



REPUBLIC OF KENYA

IN THE HIGH COURT OF KENYA AT NAIROBI

Civil Suit 7 of 2008

COMMISSIONER OF INCOME

TAX.....APPELLANT

VERSUS

MABATI ROLLING MILLS

LIMITED.....RESPONDENT

JUDGMENT

1. THE BACKGROUND OF THE APPEAL

On 24th February, 2012 the Kenya Revenue Authority issued to the respondent a notice of assessment to pay a sum of **Kshs.141,884,052/=** being tax, penalty and interest for years 1996 to 2001. The notice stated, *inter alia*:

“RE: WITHHOLDING TAX ASSESSMENTS 1996 TO 2001 YEAR OF INCOME KSH.141,884,052

As discussed with yourselves during an audit carried out between 4th and 8th February 2012, your company was found to have paid interest to several non-resident persons in respect of supply of both machinery and raw materials on credit. Such interest should have withholding tax upon payment.”

2. The respondent objected to the said assessment on the grounds that since the contact that gave rise to the payments was made in Japan, the interest payments are not income chargeable to tax under the provision of **Section 3 (1)** of the **Income Tax Act**.

3. Pursuant to **Section 86 (1) (b)** of the **Income Tax Act**, on 19th June, 2002 the respondent served a notice of appeal to the Local Committee for Nairobi South Area against the said assessment. The appeal was heard by the said committee and on 26th September, 2003 made the following decision:

“APPEAL ON WITHHOLDING TAX COVERING 1996 TO 2001 YEARS OF INCOME”

“The interest was carried by foreign companies outside Kenya on supply of raw materials

F.O.B. By reason that the total activities relating to the interest was outside Kenya the source of the interest was not Kenya. Therefore the members of the Local Committee are of the opinion that the appellant was not obliged to withhold any amount in respect of withholding tax relating to such type of interest”.

B. THE APPEAL

On 3rd October, 2003 the appellant served a Notice of Intention to Appeal to this court against the decision of the Local Committee aforesaid. The appellant filed a memorandum of appeal on 5th November, 2003.

4. Five grounds of appeal were raised as follows:

“1. The Local Committee has wrongly upheld the respondent’s appeal that the respondent was not under obligation to withhold any amount in respect of withholding tax on payment of interest to a non-resident person;

2. The Local Committee erred in Law in deciding that the respondent was not under obligation to withholding tax on payment of interest to a non-resident person;

3. The Local Committee erred in Law in charging income tax upon all the income of a person, whether resident or non-resident which accrued in or was derived from Kenya;

4. The Local Committee erred in law in refusing the deduction of withholding tax upon payment of interest, which is chargeable to tax to a non-resident person; and

5. That the Notice of Assessment issued by the Appellant on 27th February 2002 to the respondent which was the subject of the dispute between the appellant and the respondent should be upheld.”

5. The respondent filed a statement of facts (under protest) and contended, *inter alia*, that:

“9. Between 1996 and 2001, the appellant purchased raw materials and machinery from non-residents. The purchase price for the acquisition of the said raw material and machinery was on supplier credit from the respective suppliers in their respective countries of origin subject to the laws of those countries and with interest to be paid to such suppliers in their respective countries of domicile.

10. The schedule attached to the notice was prepared by the appellant after having had access to all the respondent’s records in respect of each transaction and the amounts in the 2nd column thereof state the interest amounts in US Dollars in respect of each purchase.

11. In each particular transaction, the obligation to purchase and indeed to pay interest arose in the countries of origin of the non-resident suppliers where the contracts to purchase were entered into and accordingly payment of both the purchase price and interest was made in the countries of origin of the non-resident suppliers. The contention was supported by commercial invoices in respect the transactions; one of such invoices is annexed to the notice of objection which is part of bundle marked MRM1 and referred to in paragraph 13 below.

12. None of the said non-resident suppliers produce in Kenya the raw materials or the

machinery which the appellant requires and moreover none of the said non-resident suppliers conduct any business in Kenya.

13. In the Local Committee proceedings, the respondent presented its statement of facts and the memorandum of appeal. A copy of the memorandum of appeal, statement of facts and all the documents referred to in paragraphs 2 – 8 above are annexed in a bundle marked MRM 1.

14. In response thereto, the appellant also filed what they called an “Appeal Precis”.

15. Respondent prepared and filed with the Local Committee written submissions. A copy is hereby annexed and marked MRM 2.

16. The main issue of contention in the appeal at the Local Committee stage was whether the source of interest in question was within or outside Kenya. The Local Committee in its ruling found as a matter of fact that the source of this interest was outside Kenya and therefore not subject to withholding tax. The respondent therefore had no obligation to withhold tax in respect of such interest. A copy of the Local Committee’s decision has already been attached in the appellant’s bundle of documents.

