

REPUBLIC OF KENYA
IN THE TAX APPEALS TRIBUNAL
APPEAL NO. 395 OF 2018

DE LA RUE CURRENCY & SECURITY PRINT LIMITED.....APPELLANT

-VERSUS-

COMMISSIONER OF DOMESTIC TAXES.....RESPONDENT

JUDGEMENT

BACKGROUND

1. The Appellant, De La Rue Currency and Security Print Limited (“DLRKe”) is a limited liability company incorporated in Kenya and is part of the De La Rue Plc Group whose headquarters is in Basingstoke, the United Kingdom. The Appellant is also a duly licenced Export Processing zone (EPZ) enterprise under the Export Processing Zone Act, 1990 and engages in the business of manufacturing bank notes and security printing.
2. The Respondent is a principal officer of the Kenya Revenue Authority, a public body, duly established under the Kenya Revenue Authority Act (Chapter 469 of the Laws of Kenya), whose primary duty is the collection and accounting for government Revenue.
3. The Respondent carried out an audit of the Appellant’s tax affairs for the period 2012 to 2017 for Corporation Tax, Withholding Tax, Pay As You Earn (PAYE) and Value Added Tax (VAT).
4. The Respondent issued its preliminary findings vide its letter dated 16th November 2017 in which it also sought clarification on various matters that had arisen during the audit. The Appellant comprehensively responded to these issues through its letter dated 18th December 2017.

5. Following various meetings and exchange of correspondence, the parties resolved all the issues raised during the audit, save for Corporation Tax on royalty recharge and interest income arising from the Appellant's loan to its group companies.
6. On 24th August 2018, the Respondent issued a tax assessment of Kshs **1,106,043,698.00** (being principal Corporation Tax, penalties and interest). On 21st September 2018, the Appellant objected to the Assessment.
7. Following review of the objection letter and in consideration of all facts at issue and documents availed, the Respondent issued an Objection Decision on 2nd November 2018 in which he confirmed the assessment. Being dissatisfied with the Respondent's decision, the Appellant lodged this Appeal through a Memorandum of Appeal dated 13th December, 2018 filed on 14th December, 2018.

THE APPEAL

8. The Appeal was premised on the following grounds:
 - i. The Respondent erred in law and fact by characterizing and assessing DLRKe as a fully-fledged entrepreneur responsible for all activities in the supply chain of the contract for the manufacture of banknotes with the Central Bank of Kenya (CBK) whilst the Appellant is a licensed contract manufacturer with limited risk.
 - ii The Respondent erred in law and fact in its assertion that DLRKe performs all the economically significant activities and takes on the significant risks.
 - iii The Respondent erred in law and fact by failing to acknowledge the Appellant's functional, asset and risk profile under the contract manufacturing arrangement with De La Rue International Limited (DLRI)

- iv The Respondent erred in law and fact in failing to adopt a consistent and rational approach to the Appellant's licensed contract manufacturing operations for both local indent and export banknote manufacturing which are practically identical activities.
- v The Respondent erred in law and fact in failing to recognize DLRI's involvement in the manufacturing contract from negotiations to research and development, production scheduling, sourcing and purchasing raw materials, procurement and vendor qualification, design decisions, use of know-how, logistics and invoicing.
- vi The Respondent erred in law and fact in alleging that the Appellant's total production of banknotes for CBK is not purchased whilst in fact, the Appellant's total production of banknotes for CBK is purchased by CBK.
- vii The Respondent erred in fact by alleging that DLRI was not involved in negotiations of the contract between DLRKe and CBK.
- viii The Respondent erred in fact in failing to acknowledge the historical basis and development of the contracts between DLRI and CBK and how these informed the contracting surrounding the current assessment and dispute.
- ix The Respondent erred in law and fact by alleging that DLRKe had legal and technical capacity to negotiate the contract, sign and fulfil the contract with CBK.
- x The Respondent erred in law and fact in assessing that DLRKe had created marketing intangibles due to its customer relationship with CBK.
- xi The Respondent erred in law and fact in disregarding the historical relationship between DLRI and CBK and DLRI's role in the maintenance of this relationship. The Respondent erroneously attributed the Appellant's

relationship with CBK as the key value driver whilst in fact the key value driver is DLRI's relationship and negotiations with CBK.

