REPUBLIC OF KENYA

High Court at Nairobi (Nairobi Law Courts)

Commercial Civil Case 8 of 2010

ECOBANK KENYA LIMITED.....APPELLANT

VERSUS

THE COMMISSIONER OF DOMESTIC TAXES.....RESPONDENT

R U L I N G

1. The Appellant is a financial institution incorporated in Kenya and licensed under the Banking Act to offer banking and other related financial services.

2. The Respondent is the Commissioner of Domestic Taxes appointed under **Section 122** of the **Income Tax Act**, **Cap 470** and is responsible for the control and management of the Income Tax Department and for the collection of and accounting of tax due under the said Act.

3. This is an appeal from the decision of the Local Committee delivered on **18th November 2011**, in which the Committee found in favour of the Respondent as follows:-

"On reviewing the evidence particularly the two letters relied on by both parties, the Committee concurred with the Respondent that the second letter effectively rescinded/revoked the first letter in its entirety and further that in a previous case before it, the committee had ruled that under the provisions of Section 15(7) (e) and Section 3(2) (iii) of the Act rental income was a specified source of income and tax thereon should be computed separately.

4. The brief history of this case is that by a letter dated **7th February 1979 (herein referred to as the "first letter"),** the Respondent herein issued a letter in which it was stated that the requirement of "separate sub-accounts" in the case of larger companies had been waived. The relevant part of the letter is at paragraph 9, which states thus:-

"9. Companies

I have decided to waive the "separate sub-accounts" requirement in the case of the larger companies. This group will consist of the finance institutions, insurance companies, the oil companies, the banks, the large manufacturing concerns and all companies quoted on the Nairobi Stock Exchange. This waiver will not apply however to any company whose business activities include those of agriculture."

5. In reference to the above, the Appellant continued to do business on the strength of that letter until the years of income 2006, 2007 and 2008 when the Respondent carried out an audit on the Appellant and proceeded to tax the Appellant's rental income separately. The Appellant appealed against the

Respondent's tax assessment to the Local committee. The said committee held that rental income was to be taxed separately as a source of income in its decision rendered on **18th November 2010.** The Appellant was dissatisfied and as a result they lodged the instant appeal.

6. The Appellant's case is that by way of the "first letter", the Respondent expressly waived the requirement for large companies such as banks and financial institutions to prepare separate sub-accounts. It was submitted that the reason the waiver was granted was to relieve large companies of the burden of preparing sub-accounts and accounting separately for sources of income that were not the main sources of income of the said companies. The Appellant contends that they relied on the express waiver granted by the Respondent since 1979 and did not prepare separate sub-accounts for its rental income.

7. It is further contended that the Respondent had previously carried out numerous in-depth tax audits of the Appellant's accounts and had never questioned the fact that they did not prepare separate sub-accounts for rental income. The Appellant's understanding was that the waiver contained in the "first letter" did not require them to prepare sub-accounts.

8. At the Appeal before the Local Committee, the Appellant adduced the "first letter" while the Respondent produced a letter dated **25th October 2002 (**herein referred to as the **"second letter")** and claimed that the said letter superseded the "first letter". The relevant part of the second letter is under the heading, **"Interest Income As A Separate Source of Income Under Section 15 (7) (e) (v) of the Income Tax Act"** and states thus:-

"The legal position regarding interest as a separate source of income is this:-

There are six specified sources of income under Section 15 (7) (e) of the Income Tax. The incomes from those sources are to be computed separately so that if there is a loss, it can only be carried forward to be off-set against its own source.

Interest income is not specifically specified as a source, because all the other sources have been specified. As income from those sources is to be computed separately, it follows that interest has to be computed separately and be assessed with other chargeable income.

Unless on application a ruling is given to the contrary, interest income should therefore be always computed separately from the specified sources, which includes business income."

The Local Committee concurred with the Respondent that the second letter effectively revoked the first letter in its entirety.

9. In the instant Appeal, it was submitted on behalf of the Appellant that the local committee erred in holding that the second letter revoked the first letter. The first letter gave an express waiver to large companies in preparing sub-accounts while the second letter merely made a clarification on interest income alone and that it did not make any reference to the express waiver that was granted in 1979. It was further submitted that the waiver set out in the first letter was given to large companies and the second letter did not make any reference to large companies. The Appellant gave the definition of waiver in the Black's Law Dictionary as follows:-

"to abandon, renounce or surrender (a claim, privilege, right, etc.) to give up (a right or claim) voluntarily."

Applying the above definition, the Appellant submitted that the Respondent voluntarily gave up the right to require the Appellant to account separately for rental income and was therefore bound by the waiver set out in its letter dated **7th February 1979**. In order to revoke the waiver which the Respondent had expressly given in writing, it was submitted that the Respondent was to expressly make reference in writing to the waiver and categorically state that it had withdrawn the waiver.

