.

> **[b] Whether, under Section 35 of the Income Tax Act, it was open to the Authority to assess and charge tax solely on the basis of the adjustments made in line with Section 23 of the Income Tax Act**.

[42] It could very well be, as was found by the Tribunal, that the Appellant and its holding Company were out to avoid the payment of tax, given the nature of their agreement; nevertheless, in the absence of a deeming provision, in the nature of what was introduced by the **Finance Act, 2011**, it was not open for the Respondent to require the payment of withholding tax under **Section 35(1)** of the **Income Tax Act** in the absence of proof of payment of interest. By that amendment, the words **"and deemed interest"** were inserted immediately after the word **"interest"** wherever it occurred in paragraph (e). Needless to say that that since the amendment did not carry with it retrospectivity, it cannot be applied to the instant situation.

[43] It is significant that four of the five issues the Tribunal flagged up for determination were resolved in favour of the Appellant. It is also noteworthy that, in respect of Issues No. 2 and 3, of whether interest could be deemed and withholding tax imposed thereon by dint of **Section 2** of the Act, the Tribunal was of the finding that the Respondent had no legal basis upon which interest could be deemed for purposes of withholding tax as it purported to do; and added that:

> **"Although the Respondent resorted to the definition of "paid" as contained under Section 2 of the Act, the tribunal found that the respondent had no legal basis for the tax years in question on which it could have "deemed" the rate of interest; calculated the interest payable and then levied and demanded payment of withholding tax on the interest... Before the Finance Bill of 2011 was enacted into law, it was not clear to tax payers as to whether or not the respondent had powers under the law to deem a rate of interest where none existed particularly in lender and borrower transactions between related parties. The purpose of the amendment was to fill this lacuna in the law. The tribunal observed that it is long settled that imposition of a tax obligation must be clearly spelled out in the statute imposing the obligation. As the power to deem interest was conferred on the Respondent after the tax years in question, the Appellant succeeds on this point. The Respondent, for want of powers under the Act could not charge and enforce payment of withholding tax under the concept of "deeming."**

[44] In the premises, it is manifest that the Tribunal contradicted itself, and therefore erred in confirming the subject assessment as it did. I would accordingly find and hold that the Tribunal erred as contended by the Appellant in Grounds 1, 2, 3, 4, 7, 8, 9, 10 and 11 of the Grounds of Appeal, as well as the Supplementary Grounds filed on **26 February 2015.**

[45] The Respondent made heavy weather of the apparent variance between the initial loan of **US$ 15 million** and the sum of **US$ 21,600,000** that was provided for in **Clause 6** of the Second Agreement as the sum to be repaid. Counsel for the Appellant was however of the contention that the Appellant and **Crest Holdings** are competent legal persons with the unfettered capacity to contract. He reiterated that it was in that capacity that they agreed on a 3 year moratorium when neither the principal sum nor interest was payable; and a 12 month optional window to convert the entire or part of the loan into equity by issuing non-cumulative redeemable preference shares. Counsel for the Appellant also urged the Court to note that the contracting parties are related and therefore should not be faulted in respect of the Clause relating to the repayment of **US$ 21,600,000.**

[46] Having considered these rival submissions, the conclusion to drawn in the premises is that since there was no legal foundation for the deeming of interest, not much turns on this ground, granted that when the Appellant eventually gets down to repaying that amount, the Authority will be at liberty to deem interest thereon as it is now entitled to. Indeed, in **Photo Production Ltd vs. Securicor Transport Ltd [1980] AC 827, 848 Lord Diplock** expressed the principle thus:

> **"A basic principle of the common law ... is that the parties are free to determine for themselves what primary obligations they will accept."**

[47] In the result, it is my finding that the Appellant's appeal is meritorious; and that the Tribunal erred in upholding the Withholding Tax Assessment that was done by the Respondent dated **24 November 2011**. The Appeal is hereby allowed and the decision and orders made by the Income Tax Tribunal on **17 October 2013** are hereby set aside including the Withholding Tax Assessment. Given the nature of this Appeal it is hereby ordered that each party shall bear own costs.

It is so ordered.

DATED, SIGNED AND DELIVERED AT NAIROBI THIS 24TH DAY OF NOVEMBER, 2017

OLGA SEWE

JUDGE