IN THE COURT OF APPEAL

AT NAIROBI

(CORAM: GITHINJI, OKWENGU & G.B.M. KARIUKI, JJ.A)

CIVIL APPEAL NO. 184 OF 2009

BETWEEN

KENYA COMMERCIAL BANK LIMITED……..APPELLANT

AND

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

(*An appeal from the judgment of the High Court of Kenya at Nairobi – Commercial Division* ***(Lesiit, J.)*** *dated 7th November, 2008* **in H.C. Income Tax Appeal No.14 of 2007)**

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JUDGMENT OF THE COURT

This is an appeal against the judgment of the High Court (**Lesiit, J**.) dismissing with costs the appellant's appeal against the decision of Income Tax Local Committee in **Committee Case No. 30/06/07**.

The facts leading to the appeal in the High Court were briefly as follows:

The appellant, (**bank**), entered into a ***Software Licence and Service Agreement*** dated 18th June 2007 with Infosys Technologies Limited (**Infosys**), a company incorporated in India. By the agreement, Infosys agreed to provide banking software packages and allied services including professional services. The professional services included hardware and network consultancy services. The bank was also required to procure Annual Technical Support (ATS) services from Infosys as specified in the Agreement. The bank agreed to pay the Infosys licences, ATS and professional service fee as specified in the payment schedule annexed to the agreement. The fees payable for licence for Infosys Software, ATS, third party software and professional services were specified in the agreement which were to be paid in percentages over a period. However, 15% of licence fees for part of Infosys software, 15% of Licence fees for third party software & ATS fees (**Annual Technical Support**) services, and 30% of hardware & network consultancy services were to be paid upon signing the agreement. The agreement provided that all other payments were to be made within 7 days of the receipt of Infosys invoice. In the years 2001 and 2002, Infosys raised invoices which the bank paid.

In the year 2004, after a historical review of the contract and the project, the bank and Infosys agreed to terminate the original agreement. The agreement was subsequently terminated by an addendum dated 12th May 2004 which provided in part:

"PAYMENT OF OUTSTANDING SUMS

The Bank shall pay INFOSYS the sum of United States of America Dollars Three Hundred and fifty Three Thousand Five Hundred and Sixty Five (US $353,565) as the amount agreed as outstanding for license, services, Annual Technical Support and travel expenses for the implementation of ITMS. The said sum shall be paid in full within 15 days of execution of this Addendum"

The bank maintains Nostro accounts with correspondent banks abroad principally to facilitate their customers' transactions. When the accounts fall in debit balances, interest is levied; other charges are also levied for operating the accounts.

Apparently the bank was assessed as liable to pay withholding tax on Infosys payments, interest and incidental expenses on Nostro accounts and audit fee paid by the bank to Messrs Ernest and Young. The liability to pay withholding tax on three payments was disputed by the bank. By a letter dated 13th June 2003, the Senior Deputy Commissioner, Local Tax Office notified the bank that withholding tax was payable and advised the bank to pay the tax arrears which stood at shs. 57,150,556/-as at that date.

The bank appealed to the Local Tax Committee which on 16th August 2007 made the following decision:

"1. Both parties agreed between themselves that withholding tax was not payable on audit fees.

(2) The payment to Infosys System was in respect of royalty as defined in the Income Tax Act and is therefore subject to withholding tax.

(3) Current practice is that transactions reflected in Nostro accounts attract withholding tax. The local committee reaffirms this position and sees no reason to vary the practice."

The bank appealed against that decision to the High Court which, as stated before, dismissed the appeal.

In respect of payment to Infosys, the issue before Income Tax Local Committee was whether that payment was royalties, that is, payment for normal license fees for use of the software, subject to withholding tax.

The appellant contends that since Infosys did not deliver the software and since the contract was ultimately terminated, the payments were deposits which were treated in its accounts as capital – work in progress and not payment for services rendered. It was contended that deposits do not attract withholding tax. The respondent's case was that from the invoices, the payments were installments in respect of licence fees; that Infosys was paid by the appellant as per the agreement and that the tax point for withholding tax is when a person is paid irrespective of whether he has delivered or not. The local committee rejected the appellant's case and upheld respondent's submissions. The main ground of appeal to the High Court was that the local committee erred in law in finding that the payment to Infosys was in respect of royalty.

The High Court made a finding that payment to Infosys, were for the licence to use software packages and for professional service which amounted to income for Infosys for which withholding tax was payable. The appellant appeals on the ground that the High Court erred in law and in fact in holding that the payment to Infosys was in respect of royalty as defined in the Income Tax Act and therefore subject to withholding tax.

We must confess that at the outset we entertained doubt whether or not an appeal lies to this Court from the decision of the High Court, seeing that the Income Tax Act does not specifically provide for appeal to this Court. The issue of the competence of the appeal was not raised.

Our research has revealed that the issue of such jurisdiction was directly raised in this Court in

Commissioner of Income Tax ***v.*** **Memon [1985] eKLR** and the majority decision was that the Court has jurisdiction to entertain an appeal. We would let the matter rest there.