17. The Local Committee’s decision was in tandem with Respondent’s arguments advanced before the Local Committee and as set out in paragraph 9-16 above.”

6. The respondent further protested that the appellant had filed five different appeals against the decision of the Local Committee, notwithstanding that there was only one assessment for the entire period 1996 to 2001, one appeal at the Local Committee, one decision for the same and Notice of Intention to Appeal.

7. The respondent further filed a Notice of Preliminary Objection on the grounds that:

“(a) THAT, no appeal lies from the said determination of the local committee under the provisions of the Income Tax Act.

(b) THAT, the appeal is in respect of non existent decision from the local committee.

(c) THAT, no notice of appeal has been served in respect of the appeal filed, and if any notice of appeal was served which is denied, then the same was served out of time.”

8. This appeal as well as three others, Nos. 5, 6, and 8, all of 2008, were consolidated and heard together.

9. The appellant was granted leave to file an affidavit in respect of the preliminary objection raised by the respondent. The preliminary objection was argued within the appeal and so I shall consider the arguments raised therein together with the respondent’s reply to the appellant’s submissions.

10. Mr. Ontweka for the appellant and Mr. Oraro for the respondent filed their respective clients’ written submissions and highlighted the same.

C. THE APPELLANT’S SUBMISSIONS

11. The main issue for determination in these appeals as framed by the appellant is:

“Whether interest paid by a resident person to a non resident person in respect of credit supply of raw materials and machinery by the non resident person to the resident person, is income of that non resident person which accrued in or was derived from Kenya and therefore subject to withholding tax in Kenya.”

12. Mr. Ontweka submitted that the decision by the Local Committee left the appellant with no clear implementation guideline and denied the appellant revenue that is legally due by dint of the provisions of the Act. Under **Section 87 (2) (c)** of the **Income Tax Act**, **“the appellate body may confirm, reduce, increase or annul the assessment concerned or make any other order thereon which it may think fit”**.

13. Mr. Ontweka faulted the Local Committee’s decision and contended that the interest paid by the respondent attracted withholding tax. He cited **Section 2, 3 (1) 3 (2) (b), 10 (c), 35 (1) (e) and 35 (6) (a)** of the **Income Tax Act**. He further made reference to **rule 4 (1)** of **The Income Tax (Withholding Tax) Rules 2001**, which requires a person who makes a payment of, or on account of, any income which is subject to withholding tax to deduct tax therefrom in the specified amount.

14. **Section 3 (1)** of the **Income Tax Act** provides that:

“3(1) Subject to, and in accordance with, this Act, a tax to be known as income tax shall be charged for each year of income upon all the income of a person, whether resident or non-resident, which accrued in or was derived from Kenya.”

Counsel urged the court to read the above section together with **Section 10 (c)** which states that where a resident person or a person having a permanent establishment in Kenya makes a payment to any other person in respect of interest the amount thereof shall be deemed to be income which accrued in or was derived from Kenya. However, I should point out that the above section does not apply unless the payment is incurred in the production of income accrued in or derived from Kenya or in connection with a business carried on or to be carried on, in whole or in part in Kenya.

15. The appellant’s counsel cited two cases in support of his submissions:

(i) In **KENYA COMMERCIAL BANK LTD vs. KENYA REVENUE AUTHORITY**, Income Tax Appeal No. 14 of 2007 [2008] eKLR; the appellant was challenging a decision of the Income Tax Committee that payment to a company known as Infosys System was in respect of a Royalty and therefore subject to withholding tax. The High Court held that interest paid to a resident person attracts withholding tax.

(ii) In **STANBIC BANK KENYA LTD vs. THE KENYA REVENUE AUTHORITY**, Civil Appeal No. 77 of 2008 [2009] eKLR, the Court of Appeal held that payment made to a non-resident person attracts withholding tax. The appellant had paid certain amounts of money to Reuters (UK) for services rendered as management and professional fees and thus subject to withholding tax.

D. THE RESPONDENT’S SUBMISSIONS

16. Regarding the preliminary objections, Mr. Oraro submitted that:

(a) Notice of intention to file appeal was filed on 3rd October, 2003 and thereafter memoranda of appeals were served on 12th November, 2003 well out of time without seeking any extension. See **rule 3** of the **Income Tax (Appeals to the High Court) Rules**.

(b) **Section 3 (1)** of the **Act** provides that:

“3(1) Subject to, and in accordance with, this Act, a tax to be known as income tax shall be charged for each year of income upon all the income of a person, whether resident or non-resident, which accrued in or was derived from Kenya.”