10. It was the Appellant's contention that they had been relying on the express waiver for a period

of over 25 years and during that period they had never prepared separate sub-accounts in respect of its rental income. Therefore, the Appellant claimed that they were entitled to legitimately expect that the rental income would not be assessed separately for tax. It was further stated that the legitimate expectation was also created by the Respondent's subsequent conduct wherein the Respondent did not raise any issue with regard to the rental income after the waiver in the letter dated **7th February 1979** was given and even after the letter dated **25th October 2002** was issued.

11. Therefore, it was the Appellant's case that the Respondent acted in an uncertain and unpredictable manner in suddenly demanding that the Appellant was to account separately for its rental income when it had never raised the issue since 1979. The Appellant submitted that the local Committee failed to take cognisance of the fact that the Appellant had been granted a waiver as regards preparation of separate sub-accounts for its rental income and that the Committee erred in holding that the letter dated **25th October 2002** revoked the waiver.

12. On their part, the Respondent avers that in October 2009, an audit was carried out on the Appellant's income for the years 2006, 2007 and 2008. They found out that the Appellant received a lot of rental income from its Fedha tower building in Nairobi and other buildings across the country. Secondly, the Appellant had been returning losses in its operations from banking activities and thirdly that the Appellant had been combining rental income with other business income thereby ending with a loss return. After those findings, the Respondent proceeded to separate the rental income from the banking income and proceeded to tax them separately.

13. It is the Respondent's case that the Income Tax Act treats that rental income as a specified source of income which should be computed and taxed separately. This provision is found in **section 15 (7) (a), (b) and (c)** of the **Income Tax Act**. The Respondent contends that the letter dated **7th February 1979** was not an express waiver for financial institutions to stop computing specified income separately. That the said letter was meant to assist large companies to stop preparing sub-accounts and consolidate them to make their accounts easier to manage. The specified sources of income were still meant to be accounted separately. It is contended that the said letter did not replace **section 15 (7) (a), (b) and (c)** of the **Income Tax Act** which clearly provides that rental income is a specified source of income that should be computed and taxed separately from any other income. Therefore, the said letter could not be considered as an express waiver for the Appellant to disregard the express provision of the law and to fail to account for rental income separately.

14. The Respondent submitted that the letter dated **25th October 2002** reiterated the six sources of income specified under **section 15 (7) (e)** of the **Income tax Act** which were supposed to be computed separately and rental income was one of them. It was further submitted that the Income Tax Act was clear in requiring rental income to be computed separately and that the Appellant's claim that the letter of **7th February 1979** gave them a legitimate expectation not to compute rental income separately was unacceptable in law. The Respondent relied on the following authorities:

- **Nairobi HC Misc Civil Application No. 964 of 2004: Republic –vs- Kenya Revenue Authority Ex-Parte Aberdare freight Services Ltd and Kenya Sugar Board and Krish Commodities Ltd (interested Parties).**

- **Nairobi HC Misc Civil Application No. 258 of 2007: Akaba Investments Ltd –v- Kenya Revenue Authority.**

In the said authorities, the Court observed that a party could not rely on a legitimate expectation where there was an express provision of the law to be complied with. In the circumstances the Respondent urged the Court to dismiss the Appeal with costs.

15. I have considered the pleadings herein as well as the rival submissions by counsels for both parties. In my view, the following are the issues for determination:-

- **Whether the letter dated 25th October 2002 rescinded or revoked the said waiver contained in the letter dated 7th February 1979;**

- **Whether there was a legitimate expectation on the Appellant's part as a result of the waiver set out in the letter dated 7th February 1979.**

16. On the first issue, I have had the opportunity to peruse the decision of the Local Committee. The Respondent's argument then was that the purpose of the second letter was more general and effectively rescinded the exemptions of the first letter. The Local Committee concurred with the Respondent in their argument. In that case, it means that the Respondent did not dispute the fact that the first letter indeed waived the requirement for the larger companies to prepare sub-accounts. Their case was essentially that the second letter effectively revoked the first letter. However, in its submissions before this Court, the Respondent's case is that the first letter was not an express waiver for financial institutions to stop computing specified sources of income separately and that the said letter was meant to assist large companies to stop preparing sub-accounts and consolidate them to make their accounts easier to manage. It is evident that the respondent has deviated from its earlier submissions before the Local Committee.