By section 3(1) as read with section 4(9) of the Income Tax Act (**Act**), income tax is charged for each year of income upon all income of a person whether resident or non-resident which accrued in or was derived from Kenya.

By section 10(a), (b) and (c) of the Act:

> ***"…where a resident person or person having permanent establishment in Kenya makes a payment to any other person in respect of:***
>
> ***(a) a management or professional fees or training fees;***
>
> ***(b) a royalty;***
>
> ***(c) interest***
>
> **…….**
>
> **…….**
>
> ***the amount thereof shall be deemed to be income which accrued or was derived from Kenya;"***

Section 35(1) of the Act provides:

> ***"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;***
>
> ***Provided that:***
>
> ***(d) …..***
>
> ***(e) interest which is chargeable to tax, deduct therefrom tax at the appropriate non-resident rate."***

Section 34(2) of the Act stipulates that tax upon the income of a non-resident person not having a permanent establishment in Kenya which, *inter alia,* consists of a management or professional fees, a royalty or interest shall be charged at the appropriate non-resident rate in force at the date of payment of that income.

Lastly, section 2 of the Act defines royalty as:

> ***"a payment, made as a consideration for use of or the right to use-***
>
> ***(a) the copyright of a literally, artistic or scientific work; or***
>
> ***(b) a cinematograph, film, including film or tape for radio, television broadcasting; or***

(c) 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 of exchange of any right or property giving raise to that royalty;"

We have considered the respective written and oral submissions. The appellant contended before the Commission, the Income Tax Local Committee, in the High Court and still contends in this appeal, that the payment for licence, to use Infosys software packages and other fees were deposits which it properly treated in its accounts as capital – work in progress and not payments for services rendered. On the other hand, the respondent has contended all along that under the agreement the payment was for licence and related services.

We agree with the respondent's submissions that whether payment was for licence and related services or deposits is a question of fact to be determined from the agreement and the transactions between the parties.

That question of fact has been determined by the Commissioner, the Income Tax Local Committee and by the High Court. The three entities have made a finding that the payments were for licence fees and related services and not deposits for capital – work in progress. The finding is amply supported by the evidence. The agreement between the parties did not provide for payment of deposits. It specifically provided for payment of licence ATS and professional services fees as per payment schedule agreed upon. The payment agreed upon stipulated the percentages of the fees to be paid at specified stages of the implementation. The several invoices which Infosys raised were paid by the appellant in pursuance of the agreement. Furthermore, even after the agreement was terminated nearly three years later, the appellant agreed to pay US dollars 353,565 being amount agreed as outstanding for licence services, ATS and travel expenses for implementation of ITMS.

As section 10, 34(2) and 35(1) of the Act stipulates, liability to pay tax arises upon making payment. The liability is not dependent on full performance of the contract or on whether the contract was ultimately beneficial to the appellant.

The question whether the payment was in respect of royalty is obviously a question of law. The word "**royalty**" is defined in the Act and it is that definition which applies in this case. The appellant has in its written submission heavily relied on the lack of clear categorization of the payments that attracted withholding tax under section 35(1) of the Act. It is contended that the respondent claimed that all three categories of payments were in respect of royalties and that it is not clear whether the respondent sought to impose withholding tax on software licence fees, ATS fees or professional services fees. The appellant faulted the High Court for making a finding outside the pleading that payment for professional services attracted tax.

As indicated above, the real issue between the parties was whether payment to Infosys in respect of licence fees for use of software was royalties subject to withholding tax. As the High Court found, the appellant did not challenge the decision to levy tax on the payments made to Infosys on the basis that payment were not for royalty. Indeed, the letter dated 18th May 2004 from Messrs Ernest & Young who were acting for the appellant to the Commissioner clearly indicates that the appellant's case was that the payment did not attract withholding tax on the basis that the payments was a deposit and not payments as licence fees for software. The issue whether payment for licence fees for use of software was royalty under the Act was not directly raised. However, the agreement between the parties was for grant of a licence to the bank to use Infosys computer software program and for provision of other services. The agreement specifically provided, *inter alia*, that Infosys would at all times retain all title, copyright and other proprietary rights in software and that the bank would not acquire any rights other than those specified in the agreement. Clause 3 of the Addendum terminating the agreement provided that all software delivered which the bank had not paid for in full should be deleted, destroyed and de-installed by the bank. It is plain from the agreement that the payment of licence fees was a consideration or the right to use Infosys intellectual property in the form of computer software program which is within the

definition of royalty under clause (c) of section 2 of the Act. The issue now raised that there was no clear categorization of the payments was not raised in the High Court and the High Court did not thus make a finding on that issue. There was no ambiguity. The issues framed before the local committee shows that "**royalties**" referred to licence fees for use of the software.

The Commissioner's letter dated 13th June 2005 referred to software licence fees or service fees as both attracting withholding tax. It was conceded by the appellant that withholding tax was chargeable under the Act on professional fees. From the foregoing, we are satisfied that the High Court reached the correct decision on the question of liability for withholding tax on payments to Infosys.

