De La Rue Security Print Ltd v Commissioner of Domestic Taxes (Income Tax Appeal E106 of 2021) [2023] KEHC 32 (KLR) (Commercial and Tax) (13 January 2023) (Judgment)

Neutral citation: [2023] KEHC 32 (KLR)

REPUBLIC OF KENYA

IN THE HIGH COURT AT NAIROBI (MILIMANI COMMERCIAL COURTS)

COMMERCIAL AND TAX

INCOME TAX APPEAL E106 OF 2021

A MABEYA, J

JANUARY 13, 2023

BETWEEN

DE LA RUE SECURITY PRINT LTD ..... APPELLANT

AND

COMMISSIONER OF DOMESTIC TAXES ..... RESPONDENT

JUDGMENT

1. The appellant is a limited liability company incorporated in Kenya in 1992. In 2002, it entered into a contract with the Central Bank of Kenya (CBK) for the production and sale of bank notes to the latter. That contract though cancelled in 2003, the two parties entered into subsequent contracts whose terms were like the first one.

2. Sometimes in 2017, the respondent carried out an audit on the appellant and by a letter dated November 16, 2017, she gave her findings and sought clarifications on a number of issues. The parties exchanged correspondences with respect to the audit which culminated with the respondent issuing a tax assessment of Kshs 1,106,043,698/- vide a letter dated 24/8/2018.

3. The appellant objected to the assessment and an objection decision was given on 2/11/2018. Dissatisfied with the objection decision, the appellant lodged an appeal at the Tax Appeals Tribunal ("the Tribunal") which dismissed the same vide its judgment of 25/6/2021.

4. The appellant has now appealed against that decision raising seventeen grounds of appeal which can be summarized as follows: -

    1. That the Tribunal erred in holding that it had jurisdiction to hear the appeal.

    2. That the Tribunal erred in holding that the appellant was not a licensed contract manufacturer for De La Rue International Limited ("DLRI").

3. That the Tribunal erred in disregarding the Know-how and technical Assistance Agreement and acknowledging that no evidence had been submitted of the assistance provided by DLRI.

4. That the Tribunal erred in disregarding the letter dated October 13, 2017 by the National Treasury.

5. The respondent opposed the appeal vide a Statement of Facts dated 30/7/2021. She contended that, the appellant's main business was to print bank notes and security documents. That in Kenya, the appellant manufactured bank notes for the CBK and printed security documents to local commercial banks.

6. That she had audited the appellant for the period of 2013 to 2017 and communicated her findings on November 16, 2017. That upon considering all facts, she issued an objection decision dated November 2, 2018 confirming the assessment of taxes amounting to Kshs 1,106,043,698/-.

7. She contended that the Tribunal did not err in holding that the appellant was a manufacturer in the contract between the appellant and the CBK and that there was no evidence showing that DLRI was a party to the said contract. She further contended that MAP should not be the only dispute mechanism as the mechanisms in the *Tax Procedures Act* (TPA) ought to be exhausted first. That the appellant was the owner and manufacturer of the CBK bank notes under its own name and with regard to DLRI, the appellant was only a contract manufacturer of the bank notes for DLRI customers.

8. That in the CBK contract, the appellant was a full-fledged manufacturer and it had not assigned any of its rights to DLRI. Although the appellant had entered into a Know how license and Technical Assistance Agreement with DLRI, there was nothing to show that in its contract with CBK for the manufacture of bank notes, DLRI gave any license for the same.

9. It was further contended that, the appellant did not avail evidence to show that there was some additional support or knowhow received from DLRI or that the latter was involved in the manufacturing of the notes for CBK. That the letter from Treasury sought to govern the relationship between the parties and could not be interpreted as a tax decision.

10. This being a first appeal, this Court's jurisdiction is well settled. The Court is enjoined to re-evaluate the evidence presented in the court below and come to its own independent findings and conclusions. See *Selle v Associated Motor Boat Company Ltd* [1968] EA 424.

11. The case before the Tribunal was that the appellant is a Company registered in Kenya but is part of the De La Rue Plc Group. In 2002, it signed a contract with the CBK for manufacture of bank notes for the latter. That DLRI as a bank note manufacturer is involved in continuous research and development to avoid the risk of counterfeit bank notes. In undertaking the said research and development, DLRI owns intellectual property which is used in the bank notes manufacturing business.

12. That the appellant entered into a Know-how and technical Assistance Agreement DLRI for which it was paying royalty. That 15% withholding tax had been paid on the said royalties to the respondent. That in the premises, the respondent should not have brought to charge the royalties paid to DLRI. That this amounted to double taxation.

