REPUBLIC OF KENYA

IN THE HIGH COURT OF KENYA AT NAIROBI

MILIMANI LAW COURTS

COMMERCIAL & TAX DIVISION

INCOME TAX APPEAL NO E001 OF 2021

COMMISSIONER OF DOMESTIC TAXES.....APPELLANT

VERSUS

SOCABELEC EAST AFRICA LIMITED .....RESPONDENT

(An appeal from the Judgment of the Tax Appeals Tribunal delivered on 26th February 2020 in Tax Appeal No. 195 of 2017)

J U D G M E N T

1. The Appellant filed the Memorandum of Appeal dated 21st April 2020, against the Judgment of the Tax Appeals Tribunal delivered on 26th February 2020 in ***Tax Appeal No. 195 of 2017***, raising the following five grounds:-

    (1) THAT the Tribunal erred in fact and in law in applying the definition of "all loans" to determine the meaning of loans.

    (2) THAT the Tribunal misdirected itself in law by failing to comprehend that the use of this phrase "all loans" is restricted to Section 16 subsection (2) of the Income Tax Act.

    (3) THAT the Tribunal erred in fact and in law by failing to appreciate that Deemed Interest only applies to loans that are provided free of interest.

(4)THAT the Tribunal misdirected itself in fact and in law in arriving at the erroneous interpretation that for any form of indebtedness to qualify as a loan, there MUST be a fixed charge, interest, discount or premium.

(5)THAT the Tribunal erred in failing to accept the Respondent's' financial statements which classified amounts owed to Socabelec SA and SA Durjau as "borrowings" as proof of indebtedness.

(6)THAT the Tribunal erred in fact and in law in arriving at the determination that the Appellant ought to have produced a loan agreement to prove that the amount due from *Sa Durjau Exploration* agreement was a loan, when in fact the Appellant relied on the Respondent's financial statements, who did not object and was ready to pay withholding tax on the deemed interest thereon.

2. The Appellant also filed written submissions dated 28th March 2023 urging this Court to set aside the impugned judgment and the consequential orders and that the costs of this appeal be awarded to it.

3. The Respondent having been served through their last known address at the directions of this court, neither entered appearance nor filed a statement of facts or written submissions. The Appellant filed the affidavit of service sworn on 30th May 2023 by MARTIN KIOGORA, a licensed Court process server, confirming that he served the hearing notice of the same date for the highlighting of submissions slotted for 26th June 2023 at 9.00 a.m., together with the record of appeal and the

submissions through the Respondent's email addresses that are on the iTax portal. However, on 26th June 2023 there was no appearance by the Respondent.

4. In brief, the backdrop to this appeal is that the Appellant carried out a verification audit on the Respondent for the years 2014 to 2017. It was established that the Respondent had borrowings from foreign entities amounting to Kshs.197,418,065/=, being Kshs.32,163,801/= for related party payables, Kshs.13,136,399/= for SA Durjau Exploration and Kshs. 134,117,865 for Socabelec SA. The borrowings were interest free but withholding tax on deemed interest was not remitted. Hence, the Appellant raised an additional withholding tax assessment of Kshs.11,134,488/= on 11th September 2017.

5. The Respondent issued a notice of objection to the assessment dated 6th October 2017. In response, the Appellant issued its objection decision dated 17th November 2017 confirming the assessment.

6. Aggrieved, the Respondent filed an appeal before the Tax Appeals Tribunal on the basis that the amount of Kshs.134,117,865/= for Socabelec SA was a transactional supplier balance not part of all loans as defined under section 16(3) of the Income Tax Act; that deemed interest is only applicable if there is a financial charge on the outstanding balance and that the balance of Kshs.32,163,801/= was transactional net balances owed to two Kenyan companies that had been outstanding

since 2008.

7. The Appellant opposed that appeal and urged the Tribunal to uphold the objection decision on the basis that the loans were subject to deemed interests as they were provided by non-resident persons and were interest free and that it be allowed to review the rate of tax from 15% to 10% in accordance with the double taxation reliefs.

8. Through its judgment dated 26th February 2020, the Tribunal allowed the appeal and set aside the withholding tax assessment on the basis that from the definition of "all loans' under section 16 (3) of the Income Tax Act, for any form of indebtedness to qualify as a loan, there must be a fixed charge, interest, discount or premium; that there was no evidence to support payment of a fixed charge, interest or discount or premium by the Appellant to whom the separate amounts are due to or any provision for any charge or payment of interest or otherwise paid or levied at a future date; that when Section 16(3) is strictly applied, absence of any interest, premium or financial charge excluded the debts owed by the Appellant in its books from the classification as "loans' and renders the assessment erroneous and that until there is legislation that defines loans to include interest free loans, the benefit of such a lacuna must be given to the Respondent. This decision is what promoted the present appeal.