As regards the question whether payments for interest and other incremental charges levied on Nostro accounts held by the appellant outside Kenya is subject to withholding tax, the Commissioner's decision advised the appellant that by the definition of "**interest"** in section 2 of the Act, interest and incidental expenses are subject to withholding tax. The Local Committee made a finding that the current practice is that transactions related in Nostro accounts attract withholding tax.

The High Court held that payment of withholding tax on interest on Nostro accounts is not exempted by the Act and that the definition of "**interest**" under the

Act covers charges paid by the appellant on Nostro accounts. The appellant avers in the grounds of appeal that the High Court erred in law and fact in upholding the decision of the Local Committee and failing to appreciate the legal significance of the words "**current practice**" used by the local committee.

Mr. Namachanja the appellant's counsel has made extensive submissions including that:

(i) Section 35(1) of the Act does not apply to Nostro accounts.

(ii) Given the way Nostro accounts operate there is no way that the appellate court will be able to comply with requirement of deducting tax upon payment of an amount to a non resident.

(iii) Deduction at source cannot amount to payment.

(iv) The bank charges incurred on overdrawn Nostro accounts in India accrued in or were derived from India and not from Kenya.

(v) The definition of interest does not include incidental expenses.

(vi) The Act does not provide a system of how to deal with Nostro accounts.

(vii) Bank charges incurred on Nostro Accounts cannot be subject to withholding tax on the basis of "current practice".

(viii) In Australia, bank charges for maintenance of Nostro accounts and interest gained on Nostro amount held in those accounts are not taxed.

The respondent relies on definition of "**interest"** in section 2 of the Act and on provision of Section 35(1) for the submission that withholding tax on Nostro accounts is based in law or usage having the force of law.

We have encountered difficulties in determining the issue whether payment for interest and incidental charges levied on Nostro accounts held by appellant outside Kenya is subject to withholding tax. The first problem is that we cannot decipher the particular Nostro account which is alleged to be subject to withholding tax in this case and the amounts involved. It is not clear whether the withholding tax relates to Nostro accounts operated in India in respect of Infosys payments or to Nostro accounts generally operated by the appellant in several countries.

The Commissioner's letter dated 13th June 2005 merely refers to interest and incidental expenses in Nostro accounts. Similarly the appeal précis merely refers to interest and other incidental charges levied on Nostro accounts held by the appellant outside Kenya.

The second problem is that there are no documents evidencing the operations and managements of those accounts and therefore it is difficult to know how and when the interest and charges accrued and how and when they were paid by the appellant.

The third problem is that there were no agreed facts before the Income Tax Local Committee relating to the operations and state of the Nostro accounts at the time withholding tax was assessed. In the absence of any agreed facts by the parties, the extensive submissions by the appellant's advocates are largely abstract and speculative.

The fourth problem is that there was no expert opinion before the local committee on whether interest and other charges levied in Nostro accounts are subject to withholding tax under the Act.

The Court is nevertheless required to determine the issue based on income tax principles stipulated in the Act in spite of those limitations. By Section 34(2) of the Act, tax upon the income of a non-resident person not having a permanent establishment in Kenya consisting of "interest" is charged at appropriate non-resident rate at the date of payment.

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.

Interest is defined in section 2 as meaning "***interest payable in any manner in respect of a loan, deposit, debt, claim or other right or obligation and includes a premium or discount by way of interest and a commitment on service fees paid in respect of any loan or credit".*** The word "**paid**" is also defined in section 2 of the

Act and includes "***distributed, credited, dealt with or decreed to have been paid in the interest or on behalf of another person***."

In the course of our research on the issue of whether Nostro accounts attract withholding tax, we have discovered that the issue was considered by the Police Unit Technical Think Tank of the respondent ten years ago, in the quarterly Technical Bulleting No. 001 for period from July – September 2006, The issues now being raised by **Mr. Namachanga** including administrative difficulties to operate the withholding tax on Nostro accounts were raised by financial institutions and the Police Unit Technical Think Tank made a ruling on the issue framed as **Issue No. 9** thus:

> ***"Whatever is charged by foreign banks on Nostro accounts falls within the meaning of interest as defined in section 2 of the Income Tax Act. The charges also fall within the ambit of interest since they are levied in connection with credit advanced to the banks, financial obligation, claim commitment or a service.***
>
> ***As long as the expense is debited from the banks account, it is deemed to have been paid and withholding tax becomes immediately payable. This is in line with the definition of the word "paid" which deems a payment to have been effected once the expense has been dealt with or recognized in the bank's books".***

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 appellant for foreign exchange transactions. The appellant does not contend that it did not pay to the correspondent bank for those services.

In the premises, we agree with the finding of the High Court that the liability to pay, deduct withholding

tax on Nostro accounts is based on the income tax law and not as the local committee erroneously held on current practice.

For those reasons, the appeal is dismissed with costs to the respondent.

Dated and delivered at Nairobi this 5th day of August, 2016.

E. M. GITHINJI

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JUDGE OF APPEAL

H. M. OKWENGU

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JUDGE OF APPEAL

G.B.M. KARIUKI

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JUDGE OF APPEAL

I certify that this a true copy of the original

DEPUTY REGISTRAR