- xii The Respondent erred in law and fact by failing to recognize and take into account the product and process know-how and technical assistance provided to the Appellant by DLRI.
- xiii The Respondent erred in law and fact in failing to appreciate the roles and function executed by DLRI in production planning and scheduling, oversight and quality control, all of which confirm the characterization of the Appellant as a licensed contract manufacturer in respect of the CBK banknote production.
- xiv The Respondent erred in law and fact by failing to acknowledge DLRI's practical inability to assume all the risks associated with the CBK contract.
- xv The Respondent erred in law and fact in its assertion that the Appellant owns all the intangibles. The Respondent has further failed to take into consideration the role played by DLRI in the development, enhancement, maintenance, protection and exploitation (DEMPE) of the intangibles employed in fulfilling the customer's orders. These intangible assets include patents, trademarks, copyrights, manufacturing know-how and marketing intangibles.
- xvi The Respondent erred in law and fact in failing to acknowledge that the relevant intangibles in the manufacture of banknotes are owned by the Appellant's related party DLRI.
- xvii The Respondent erred in law and fact in alleging that the Appellant designed a scheme to erode its tax base whilst in fact, the Appellant has a properly and fully documented transfer pricing policy setting out the basis of the royalty charges.

- xviii The Respondent erred in law and fact by failing to recognize the letter from the National Treasury which is in fact the competent authority in Kenya on transactions with international parties to the shareholder of the Appellant, Thomas De La Rue AG, approving the terms of the Know How Agreement
- xix The Respondent erred in law and fact by disregarding the importance of the letter which in essence validated the royalty payments to DLRI as being adequate compensation.
- xx The Respondent erred in law in breaching the Appellant's legitimate expectation based on the conclusive position and decision expressed and communicated to Thomas De La Rue AG by the Cabinet Secretary for the National Treasury in a letter dated 13 October 2017.
- xxi The Respondent erred in law by wrongfully and irregularly imposing a tax shortfall penalty under Section 84 of the TPA which only applies where taxpayers knowingly provide misleading information.
- xxii The Respondent erred in law and fact by assessing the Appellant under Section 16(1) of the Income Tax Act (ITA) on the basis that the royalty was not incurred in production of income by the Appellant while the matter in question is a transfer pricing matter and should therefore have been properly considered under Section 18(3) of the ITA.
- xxiii The Respondent erred in law and fact in failing to acknowledge that without the Appellant paying the disputed royalty, the Appellant could not carry on its business of licensed contract manufacturer of banknotes for the CBK contract. The Respondent therefore erred in failing to recognize the critical importance of the royalty paid by the Appellant to DLRI.
- xxiv The Respondent erred in law and fact by disregarding the existing transfer pricing documentation and support provided by the Appellant to justify the

relevant parties' characterization and royalty payments made to DLRI and whether the royalty payments comply with the arm's length principle recognized under the Income Tax (Transfer Pricing) Rules, 2006.

- xxv The Respondent erred in law and fact by not providing a clear and rational basis of the impugned assessment in assessing tax under Section 16(1) of the ITA which relates to disallowed expenses yet still made reference to the OECD guidelines and principles under transfer pricing.
- xxvi The Respondent erred in law and fact in its computation of the confirmed assessment by subjecting the total sales to CBK to tax and failing to take into account the correct royalties actually paid. Accordingly, as the principal tax computation is erroneous, the penalties and interest computation is also excessive and erroneous.
- xxvii The Respondent erroneously and irregularly applied a higher interest rate contrary to that prescribed in Section 38(1) of the TPA.
- xxviii Without prejudice to the foregoing, the Respondent further erred in law and fact by failing to take into account the 15% withholding tax already paid on the same and disputed royalties.
- xxix The Respondent erred in law by failing to appreciate that the dispute in question is founded on the Appellant's interpretation of the law for which it has provided sufficient evidence.
- xxx The Respondent erred in fact by computing penalties on the principal tax due without appreciating the international best practice of penalty protection.
- xxxi The Respondent erred in fact by failing to provide penalty protection to the Appellant when the Appellant has provided sufficient transfer pricing documentation and the matter in dispute is the grounds of adjustment.