13. The appeal was canvassed by way of written submissions that were highlighted by Learned Counsel.

14. The appellant submitted that by virtue of section 29(1) of the Kenya –UK Double Taxation Agreement (DTA), it was mandatory that a tax dispute likely to resort in double taxation be resolved through Mutual Agreement Procedure (MAP). That for this reason, the Tribunal had no jurisdiction to hear and determine the matter without first MAP being exhausted. It was further submitted that the Tribunal had erred in not considering the Know How License and Technical Assistance Agreement which demonstrated the role played by DLRI in the appellant's bank notes manufacturing process and the continued use of the intangibles.

15. Counsel further submitted that the Tribunal failed to consider other functions played by DLRI and the evidence given by the appellant's witness Mr Francis Gakuru on how the appellant was reliant on DLRI on the product and process IP. That the royalty payments to DLRI were allowable expenses in determining the tax liability of the appellant and were incurred in furtherance of the appellant's business.

16. It was further submitted that by a letter dated October 13, 2017, the National Treasury granted the approval of the Know How License and Technical Assistance Agreement and the transfer pricing arrangements of the appellant and DLRI. The Tribunal was faulted for disregarding that letter. On transfer pricing guidelines, counsel submitted that DEMPE risks of the intangibles used by the appellant are borne by DLRI.

17. On her part, the respondent submitted that there was no error on the part of the Tribunal as the terms of the DTA were not mandatory and the Map process could still go on concurrently with the local dispute resolution mechanism under national law. That the provisions of Article 29(3) of the Kenya – UK DTA by incorporating the words "shall endeavor" imposed no mandatory obligations. It was the respondent's submissions that the UN and OECD commentaries on the article on MAP allowed the tax payer freedom to invoke both the domestic and MAP dispute resolution mechanisms.

18. That the appellant did not subcontract the work from DLRI in respect of the contract with CBK. That in the premises, the appellant was not a licensed contract manufacturer but a fully-fledged one. It was contended that the evidence by the appellant during cross examination of its witness demonstrated that DLRI's role was minimal in the operations of the contract between CBK and the appellant.

19. It was submitted that there was no indemnity from CBK in respect of defective bank notes as per the contract between DLRI and the appellant and that the appellant bore the risk for the period between the production and before delivery. It was submitted that the appellant failed to show how DLRI controlled the risks on behalf of the appellant and there was no evidence to show that DLRI was involved in negotiation of year 2002 contract.

20. It was averred that the product design and specifications of the bank notes came from CBK and thus became the proprietor of the design. Counsel submitted that any payment with regard to transfer of IP was contained in the cost of the bank note paper and the charges in form of royalties amounted to duplicated charges

21. Finally, it was submitted that the National Treasury letter dated October 13, 2017 was not applicable as it sought to govern the relationship between the parties and not the taxability of royalties.

22. I have considered, the record, the statement of facts and the submissions. I have also carefully considered the authorities relied on by Learned Counsel. The failure to regurgitate the same here is not that the same were not considered.

23. The first ground is that the Tribunal lacked the jurisdiction to hear and determine the appeal as the appellant had already invoked MAP.

24. It is not in dispute that on July 31, 1973, Kenya and the United Kingdom entered into a treaty to avoid double taxation ('the DTA'). The appellant submitted that article 29 of the DTA made it mandatory for transfer pricing disputes which were likely to result in double taxation be resolved through MAP and not a unilateral approach from one treaty partner.

25. It was therefore contended by the appellant that the Tribunal lacked jurisdiction as it was first required to allow the parties exhaust MAP before assuming jurisdiction of the matter. The appellant further faulted the respondent for not making attempts to have the dispute resolved through mutual agreement. The appellant maintained that once the matter was referred to MAP as mandated by the DTA, the domestic processes ought to be held in abeyance.

26. The respondent on the other hand contended that the tax payer was at liberty to invoke both the domestic and MAP dispute resolution mechanisms and the same could run parallel. In this regard, the respondent stated that the Tribunal, regardless of the existence of the MAP had jurisdiction to determine the dispute.