The appellant made a consolidated assessment for the years 1996 to 2001 contrary to the Act. Assessment should have been for each year. Mr. Oraro submitted that the appellant realized its fatal and incurable error in making a consolidated assessment for five years hence its filing of five separate appeals for each of the five years without assessment in respect of the claim for each of the years. The respondent urged the court to strike out the appeals.

17. Without prejudice to the preliminary issues aforesaid, the respondent contended that the payments made by itself to the Japanese company did not attract any withholding tax under **Sections 10 (c)** and **35** of the **Act**.

18. The respondent emphasized the following facts:

“(i) The supplier had its permanent residence in Japan.

(ii) The contract was entered into in Japan.

(iii) Applicable law for dispute resolution was in Japan.

(iv) The goods were and delivered in Japan.

(v) Risk and ownership of the said goods passed to the respondent company in Japan.”

In view of the foregoing, it was submitted that:

“(vi) The issue is not therefore whether interest payable by a resident person to a non resident person in respect of credit for supply of machinery is income accrued or derived from Kenya but whether a contract entered into and performed outside Kenya in this event in Japan, attracts withholding tax pursuant to the provisions of the Section 10 (c) and 35 (e) of the Income Tax Act.”

19. Mr. Oraro cited the provisions of **Section 35 (1)** of the **Income Tax Act** which states:

“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 fees 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 of a bond, loan, claim, obligation of other evidence of indebtedness measured as the original issue discount;

provided that –

- (i)
- (ii)
- (d)
- (e) interest
- (f)
- (g)

which is chargeable to tax, deduct therefrom tax at the appropriate non-resident rate;”

However, counsel submitted that **Section 35 (1) (e)** above can only be applicable if the income made by such person accrued from or was derived in Kenya and not where the whole transaction took place outside Kenya. A person is chargeable to tax by the provision of **Section 3 (1)** of the **Act**, he added.

20. Regarding **Section 10** of the **Act**, Mr. Oraro submitted that it is a deeming provision and provides that where a resident person or a person having a permanent establishment in Kenya makes a payment to any other person in respect of interest (among other items), the amount thereof is deemed to be income which accrued in or was derived from Kenya provided the payment was incurred in the production of income accrued in or derived from Kenya or in connection with a business carried on or to be carried on in whole or in part in Kenya. In this case, the interest was paid to a company which on the sale of its machinery or raw materials had no connection whatsoever with Kenya and to support its position, it ensured that the contract, the delivery and payment was made in Japan. The payment was not incurred in the production of income accrued in or derived from Kenya or in connection with a business carried on or to be carried on in Kenya.

21. The respondent cited the case of **ESSO STANDARD EASTERN INC. vs. INCOME TAX [1971] E.A. 127**. The brief facts of that case were that the Commissioner of Income Tax confirmed an assessment on the appellant of income tax on interest received by it in respect of a loan. The agreement of the loan was made with a Kenyan company for the construction of a refinery in Kenya and for working capital. The agreement was made in New York, the payment of the loan was made in New York in dollars and all repayments were to be made in New York in dollars. The question at issue was whether the interest on the loan accrued in or was derived from Kenya. The Court of Appeal held that the words “**accrued in**” and “**derived from**” are synonymous. The court went on to state that the source of income is the place from which it is derived and this is a question of fact. The source of the interest was the contract made in New York, the location of that source was New York and the interest neither accrued in nor was derived from Kenya.

22. Mr. Oraro further submitted that none of the cases referred to by the appellant are of any relevance. In respect of **KENYA COMMERCIAL BANK vs. KENYA REVENUE AUTHORITY (Supra)**, the question for determination was whether withholding tax was payable in respect of royalty paid to a non-resident company for services rendered in Kenya by providing software which is a different issue from the one under consideration in this appeal. In **STANBIC KENYA LIMITED vs. KENYA REVENUE AUTHORITY (Supra)**, the issue that fell for consideration was whether a person who had been offered services in Kenya through subscription of a foreign company including technical support and consultancy

was subject to the provisions of withholding tax. The Court of Appeal held that such a person was subject to the provisions in respect to withholding tax. In that case the contract had been entered into and rendered in Kenya. Counsel urged the court to dismiss the appellant's appeal.

E. THE APPELLANT'S RESPONSE

23. **Mr. Ontweka** briefly responded to the preliminary issues raised by the respondent and stated that there was no memorandum of appeal served upon the respondent by the appellant. It is the court which was to effect service upon the respondent. **Rule 7 of the Income Tax (Appeals to the High Court) Rules** stipulates that a copy of the memorandum of appeal and the documents referred to in **rule 5** shall be served by the Registrar upon the respondent. The memorandum of appeal was filed on 5th of November, 2003 and the respondent was served on 12th November, 2003.