- xxxii The Respondent erred in law and fact in applying an erroneous penalty of 20% contrary to the Tax Procedures Act (TPA).

The Appellant's Case

9. The Appellant's case is premised on the hereunder material documents and proceedings:-
- i. The Appellant's Statement of Facts dated 13th December 2018 together with the documents filed therewith on 14th December 2018;
 - ii. The witness statement of Titus Mukora dated 16th March 2021 filed on the same day;
 - iii. The witness statement of Francis Gakuru dated 16th March 2021 filed on the same day;
 - iv. The Appellant's written submissions dated 24th March 2021 filed on 25th March 2021 together with the attached copies of legal authorities.
10. The Appellant has, in its submissions, summarized the above grounds into the following key points which it deems form the issues for determination:
- a) Whether the Appellant is a licensed contract manufacturer of DLRI.
 - b) Whether DLRI was significantly involved in the negotiation of the CBK contracts and continued relationship with CBK from 1991 to date.
 - c) Whether the Respondent has failed to recognize and consider the product and process know-how and technical assistance provided to the Appellant by DLRI.
 - d) Whether the Respondent as an agent of the Government failed to recognize the letter from its principal, the National Treasury, approving the terms of the Know How Agreement between the Appellant and DLRI and validating

the transfer pricing agreements and royalty payments to DLRI as being adequate compensation.

- e) Whether the Respondent's computation of principal tax due, penalties and interest is erroneous. The Respondent disregarded Withholding Tax already collected in respect of royalty payments to DLRI and further demands Corporation Tax on the royalty expense. In addition, the Respondent applied 30% Corporation Tax for the year 2014 yet the applicable rate was 25% being the 20th year of operation as set out in paragraph 2(f) of the Third Schedule to the Income Tax Act
- f) Whether any dispute in respect of the matter is an international issue subject to Mutual Agreement Procedure (MAP) under the Kenya-UK Double Tax Avoidance Agreement, as DLRI has paid income tax on the royalty income in the UK to Her Majesty's revenue and Customs (HMRC)

Introduction of the Appellant

- 11. The Appellant submits that it is part of the De La Rue Plc Group. The main operating company in the group is its UK Company De La Rue International Limited (DLRI), which operates the main UK sites. DLRI has been involved in manufacturing and printing CBK's bank notes for over 50 years and has manufactured CBK's bank notes between 1991 and 2002. In 2002, the contract was signed by the Appellant.
- 12. According to the Appellant, DLRI as a banknote manufacturer is constantly involved in research and development to mitigate the risk of counterfeit bank notes. DLRI undertakes the research and development and owns the Intellectual Property (IP) in the group. DLRI also has the majority of the central functions and teams as well as the contracts with customers around the world on the back of contract manufacturing arrangements with subsidiaries in countries such as Malta, Kenya and Sri Lanka.

13. The Appellant avers that its principal business during the period under review included manufacture of banknotes for various central banks under license from DLRI. Upon its establishment in 1994, the Appellant engaged in the manufacture of banknotes as a licensed contract manufacturer for DLRI in respect of the banknotes for CBK and for other central banks in the world. Through-out this period and owing to its historic presence in Kenya, DLRI as the principal party to the contracts with various central banks, including the CBK, was directly involved in the tendering, negotiations and contractual process for the contract for manufacture of banknotes.
14. It is the Appellant's assertion that despite the change of party to the contract in 2002 from DLRI to the Appellant, the terms of the contract with CBK for the manufacture of the banknotes remained the same. For instance, the product specifications and delivery terms (ex-works) remained the same as the provisions of the 1991 contract between DLRI and CBK.
15. Save for the change of contracting parties in 2002, the Appellant avers that the functions, rights, obligations and risks under the contract with CBK have also remained unchanged since 1991.
 - a) **The Appellant is a licensed contract manufacturer of DLRI.**
16. The Appellant submits that the decision of the Respondent was premised on the erroneous assumption and disregard of DLRI's critical role in the contract between the Appellant and CBK.
17. It is the Appellant's submission that it provided evidence of DLRI's involvement in the Appellant's banknote manufacturing process and customer relationship support, for example through the DLRI sales and legal teams. The Respondent disregarded DLRI's product and process and know-how and license and support availed to the Appellant in the manufacture of banknotes for CBK. This erroneous understanding is also anchored on the

misguided view that the Appellant is a fully-fledged manufacturer and not a licensed contract manufacturer for DLRI.

