REPUBLIC OF KENYA

IN THE HIGH COURT OF KENYA

AT NAIROBI (MILIMANI COMMERCIAL COURTS)

Income Tax Appeal 14 of 2007

KENYA COMMERCIAL BANK……...APPELLANT

VERSUS

KENYA REVENUE AUTHORITY…….……..……....……RESPONDENT

JUDGMENT

This is an appeal by Messrs Kenya Commercial Bank Limited, (hereinafter referred to as the Appellant) from the decision of the income tax local committee made on the 16th August, 2007 in case No. 30/06/07. By that decision, the Income Tax Local Committee (hereinafter referred to as the Committee), upheld the decision of the Commissioner of Domestic Taxes to charge the Appellant Withholding Tax on payment made by the Appellant to an entity called Infosys Technologies limited, (hereafter referred to as Infosys) on interest paid by the Appellant on nostro accounts. The sums charged inclusive of arrears stood atKshs.57, 150,556/- as at the date of demand made against the Appellant. The appeal was against point 2 and 3 of the decision where the Committee ruled:

(2) The payment to Infosys system was in respect of a Royalty as defined in the Income Tax Act and therefore is subject to Withholding Tax.

(3) Current practice is that transactions reflected in nostro accounts attracted Withholding Tax.

The Appellant has set out six grounds of appeal, the principles ones being grounds 1, 2, 3 and 4 which are expressed as follows: -

1. The Income Tax Local Committee ("the Committee") erred in fact and law in finding that withholding tax is applicable to the payment made by the Appellant to Infosys Technologies Limited.

2. The Committee erred in law in finding that the payment to Infosys Technologies Limited was in respect of royalty as defined in the Income Tax Act and therefore was subject to withholding tax.

3. The Committee erred in fact and law in finding that interest and other charges levied under the nostro accounts attract withholding tax.

4. The Committee erred in fact and law in basing their decision with respect to the nostro accounts on current practice rather than the provisions of law and what the justice of the particular case required.

In support of the grounds of appeal, the Appellant has relied upon its Statement of Facts dated 27th September, 2007, written submissions filed on 28th March, 2008, and several authorities which I have read. The latter documents elaborate and substantiate the above grounds of appeal. The appeal is opposed. The Respondent relies on its written submissions filed on 26th June, 2008. Counsel further made extensive oral submissions before me which I have also carefully considered.

This appeal turns on the interpretation of "Royalty" and "Interest" under the Income Tax Act (hereinafter referred to as the Act). The Appellant's contention is that the payments made to Infosys was for software packages the former was supplying to the Appellant for use in its banking services and that they did not fall within the definition of royalty under section 35(2) of the Act. Mr. Namachanja for the Appellant relied on the case of **R. vs Commissioner of Income Tax ex-parte SDV Transami (K) Ltd (2005)** 1 EA 53, where Ojwang J. held;

''Royalty fees are a payment to the creator of an industrial or artistic work or design which bears a certain 'capital' quality that will serve intellectual, reproduction or entertainment purposes. The payment made by the Applicant to a third party to access information from its website did not constitute royalties for the purposes of the Income Tax Act.''

Ms. Lavuna for the Respondent submitted that payments made to Infosys were for software products and licensing fees which products and fees were not tangible and that under the Act, they were recognized as royalties. Counsel relied on the **Halsbury's Laws of England Vol. 23(2) paragraph 1788** which deals with this Court's jurisdiction in an appeal. The court's jurisdiction is not in issue and I therefore see no need of putting down the quotation.

Under section 2 of the Act Royalty means: (Cap 470)

"***A payment made as a consideration for the use of or the right to use-***

(a) the copyright of a literary, artistic or scientific work; or

(b) a cinematograph film, including film or tape for radio or television broadcasting; or

(d) a patent, trade mark, design or model, plan, formula or process; or

(d) any industrial, commercial or scientific equipment, or for information concerning industrial, commercial or scientific equipment or experience, and gains derived from the sale or exchange of any right or property giving rise to the royalty."