27. Article 29 of the DTA provides that: -

> " Mutual Agreement Procedure
>
> a. Where a resident of a contracting state considers that the actions of one or both of the contracting states result or will result for him in taxation not in accordance with this agreement, he may notwithstanding the remedies provided by the national laws of those states, present his case to the competent authority of the contracting state of which he is resident.
>
> b. The competent authority shall endeavor, if the objection appears to it to be justified and if it is not itself able to arrive at an appropriate solution, to resolve the case by mutual agreement with the competent authority of the contracting state with a view to the avoidance of taxation not in accordance with the agreement.
>
> c. The competent authorities of the contracting states shall endeavor to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the agreements.
>
> d. The competent authorities of the contracting states may communicate with each other directly for the purpose of reaching an agreement".

5. On this issue, the Tribunal was clear that the OECD and UN commentaries did not require that MAP proceedings to take precedence over local proceedings. In its judgment, the Tribunal was of the view that the use of the words "shall endeavor" in article 29 meant that the process was not mandatory.

6. The appellant relied on the OECD commentary more specifically on paragraph 27 and 34 where it states that domestic law would not justify a failure to meet treaty obligations and that in most cases the domestic recourse provisions would be held in abeyance in favour of less formal and bilateral nature of Mutual Agreement Procedure.

7. The respondent on the other hand relied on paragraph 42 on the UN commentary on article 25 which provides that where there is an ongoing suit on the issue upon which agreement is sought by the same taxpayer the discussions should await a court decision.

8. From the foregoing, the question for determination is whether by virtue of Article 29 of the DTA, the Tribunals jurisdiction was limited by the procedures of MAP.

9. I have looked at Article 29 the DTA. It is clear that MAP is to be resorted to notwithstanding any remedies available in the contracting state. The use of the terms "shall endeavor" makes the process permissive and not mandatory. In any event, MAP is to be resorted to if it appears to the competent authority that the objection is justified and itself is not able to arrive at an appropriate solution.

10. In view of the foregoing, notwithstanding that MAP had been resorted to, there is no evidence to show that the respondent had found the appellant's objection to be justified and that the respondent was not able to arrive at an appropriate solution. She applied the Kenyan Tax Statutes and in her view resolved the issue. This is by way of the tax assessment and followed by the objection decision.

11. Since the filing of the appeal before the Tribunal is the procedure laid down by the law, and there be no provisions either in the DTA or OECD or UN commentaries that oust the national legal provisions, the Tribunal had the jurisdiction to hear the matter.

12. Whilst this Court appreciates the importance of the MAP, the same cannot be a bar to the domestic procedures laid out by the national laws. If anything, the interests of justice would be to allow parties to elect the forum where their disputes are to be adjudicated. The appellant invoked both the MAP and the Tax Appeals Tribunal. The Tribunal's jurisdiction having been invoked in accordance with the law, it properly exercised the same and cannot be faulted for refusing to abdicate the same. That ground therefore fails.

13. The second ground was that the Tribunal erred in holding that the appellant was not a licensed contract manufacturer for DLRI. In its judgment, the Tribunal held that it was not convinced that the appellant was a contract manufacturer on behalf of the DLRI for reasons that; firstly, the contract between CBK and the appellant was between the two parties, and secondly, the quantities to be produced were agreed upon by the appellant and the CBK.

14. The Tribunal found that no evidence had been adduced to show that DLRI had been involved as a party in the CBK contract. Further that, it had not been shown that DLRI was instrumental in activities involving production, planning, procurement among others.

15. Paragraph 9.50 of the OECD Transfer Pricing guidelines 2017 describes a fully-fledged manufacturer as: -

> " Assume a taxpayer, which is a member of an MNE group used to operate as a fully-fledged manufacturer and distributor, ...
>
> The tax payer purchased raw materials, manufactured finished products using tangible property and intangibles that belong to it or were rented/ licensed to it, it performed marketing and distributing functions and sold the finished products to third party customers. In doing so. The Company assumed a series of risks such as inventory risks, bad debt risks and market risks."

16. The appellant contended that there was no bar for a fully-fledged manufacturer paying for IP rights in fulfilment of the contract. It was also submitted that the appellant was a DLRI contract manufacturer for export work.

17. I have considered the material on record. The contract for manufacture of bank notes between the appellant and CBK was between the two parties. The obligations of each party was therein set out. Nowhere was DLRI indicated therein as having any role to play in the aforesaid manufacture and or performance of that contract.

18. The contract tasked the appellant with the production of the bank notes and in the event the notes did not meet the conditions specified in the contract, the appellant would assume the risk. The appellant assumed all the risks associated with the performance of that contract. Therefore, from the contract, it is evident that the appellant was a full-fledged manufacturer. The Tribunal did not err. Accordingly, that ground fails.