18. The Appellant submits that the Respondent's assertion is incorrect for the following reasons:

- i) In order to deliver per the specifications and requirements of CBK, the Appellant is heavily reliant on both the product and process IP provided by DLRI. This is evidenced, for example by DLRI's planning involvement in the Appellant's manufacturing process where DLRI guides on the list of approved materials to be used for manufacture of CBK's Kenya Shilling 100 denominational notes. This particular example of DLRI's banknote order form relied on by the Appellant gives specific directions to the Appellant in respect of the technical specifications such as Litho and Intaglio printing of the banknotes. Further, DLRI has held and continues to hold the customer relationship since 1991.
- ii) The witness for the Respondent, Mr. Philip Munyao, acknowledged during cross-examination that the Appellant does not have a research and development team, neither did it have a legal team involved in contract negotiations unlike DLRI that has such teams. The Appellant's expert witness outlined that under paragraph 6.65 of the OECD Guidelines, DLRI bears the research and development risk. The Appellant therefore submits that it is clear that it does not undertake any research and development in respect of the banknotes that it manufactures. It does not design the banknotes, nor does it manufacture the plates used in manufacturing the banknotes, nor does it maintain any client relationships and does not make any decisions relating to the contractual process including the contents of the contract between DLRI and its customers. Therefore, it is not a fully-fledged manufacturer.

iii) The Appellant submits that despite being provided with both the group and the Appellant's transfer pricing policies, the Respondent failed to understand the functional, asset and risk profile of the Appellant and especially the Appellant's functional profile as a contract manufacturer. As a result, the Respondent has erroneously characterized the Appellant as a fully-fledged manufacturer entitled to all the residual returns from the sale of banknotes to CBK. Indeed, the Appellant's witness, Mr. Titus Mukora, on cross examination by Respondent's counsel, confirmed that having reviewed the Appellant's and DLR Group transfer pricing policy he found that:

a) The question for consideration by the Tribunal is whether DLRI owns an intangible. The Respondent had already admitted that DLRI owns the intangible in a statement made in its Objection Decision of 2nd November 2018;

b) In his expert opinion and having reviewed the Appellant's and DLR Group's transfer pricing policies, the Appellant's transfer price for the royalty payment is well within arm's length.

iv) The Appellant argues that having demonstrated its role in the manufacture of banknotes and that the process of manufacture of banknotes for the CBK is identical to that of manufacturing bank notes for other DLRI customer central banks, it is inexplicable how the Respondent was satisfied that the Appellant is a contract manufacturer in respect of the other DLRI customer central banks' banknotes and not for CBK. As the banknote manufacturing processes are identical, it follows that the Appellant is a contract manufacturer.

- v) According to the Appellant, it is evident that DLRI has held the customer relationships. This is corroborated and strengthened by the fact that the 2018 CBK contract for the new generation bank notes has been signed by DLRI which, as per the group organogram, has the capacity to execute the role and function of a designer, IP developer and owner of such IP.
- vi) Further, Mr. Titus Mukora asserted that there is no bar to a fully-fledged manufacturer paying a third party for IP rights. This was also confirmed by the Respondent's witness Mr. Munyao during cross examination.
- vii) The above approach by the Appellant is consistent with the arrangements that the Group applies for a similar contract that it has in Sri Lanka, through a company in which the Government of Sri Lanka owns 40% shareholding, and which has also entered into an identical Know How License and technical assistance agreement effective 1st April 2020.
19. Further, in his witness statement, the expert witness Mr. Mukora affirmed the position that DLRI is a significant company with substance, and which earned royalties from the use of its intangibles. Mr. Mukora notes further that having established that the intangibles are owned by DLRI and reviewed the transfer pricing reports, the Respondent neither challenged the method that the Appellant used nor the comparable used by the Appellant in its benchmarks.
20. The Appellant therefore asserts that the royalty payment for DLRI's Know How and Technical Assistance Agreement is commercially supported and absolutely necessary for the Appellant's execution of its contract. Further, the payment of these intangibles is properly supported and benchmarked, and that the Respondent has not disputed the transfer price or benchmarks. Consequently, the Respondent's disallowance of the royalty expense is incorrect, lacks legal basis and ought to be set aside.