24. Regarding absence of specific assessments for each year, Mr. Ontweka submitted that prior to 2001 there were no guidelines regarding appeals relating to withholding tax. In his view, therefore, **Section 3 (1) of the Income Tax Act** does not apply to withholding tax.

25. Regarding the case of **ESSO STANDARD EASTERN INC. vs. INCOME TAX (Supra)** counsel submitted that the appellant was non-resident company as opposed to the respondent in this case. He added that the raw materials and machinery were used in Kenya and the respondent was therefore subject to the provisions relating to withholding tax, even if interest was paid in Japan.

F. FINDINGS

26. I have considered all the submissions made by counsel for the parties as well as the material on record. I will start by making a finding on the preliminary issues raised by the respondent.

27. It was submitted that the appeals are not admissible because notice of intention to appeal was filed on 3rd October, 2003 and the memoranda of appeals served on 12th November, 2003 outside the thirty (30) days' period stipulated under **rule 3 of the Income Tax (Appeals to the High Court) Rules**. It appears to me that the memoranda of appeals were filed within time but service thereof was delayed. As rightly pointed out by Mr. Ontweka, **rule 7** clearly stipulates that it is the Registrar who is supposed to effect service of the memorandum of appeal as well as the other documents referred to in **rule 5** and not the appellant. The appellant cannot be faulted for an omission occasioned by the Registrar.

28. Regarding the provisions of **Section 3 (1) of the Income Tax Act**, it is explicit that income tax is charged for each year of income. The appellant made a consolidated assessment for the years 1996 to 2001. The respondent was dissatisfied with that assessment and preferred an appeal to the Local Committee. There was no assessment for each year of income that was made and consequently there was only one appeal before the Local Committee. It follows therefore that the decision of the Local Committee could not give rise to a multiplicity of appeals. That would be contrary to the provisions of **Section 86 (2) of the Income Tax Act**. Strictly speaking the various appeals filed herein are bad in law and are liable to be struck out for that reason.

29. But be that as it may be, I deem it appropriate to consider the merits of the appeal. The Local Committee was satisfied that the total activities relating to interest were done outside Kenya and the source of the interest was also not Kenya. The Committee concluded that the respondent was not obliged to withhold any amount in respect of withholding tax.

30. An appeal to this court is by way of a retrial and that implies that the appellate court has

jurisdiction to consider whether the decision of the Local Committee was arrived at appropriately or not. The appellate court can confirm, reduce, increase or annul the assessment concerned or make any other order as it deems fit.

31. The crux of this appeal is a determination as to whether there was any interest which accrued or was derived from Kenya in terms of **Section 3 (1)** of the **Act** and which was therefore subject to withholding tax. I have already highlighted the provisions of **Section 35 (1)** of the **Act**.

32. The contract between the supplier and the respondent was entered into in Japan and the goods were sold and delivered in Japan. **Section 10 (c)** of the **Act** stipulates that where a resident person makes a payment to any other person in respect of interest the amount thereof shall be deemed to be income which accrued in or was derived from Kenya. However, one of the provisos to that Section is that the section shall not apply unless the payment is incurred in the production of income accrued in or derived from Kenya or in connection with a business carried on in whole or in part in Kenya. No evidence was adduced by the appellant to the effect that the payment that was made by the respondent was incurred in production of income accrued in or derived from Kenya. I do not think that the interest was chargeable to tax and thus obliged the respondent to deduct therefrom withholding tax. I am in agreement with the decision of the Court of Appeal in **ESSO STANDARD EASTERN INC. vs. INCOME TAX (Supra)** in all material aspects.

33. The issue of where the interest is paid is a matter of fact and that was determined by the Local Committee. In the case of **COMMISSIONER OF INCOME TAX vs. P. CO. LTD. (4) (1 E.A.T.C. 131)** Sinclair, J. (as he then was), in the High Court of Tanganyika held:

“It seems to me that where income is really derived from is a question of fact which should be determined as a practical man would determine it.”

34. From the facts on record it is clear that the contract was entered into in Japan, payment and delivery of the goods was done in Japan and consequently, interest derived entirely from the place where the goods are sold is not amenable to withholding tax. I uphold the decision of the Local Committee and dismiss these appeals with costs to the respondent.

DATED, SIGNED AND DELIVERED AT NAIROBI THIS 1ST DAY OF OCTOBER, 2012.

D. MUSINGA

JUDGE

In the presence of

Irene – Court Clerk

Mr. Ontweka for the Appellant

Mr. Oraro for the Respondent



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