ANALYSIS AND DETERMINATION

9. I have carefully considered the memorandum and record of appeal and the submissions filed by the Appellant. Though the Respondent was served with this appeal and evidence of the said service produced, the Respondent did not participate in the Appeal herein and did not file any responses to it.

10. As regards the mandate of this Court in such an appeal, Section 56 of the Tax Procedures Act provides that:-

> *"56. (1) In any proceedings under this Part, the burden shall be on the taxpayer to prove that a tax decision is incorrect.*
> *(2) An appeal to the High Court or to the Court of Appeal shall be on a question of law only.*
> *(3) In an appeal by a taxpayer to the Tribunal, High Court or Court of Appeal in relation to an appealable decision, the taxpayer shall rely on the grounds stated in the objection to which the decision relates unless the Tribunal or Court allows the person to add new grounds."*

11. The Court has considered what pertains to be a question of law only in **Tumaini Distributors Company (K) Limited v Commissioner of Domestic Taxes (Tax Appeal No. 3 of 2020) [2020] eKLR**, as follows: -

> *"31. The second aspect of this court's jurisdiction is that it is limited to, "a question of law only." What amounts to, "matter of law" was elucidated by the Court of Appeal in John Munuve Mati v Returning Officer Mwingi North Constituency*

& 2 others NRB CA EPA NO. 5 OF 2018 [2018] eKLR where it observed as follows:-

> *[T]he interpretation or construction of the Constitution, statute or regulations made thereunder or their application to the sets of facts established by the trial Court. As far as facts are concerned, our engagement with them is limited to background and context and to satisfy ourselves, when the issue is raised, whether the conclusions of the trial judge are based on the evidence on record or whether they are so perverse that no reasonable tribunal would have arrived at them. We cannot be drawn into considerations of the credibility of witnesses or which witnesses are more believable than others; by law that is the province of the trial court." [Emphasis mine]*

12. Back to the instant appeal, the issues that fall for determination are **whether the Tribunal erred by failing to appreciate that deemed interest only applies to loans that are provided free of interest and failing to comprehend that the use of this phrase "all loans" is restricted to Section 16 subsection (2) of the Income Tax Act.**

13. In the present case, I note that the Appellant based its assessments for withholding tax on the Respondent's trade debts which were classified under borrowings in its balance sheet. The Appellant argued that the Tribunal erred by relying on the definition of 'all loans' under Section 16(3) instead of adopting the ordinary meaning of the phrase loan. It

relied on the case of **Inland Revenue Commissioners v McGuchian [1997] 1 WLR 991, 1001G** for the proposition that the ordinary principles of statutory construction must then be applied to the words used by Parliament which describes the effect of the transaction for tax purposes. The Appellant submitted that the requirement for there to be a fixed charge, interest, discount or premium for an indebtedness to qualify as a loan does not arise if the term loan is given its ordinary meaning. The Appellant again faulted the Tribunal for finding that in cases of interest-free loans, where there arise deemed interest for the purposes of tax laws, that there was no deemed interest. The Appellant highlighted that the Tribunal made a strict interpretation of Section 16 (3) where it held that in absence of interest, premium or financial charge the debts owed by the Respondent in its books were not loans and rendered the Appellant's assessment erroneous.

14. Section 16 (2) and (3) of the Income Tax Act provide that:-

> *"(2) Notwithstanding any other provision of this Act, no deduction shall be allowed in respect of –*
> *(ja) an amount of deemed interest where the person is controlled by a non-resident person alone or together with not more than four other persons and where the company is not a bank or a financial institution licensed under the Banking Act.*
> *or an amount of deemed interest where the company is in the control of a non-resident person alone or together with four or fewer other persons and where the company is not a bank or a financial institution licensed under the Banking Act; and for the purposes of*

this paragraph "control" shall have the meaning ascribed to it in paragraph 32 (1) of the Second Schedule;

Provided that this paragraph—

(i) shall apply to loans advanced to the company by a non-resident associate of the non-resident company controlling the resident company…."

"16. (3) For the purpose of subsection (2), the expression-

"all loans" means loans, overdrafts, ordinary trade debts, overdrawn current accounts or any other form of indebtedness for which the company is paying a financial charge, interest, discount or premium."