b) DLRI was significantly involved in the negotiation of the CBK contract and continued relationship with the client

21. It is the Appellant's submission that DLRI has been significantly involved in the contract for the manufacture of banknotes for CBK from the onset (hence the signing of the 1991 to 2002 contracts) and subsequent negotiations leading up to the signing of the CBK contract in 2002 between the Appellant and CBK. The initial contacts between 1991 and 2002 were between DLRI and CBK. Through this and historically since 1966, DLRI developed and established a long-standing relationship with CBK which the Appellant continued to enjoy.
22. The Appellant submits that in 2002, it did not have the technical capacity to bid or negotiate for contracts with CBK in isolation of DLRI. The Appellant and DLRI worked in conjunction with each other for subsequent years. This is further evidenced by the fact that the 2018 tender that led to the contract for supply of banknotes to CBK from 2019 was negotiated with DLRI and was in fact signed by DLRI and CBK, and not the Appellant.
23. It is the Appellant's assertion that it continued to rely heavily on the already established customer relationship between DLRI and CBK for the continuance of production and supply of banknotes currently sold by the Appellant to CBK.
24. According to the Appellant, even if it had developed marketing intangibles (which is denied) the customer relationship with CBK is wholly and solely attributable to the initial and deliberate efforts by DLRI to negotiate, win and sustain the relationship with CBK under the contract for the production of bank notes at its Kenya plant. As captured by Mr, Mukora in his witness statement, the DLR Group is more than 300 years old. During this time, the group has developed intangibles including customer intangibles that is

brought to bear in all the group's customer relationships, including the Appellant's contract with CBK in 2002.

25. The 2010 contract between the Appellant and CBK provides at clause 1.9 that:

“If for any reason the Company is not able to meet the Bank's orders or the Company's delivery commitments to the Bank from the Plant, the Bank consents to the Company meeting any delivery through production at any of the other facilities owned or operated by the De La Rue group of Companies.”

This clause, it argues, shows that the Appellant is one of DLRI's several contract manufacturers and that DLRI and the larger group effectively guaranteed and assumed the performance risk in respect of the Appellant's contract in the event that it failed to deliver on its part. This is yet another demonstration of DLRI's significant involvement in the Appellant's contract to supply CBK with banknotes.

26. It is the Appellant's assertion that under clause 3.1 of the 2010 contract between the Appellant and CBK, payments for the supply of the banknotes were made directly to DLRI in the UK on behalf of its licensed contract manufacturer, the Appellant. This, it argues, also points to DLRI's significant involvement and relationship with CBK with respect to the contract, including DLRI taking on the role of following up and collecting payments from CBK. By way of example, the Appellant referred to a letter from DLRI to CBK acknowledging receipt of a down payment for an order of 300 million bank notes.

27. Based on the foregoing, the Appellant submits that it is undoubtedly a limited risk manufacturer especially as it has no Research and Development or any registered IP or patents in Kenya as was confirmed by Mr. Francis Gakuru, witness for the Appellant and by Mr. Munyao, on cross-examination by the Appellant's counsel. The Appellant therefore submits that the Respondent therefore has no basis or justification for its characterization of the Appellant as an independent manufacturer and not a licensed contract manufacturer for DLRI.

c) The Respondent failed to recognize and consider the product and process know-how and technical assistance provided to the Appellant by DLRI

28. The Appellant submits that it and DLRI entered into a Know How License and Technical Assistance Agreement (the Agreement) that came into force on 1 April 2010. The Agreement stipulates a strict limitation to the license with Clause 1.1 defining the field of use as “...for the manufacture, sale and distribution of banknotes to the Central Bank of Kenya.”

29. The Agreement further confirms the licensed products as ‘banknotes’ and the territory as ‘Kenya’. The Appellant submits that the effect of this clause is that the Appellant has limited use of the know-how owned by DLRI and used in the manufacturing process and the rights to do so are owned, controlled and licensed by DLRI.