The definition given to 'royalty' is wide which I think is an indication of the extensive range of underlying transactions giving rise to a royalty that the Income Tax Commissioner would target. The width of the definition is also important because in my view, it gives the Commissioner the right to seek withholding tax on royalty payments made offshore, and on the other hand he would expect to see similar payments being received in Kenya by the holders of Kenyan Intellectual Property that is used outside Kenya.

Section 10 of the Act is also relevant and it stipulates:

"*10. For the purposes of this Act, where a resident person or a person having a permanent establishment in Kenya makes a payment to any other person in respect of –*

(a) a management or professional fee;

(b) a royalty;

(c) interest

(d) …

(f) …

(e) …

Provided that -

(i) this section ***shall not apply unless the payment is incurred in the production of income accrued in or derived from Kenya or in connexion with a business carried on or to be carried on, in whole or in part in Kenya;***

(ii) this section shall not apply to a payment made or purported to be made, by the permanent establishment in Kenya of a non-resident person to that non-resident person.''

The Agreement between the Appellant and Infosys involved the provision of banking software packages and allied services by Infosys to the Appellant. Under that Agreement, whereas the title in the software remained in Infosys, the Appellant had the use of Infosys trade mark under the latter's policies and procedures. Clause 3 of the Agreement under subtitle 'title' provides:

"***3. TITLE***

INFOSYS ***and*** *Third Party Vendors* ***shall at all times retain all title, copyright, and other proprietary rights in*** *Software****, any modifications thereto and translations thereof.*** *Bank* ***does not acquire any rights in*** *Software* ***other than those specified in this Agreement."***

The Respondent claims therefore that the product sold to the Appellant by Infosys is clearly covered in the definition "Royalty" under the Act.

There is no dispute that Infosys was a foreign company. It is therefore a non-resident establishment and when the Appellant made payments to it, those payments amounted to income for Infosys. Under section 34(2) of the Act that income attracted tax at the appropriate non-resident rate in force at the date of payment of the income.

Section 34(2) of the Act provides

"***34(2) Tax upon the income of a non-resident person not having a permanent establishment in Kenya which consists of_***

(a) a management or professional fee;

(b) a royalty;

(c)

(d)

(e) interest;

(f)

(g)

(h)

shall be charged at the appropriate non- resident rate in force at the date of payment of that income

and shall be charged to tax under subsection(1)''

Under the Agreement between the Appellant and Infosys, the latter provided management and consultancy services to the Appellant. Under the Agreement between the parties, under title 'Annexure IV – Professional Services', it sets out the professional services rendered to the Appellant by Infosys. The Appellant clearly made payments for professional services received by it from Infosys. Under section 34(2) of the Act, as read with section 35(1) of the same Act, payment for those services attracted tax.

Section 35(1) of the Act provides:

"***35 (1) 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 and audit fees for analysis of maximum residue limits paid to a non-resident laboratory or auditor;

(b) a royalty;

(c) interest, including interest arising from a discount upon final redemption or a bond, loan, claim, obligation or other evidence or indebtedness measured as the original issue discount;

Provided that –

(i) Consultancy, agency or contractual fee;

(ii) …

(d) …

(e) interest;

(f) …

(g) …

(h) …

which is chargeable to tax, deduct there from tax at the appropriate non-resident rate;''

It is quite clear that the Appellant was not paying Infosys in order to access information from the formers website. Rather the Appellant was paying Infosys for the license to use software packages

Having come to that conclusion, I do find that grounds 1 and 2 of the appeal must fail. These grounds cannot succeed on the further grounds that the Appellant did not challenge the decision to levy tax on payments made to Infosys on the basis that the payments were not for Royalty. His challenge before the matter was referred to the Local Committee was on the ground that it made deposits and that the payments were treated in his books as Capital Work in Progress. On that basis, the Appellant contended that withholding tax was not deductable. The Appellant further contended that the contract between it and Infosys was in any event terminated and if payment of withholding tax was to be made, it would amount to double taxation. Those grounds appear to have been abandoned by the Appellant.

In my view, the Appellant's present averment that it could not deduct withholding tax because the payment was not for royalty is clearly without merit.