15. Looking at section 16(2) quoted above, I am persuaded that the Tribunal erred in its interpretation of the meaning of all loans. Faced with a similar issue, this Court in **Commissioner of Domestic Taxes v Dominion Petroleum Kenya Limited (Tax Appeal E093 of 2020) [2021] KEHC 283 (KLR) (Commercial and Tax) (19 November 2021) (Judgment)** observed as follows in respect of deemed interest:-

"23. WHT is a method of tax collection whereby the payer is responsible for deducting tax at source from payments due to the payee and remitting the tax so deducted to the Commissioner. Under section 10(1) of the ITA, the resident company paying interest and deemed interest is required to pay WHT to the Commissioner as follows:

10. Income from management or professional fees, royalties, interest and rents

(1) 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-

(c) interest and deemed interest

24. Under section 16(3) of the ITA "Deemed Interest" is defined as "….an amount of interest equal to the average ninety-one day Treasury Bill rate, deemed to be payable by a resident person in respect of any outstanding loan provided or secured by the non-resident, where such loans have been provided free of interest." In essence, it is applicable on interest free borrowing and loans received from foreign-controlled entities in Kenya. Further by section 35(1) of the ITA, 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 which is provided for in the Third Schedule to the ITA.

25. Resolution of this issue involves around the nature of financial agreements entered into by the Respondent and its affiliate companies. The Commissioner contends that the agreement between the Respondent and its related companies were interest free outright loan agreements and any payments made to them by the Respondent thereunder fell within the definition of "Deemed Interest". It observes that all of the Respondent's related party lenders disclosed in their audited financial statements that the loans were interest free and that the Respondent attempted to introduce a 0.1% rate on one of the loans with Dominion Petroleum Acquisition Limited through contracts dated 5th February 2015 and 10th February

2015 respectively which were backdated to an effective date of 1st January 2014. The Commissioner thus accuses the Respondent of attempting to circumvent provisions of the ITA regarding treatment of interest free loans.

26. The Commissioner faults the Tribunal for holding that the "inter-company loans" do not fit the description of a loan as defined under section 16(3) of the ITA when the parties themselves had decided to call those arrangements 'loans' and that there is no such thing as "quasi-equity" from the definition in section 16(3) aforesaid which provides that, '"all loans" means loans, overdrafts, ordinary trade debts, overdrawn current accounts or any other form of indebtedness for which the company is paying a financial charge, interest, discount or premium." The Commissioner urges the court to take cognizance of the fact that this very chicanery called tax planning is the reason we have an entire body of practice called Transfer Pricing to ensure that related-parties transact at arm's length as though they are related.

(...)

34. I hold that the main factor of consideration is whether there was any interest provided for in the financing agreements amounted to a loan; if there was no interest, then WHT on 'Deemed Interest' would apply at the 91-day Treasury Bill rate; if there was interest, WHT would still apply at the rate provided for in the Third Schedule of the ITA. What should be noted is that whichever the case, WHT would still apply." (Emphasis added)

16. From the above, it is clear that if there is an indebtedness to a non-resident entity, withholding tax would apply whether there was interest payable or not. The only difference is that where there was no interest, deemed interest would apply at the 91 Treasury bill rate. Therefore, I find and hold that the Tribunal erred in by failing to appreciate that deemed interest only applies to loans that are provided free of interest and in concluding that for any form of indebtedness to qualify as a loan, there must be a fixed charge, interest, discount or premium. I find and hold that the Tribunal erred in failing to accept the Respondent's' financial statements which classified amounts owed to Socabelec SA and SA Durjau as "borrowings" as proof of indebtedness.

17. According to the Respondent, the amounts outstanding to Socabelec SA and SA Durjau were supplier trading balances. The amount of Kshs.134,117,865/= owing to Socabelec SA had been outstanding since December 2013 and was classified under "non-current" borrowing in its balance sheet. I find that the Respondent's outstanding balances are subject to withholding tax in accordance with section 2, 10(c) and 35(1)(e) of the Income Tax Act. Hence, in this case, deemed interest is applicable because there is no interest payable on the supplier trading balances. For avoidance of doubt, the deemed interest rate applicable is 10% as inscribed in the Double Taxation Agreement between Kenya and South Africa.

18. The Tribunal found that the Appellant ought to have produced more evidence to prove that the trade balance of Kshs.13,136,399/= was owed to SA Durjau Exploration and the transactional net balances of Kshs.32,163,801/= was owed to Kenyan entities and not non-residents. I am inclined to agree with the Appellant that the Tribunal erred in this respect. The correct position is that the burden of proving that an assessment is wrong or excessive is upon the tax payer, as set out under section 30 of the Tax Appeals Tribunal Act and Section 56 of the Tax Procedures Act.

19. For the foregoing reasons, I allow the appeal with costs.

It is so Ordered.

DATED, SIGNED and **DELIVERED VIRTUALLY** at **NAIROBI** this **19th DAY** of **MARCH, 2024**

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J.W.W. MONG'ARE
JUDGE

In the Presence of:-

1. Mr. Chabala for the Appellant.
2. No appearance for the Respondent.
3. Amos - Court Assistant