30. During cross-examination, the Respondent's witness, Mr. Munyao suggested that the banknotes come ready and that all the Appellant does is to “add colour”. The Appellant submits that this is a very simplistic view that does not bear resemblance to the commercial reality of banknote manufacturing-otherwise, every ordinary printer in Kenya could manufacture banknotes for CBK.

31. The Appellant's witness Mr. Francis Gakuru asserted during cross-examination that the Kenyan banknotes have about 120 security features that change depending on user and customer feedback. The paper that the Appellant imports comes with only 20 of these features embedded in it. The Appellant under the direction and support of DLRI and using DLRI's intangibles inputs the balance of these features. There is also critical technical support in form of ink procurement, ink mixing and quality control all of which are part of the Know How License and Technical Assistance Agreement between the Appellant and DLRI. Therefore, the Respondent's claim that DLRI's IP is embedded in the paper and ink is incorrect. Consequently, the Appellant does not double pay for any royalties through the paper and ink as alleged by the Respondent.
32. The Appellant submits that as indicated in Mr. Mukora's witness statement, it is not disputed that DLRI owns intangibles. Mr. Munyao, witness for the Respondent also conceded that the Appellant does not have any design and legal team or functions both of which are critical in the development and protection of intangibles. Mr. Munyao also conceded during cross-examination that DLRI, on the other hand, has a design and legal function both of which are necessary for the development and protection of intangibles. The Appellant therefore submits that the Respondent failed to take into consideration the role played by DLRI in the development, enhancement, maintenance, protection and exploitation (DEMPE) of the intangibles-all of which are DLRI intangibles that are used in CBK banknotes.
33. To further demonstrate DLRI's involvement in the development of these intangibles under the DEMPE principle as outlined in paragraph 6.6 of the OECD guidelines on Transfer Pricing, DLRI bears the risk of maintenance and protection of the intangibles that it owns, and which are used by the Appellant. To support this, the Appellant relied on excerpts of DLRI's audited

financial statements which show that DLRI incurred research and development costs for the years 2013 to 2016 in coming up with proprietary intangibles. This was also admitted by Mr. Munyao during cross-examination. In contrast, the Appellant does not have a research and development team or costs. Other than the supply of printing paper, DLRI supports the Appellant in the following functions:

- a) Sales as evidenced by correspondence between DLRI and CBK on a contract extension.
- b) Training-as evidenced by DLRI training materials.
- c) Shipping/logistics-as evidenced by packing details.
- d) Equipment procurement and investment.
- e) Health and safety training and certification
- f) Advanced manufacturing engineering support including conducting trials on new products all under the Group Chief Operating Officer (COO).
- g) Systems and security audits.
- h) Quality control including review of samples.
- i) Procurement which includes managing relationships with external suppliers and procurement of capital projects all managed within the COO function under the procurement director.
- j) Manage and issue master production schedules and regular pulse calls to manage inventory.
- k) Liaising with the UK banks for organizing guarantees on behalf of the Appellant in respect of the CBK contract.

34. It is the Appellant's assertion that DLRI owns the rights in all intangible assets and process know how referred to above and listed in the schedule to the know-how license and technical assistance agreement. The 2017 DLR Group Master File which was not challenged by the Respondent also outlines the research and development functions undertaken by DLRI.

35. According to the Appellant, it is not uncommon for fully-fledged manufacturers to have a requirement to license certain technology to fulfil their contracts, as was the case in **SC Enviro Agro India Pvt Ltd Mumbai (TA Nos. 2057& 2018 of 2009)**. In this case, the Income Tax Appellate Tribunal (ITAT) observed that:

“This (royalty) payment is independent of whether assessee is fully-fledged manufacturer or a contract manufacturer or a toll manufacturer and the nature of manufacturing activity cannot have any bearing on the payment of royalty...”

36. The ITAT allowed the royalty payments on the grounds that:-

“Without going into the nitty-gritty of determining whether the assessee is a contract manufacturer or a fully-fledged manufacturer, since royalty is paid for allowing assessee in utilizing the technical know-how and the license for manufacturing activity, we are of the opinion that the payment of royalty is wholly and exclusively for the purpose of business...”