I now turn to the challenge raised against tax charged on interest on the so called Nostro Accounts. Mr. Namachanja for the Appellant complained that the Commissioner relied on the 'current practice' when he

invoked section 2 of the Act to demand for payment of Withholding Tax on the nostro accounts. Counsel urged that current practice did not have the force of law and that therefore the Committee erred when it applied current practice as the basis of upholding the Commissioner's decision to charge Withholding Tax on nostro accounts, since current practice was not one of the issues before them. Besides, Mr. Namachanja urged, the Appellant had no control over the debits and credits in nostro accounts and therefore it could not deduct the said Tax.

Ms Lavuna on the other hand submitted that withholding tax was not tax due from person who withholds it, but tax due to person being paid. That is the person being paid was the person earning the tax, not the one withholding it. Counsel urged that the Appellant was under an obligation by law to withhold tax for payments made to Infosys, and that deduction of the tax crystallized at the time of payment and therefore it was irrelevant whether the contract between the two parties was terminated.

According to the **Business Dictionary.com** nostro accounts are defined as foreign exchange accounts maintained by a non-local correspondent bank with a local bank in local currency. For the local bank it is a vostro Account. It is a banking term to describe an account one bank holds with a bank in a foreign country usually in the currency of that foreign country. Withholding tax on Nostro Accounts means that credit interest is withheld for foreign banks and remitted to the taxing authority, in the case of Kenya, the Kenya Revenue Authority. Whereas it is not taxed for local banks because it is considered part of operating income and will therefore be used in computing corporation tax. Exemption to payment of withholding tax, according to section 35 and section 15 of the Act, applies to interest paid to any of the institutions listed in Schedule 4 of the Act. This exemption only applies to interest and not to other payments paid to the institutions. The onus was on the Appellant to show that it should not have deducted Withholding Tax for reason of exemption or otherwise. Again the Appellant's arguments clearly do not hold water. It alleges that it was impossible for it to comply with the law and that interest was charged outside the Kenya tax jurisdiction. I agree with the counsel for the Respondent that business impossibility to effect a lawfully imposed tax cannot be a basis for lifting the tax. After all, the payment was made even though the Appellant merely describes the payment as interest. It is the Appellant alone who had the responsibility to devise workable procedures to ensure compliance with the Tax Law. Related to the issue of interest is what the Appellant describes as other charges levied under the nostro Accounts. Interest is defined under section 2 of the Act as:

"***interest payable in any manner in respect of a loan, deposit, debt, claim or other right or obligation, and includes a premium or deposit, debt, claim or other right or obligation, and includes a discount by way of interest and a commitment or service fee paid in respect of any loan or credit supplied.''***

In my view, the above definition covers the charges paid by the Appellant on the nostro Accounts. That being my view of the charges, I hold that the Respondent was entitled to levy the tax in respect of the same. The Committee did not err when it held that Withholding Tax was payable on the interest and other charges levied on the nostro account. Ground 3 of the appeal must accordingly fail.

The Appellant has also made heavy weather of the use of the words "current practice" by the Local Committee in its decision being challenged. In my view, those words are superfluous. I say so because interest on the Nostro accounts attracted tax under the Act as shown in this judgment. The use of those two words cannot in my view vitiate the decision otherwise lawfully made. Ground 4 of the appeal therefore fails.

Ground 5 of the appeal was covered when I was considering ground 2 above and it therefore accordingly fails.

My above analysis of the Appellant's appeal shows that the Local Committee considered the contentions of both the Appellant and the Respondent and the complaint that the Committee failed to consider the Appellant's case is clearly without merit. Ground 6 of the appeal therefore also fails.

In conclusion I find that the Appeal has no merit and accordingly dismiss it with costs to the Respondent.

Dated at Nairobi this 7th day of November, 2008.

LESIIT, J.

JUDGE

Read, delivered and signed in presence of:

Mr. Mbugua holding brief Mr. Namachanja for the Petitioner

Ms. Lavuna for the Respondent

LESIIT, J.

JUDGE

Mr. Mbugua

We seek leave to appeal

LESIIT, J.

JUDGE

Court

Leave to appeal is granted

LESIIT, J.

JUDGE