19. The other ground was that the Tribunal erred in disregarding the Knowhow and technical Assistance Agreement and acknowledging that no evidence had been submitted of the assistance provided by DLRI.

20. The appellant's case was that the appellant and DLRI entered into a Know how License and Technical Assistance Agreement for the manufacture and sale and distribution of bank notes to the CBK. According to the appellant, that agreement demonstrated that DLRI was involved in the manufacturing process of the bank notes and the use of DLRI'S intangibles by the appellant.

21. It was submitted that the evidence presented to the Tribunal showed that the appellant did not have a design team or function in charge of the development and protection of De La Rue's intangibles thus the appellant relied on DLRI for development, enhancement, maintenance, protection and exploitation. The appellant's contention was that the services it obtained from DLRI justified the royalty payment.

22. In reply, the respondent contended that the appellant had established the know how over the many years of experience even before the Know how License and Technical Assistance Agreement came into force. She further contended that prior to the agreement, the appellant was still able to manufacture and sell banknotes to CBK.

23. It is not disputed that the appellant and DLRI entered into a Know how License and Technical Assistance Agreement in the year 2010. The agreement was to the effect that the appellant would pay royalties to DLRI for the additional support and know – how received in performance of the Kenya CBK contract.

24. The Tribunal was not satisfied as to the nature of the technical assistance that was provided under that Agreement. Further, that there was no evidence of the customer relationship between the CBK and the DLRI.

25. The cardinal principle of the law of evidence is that, he who alleges must prove. I have perused the evidence placed before the Tribunal. Through its witnesses, the appellant explained how it benefits from that agreement with DLRI. While this Court appreciates that the appellant was at liberty to source the license from DLRI, the question that is apparent is whether the said services were actually given and whether the appellant benefited from the said agreement as alleged.

26. In this Court's view, it was not enough to allege that the appellant was heavily reliant on the process IP and product provided by DLRI, the appellant ought to have clearly demonstrated what changed after the agreement. It should be noted that the contract between the appellant and the appellant was full proof. By this I mean, CBK retained IP on the bank notes, the quality was specified and everything that was to be manufactured by the appellant.

27. As already found, the contract between the appellant and CBK was between the two and no other party. There was no mention in that contract about the involvement of DLRI in any capacity. There was no issue of the appellant having to acquire and or seek the expertise of DLRI or any other entity thereafter.

28. Further, there was no evidence to show that, after the so called Know how License and Technical Assistance Agreement, the appellant acted any different way than it was before entering into that agreement. The question is, what was added into the contract of manufacture between the appellant and CBK after the Know how License and Technical Assistance Agreement? Nothing. If there was any, the same was not demonstrated either to the Tribunal or to this Court.

29. The so-called embedded additions by way of research and development by DLRI, that was encapsulated in the cost of the bank note paper that DLRI sold to the Appellant and nothing more. In the circumstances, the payment of royalty for the same was but a double payment. Accordingly, I find no error on the Tribunal's holding on this issue.

30. The next ground is that the Tribunal erred in disregarding the letter dated October 13, 2017 by the National Treasury. I have perused the letter and it confirms that the National Treasury was satisfied with the terms of the Know how License and Technical Assistance Agreement and the pricing agreement.

31. The appellant's contention was that the respondent was bound by the said letter and the decision taken by National Treasury. The Tribunal held that the basis of the case was the audit conducted in the years 2013 to 2017 and that the decisions made to impose or exempt tax must be based on law.

32. Looking at the letter, it was not an endorsement or acknowledgment that the so-called License agreement was binding on both the CBK and the respondent. Further, that letter could not and cannot be taken to be a tax decision on which any party could or can rely on to exclude the application of the tax law. In this country, and as correctly found by the Tribunal, tax can only be constitutionally exempted in accordance with the written law. There is no written law that was cited either to the Tribunal or to this Court on the basis that the that letter was sufficient to be a tax exemption. That ground also fails.

33. On the issue of the 15% withholding tax, that was an amount withheld by the appellant on behalf of DLRI. The appellant cannot claim the same. It is DLRI to claim the same before the competent authority in its territory of operation, UK. There was no evidence to show either that DLRI had not claimed the same in the UK or that it had claimed and the same rejected. That ground also fails.

34. From the foregoing, I find that the appellant has not made out a case to warrant the interference of the Tribunal's decision of June 4, 2021. The appeal has no merit and is therefore dismissed with costs.

It is so decreed.

DATED AND DELIVEREDAT NAIROBI THIS 13TH DAY OF JANUARY, 2023.

A. MABEYA, FCIArb

JUDGE