17. It is not in dispute that the first letter dated **7th February 1979**, and in particular paragraph 9, expressly waived the requirement for larger companies to prepare "separate sub-accounts". The point of departure is as regards the computation of specified sources of income separately as provided for in the **Income Tax Act**. I have also noted paragraph 10 of the same letter under the sub-heading "Non-compliance" which states thus:-

"I hope there will be no cases where section 15 (7) is not complied with by:

(a) failure to furnish separate sub-accounts and computations or

(b) concealment in the main accounts of specified sources

18. My understanding of the above paragraph is that for one to account for specified sources of income one had to prepare separate sub-accounts. If read together with paragraph 9 of the said letter which waived the requirement for larger companies to prepare separate sub-accounts it could as well mean that the larger companies were not required to prepare the separate sub-accounts to be in compliance with section 15 (7) of the Act. If there was any ambiguity, then the same should be construed against the maker of the document, in this case the Respondent. Nothing would have been easier, than for the Respondent to put an express exemption clause to paragraph 9 of the first letter to the effect that the waiver of preparing separate sub-accounts was not to apply to specified sources of income as provided for in the Income Tax Act.

19. As regards the second letter, the relevant part is at page 6 of the letter under the heading **"Interest Income As A Separate Source of Income Under Section 15 (7) (e) (v) of the Income Tax Act".** From that heading as well as the explanation given therein, it is plain that the Respondent was clarifying that interest income was a separate source of income to be computed separately. This has no nexus to the waiver given in the first letter. In fact, the second letter in its entirety does not make any reference to the first letter. In the circumstances, it is only reasonable to deduce that the second letter did not revoke the first one. However, in any event, and more importantly it must be noted that the Respondent has always been aware of the existence and effect of section 15 (7) (a) (b) and (c) of the Income Tax Act. It cannot be said that these provisions of the Act have suddenly emerged requiring the Respondent to demand immediate compliance from the Appellant in regard thereto.

20. On the issue of legitimate expectation, it is the Appellant's submission that they had relied on the express waiver for a period of over 25 years, during which period they never prepared separate sub-accounts in respect of its rental income. In addition, the Respondent never raised an issue for over twenty five years, a clear representation that the Appellant was not required to prepare separate sub-accounts and consequently to compute for rental income separately. The Appellant in this regard submitted that they

were entitled to legitimately expect that they would not be assessed separately for tax in respect of rental income. On the other hand the Respondent submits that there can be no legitimate expectation where there is a specific statutory provision militating against the expectation.

21. In the English decision of **COUNCIL OF CIVIL SERVICES UNIONS V MINISTER FOR CIVIL SERVICE 1985 AC 374** Lord Fraser stated as follows:-

"a legitimate expectation may arise -either from an express promise given on behalf of a public authority or from the existence of a regular practice which the claimant can reasonably expect to continue."

In the instant case, the waiver was expressly given on behalf of a public authority, which is the Kenya Revenue Authority, by the Respondent herein. Furthermore, for over 25 years, the Respondent did not raise an issue with the Appellant as regards the preparation of sub accounts or computing rental income for tax separately. Therefore, the Appellant was entitled to reasonably expect that the practice would continue until communicated otherwise. In the circumstances, it is clear that there was a legitimate expectation on the Appellant's part as a result of the waiver set out in the letter dated **7th February 1979**.

I would add that the expectation herein is not just a legitimate expectation. It is an expectation backed by a written express waiver and a passive conduct in relation thereto for a period of twenty five years. All this time the Respondent was aware of section 15 (7) of the Income Tax Act. In my finding, that expectation became so legitimate, and so strongly grounded, that it established an economic right that only an express, concise, and specific waiver clearly communicated and delivered, could uproot. The Appellant and other business people have a right of certainty and predictability in the applicability of conduct, rules, policies and procedures which underlie the proper regulation of economic activities. This right necessarily militates against policies, regulations and procedures which are haphazardly resorted to by public regulatory bodies without adequate notice to those whose conduct or behaviour is to be regulated.

In an environment of business, that certainty and predictability is so crucial that to deny the same amounts to a denial of an economic right. Now, when such haphazard regulation affects a citizen's income the effect will be felt well beyond the comfort or discomfort of the two parties before the court. It is an issue which a court of law must tread on carefully, and where possible, restore the rights of the appellant and to reduce, as far as possible, the cascading negative impacts on all the parties associated with that income.

22. I am aware that the Respondent is entitled to exercise its authority in performing its public duties, and the court does not intend to impede or interfere with the said authority. However, the same should be exercised in a manner which recognises and honours existing contractual arrangements which remain in place until effectively withdrawn in an appropriate communication.

23. In light of the foregoing, I allow the Appellant's appeal with costs.

DATED, READ AND DELIVERED AT NAIROBI

THIS 15TH DAY OF OCTOBER 2012

E. K. O. OGOLA
JUDGE

PRESENT:
Malik for the Appellant

Ngugi H/B for Twahir for Respondent

Teresia – Court Clerk