37. The Appellant further relied on the case of **Samsung India Electronics Private Limited (ITA No. 5316 of 2011)** the ITAT rejected the disallowance of the royalty payment and observed that the taxpayer cannot carry out the manufacturing activity without access to the technical know-how and expertise developed by the group company. Of greater importance was the ITAT’s finding that the group company cannot be deprived of its right to earn the Research and Development investment in the technology it has made over the years.

38. It is the Appellant's contention that the above cases cited demonstrate its rationale for the royalty payment to DLRI and why such royalty payments are fully allowable in determining its tax liability. It is therefore the Appellant's submission that the royalty payments by the Appellant to DLRI were properly incurred in furtherance of its business and are therefore allowable. The Respondent's act of disallowing these royalty expenses is without legal basis and ought to be set aside in totality.
39. Despite the Appellant demonstrating DLRI's involvement in the Appellant's banknote manufacturing process and its use of DLRI's intangibles and presenting both the group transfer pricing policy and DLRKe's transfer pricing policy, the Respondent did not question the selected transfer pricing method or resultant benchmarks forming the basis of the Appellant's remuneration. Therefore, the Appellant can only logically conclude that, just like the National Treasury, the Respondent accepted the transfer pricing arrangements in respect of the Know How License and Technical Assistance Agreement of 2010.
40. The Appellant pointed out that prior to 2010 there were management charges between DLRKe and DLRI. In all instances, the transactions targeted a stable return for DLRKe in accordance with the transfer pricing policy - irrespective of how the charge from the UK was made.
41. The Respondent in its statement of facts alleged that the costs related to technical assistance were recharged separately to the Appellant. The Respondent picked a few invoices dated between 2014 and 2016 from DLRI to the Appellant which related to recharge of costs for expatriates working in Kenya including Steve Craig (operations Manager) Annesley Wilson (Security manager) and David Hepple (Finance Manager). The Appellant's submission is that these three were employed by the Appellant as expatriates and that their salaries and other expenses would be paid for by DLRI and recharged to

the Appellant. The Appellant avers that the Respondent acknowledged that the Appellant is charged a management fee for the expatriates seconded to Kenya. As confirmed by Mr. Gakuru during re-examination, these costs were and are separate and distinct from the royalty charge for use of DLRI's intangibles and are not a duplication of costs, as alleged by the Respondent. In any event, it is important for this Tribunal to note that the cost of the expatriates still formed part of the Appellant's cost base on which it earned a return under its transfer pricing policy.

42. The Appellant also noted that the Respondent attached a local contract for Scott Atkins and his secondment agreement between DLRI and the Appellant. Scott Atkins was employed to deal with passports and not banknotes and his expenses were paid for locally and recharged to DLRI at cost plus 10%.
43. The Appellant therefore submits and as outlined in the witness statement of Mr. Mukora, DLRI, which is a company registered in the U.K has substance. It owns intangibles that are exploited by the group which ought to be rewarded and had no incentive to enter into a scheme. Further, the Appellant documented a transfer pricing policy in support of its royalty payment to the DLRI. The Respondent neither challenged the transfer pricing method nor the resultant benchmarks applied by the Appellant. Consequently, it is the Appellant's submission that the Appellant's transfer pricing arrangements comply with the arm's length requirement and that its royalty payment is a legitimate and allowable business expense.
44. According to the Appellant, Mr. Gakuru during his cross-examination confirmed that the Appellant manufactures CBK's banknotes on the back of an order from CBK. Consequently, it does not carry any inventory risk as all the banknotes produced are taken up by CBK. Mr. Mukora also confirmed during his cross-examination that, based on its functions as outlined in its transfer pricing policy, the Appellant does not take any inventory risks. Mr.

Mukora further explained that inventory risk is the risk that a manufacturer will not be able to sell its products due to market changes. Clearly, as the Appellant manufactures banknotes to CBK's order, it does not carry any inventory risk. These confirmations support the Appellant's assertion that it is a limited contract manufacturer and not a fully-fledged manufacturer as alleged by the Respondent.

d) Letter from National Treasury

45. The Appellant invited the Tribunal to take note of the National Treasury letter dated 13th October 2017, in which the Respondent's parent ministry, as set out in Section 5 of the Kenya Revenue Authority Act, confirmed having reviewed and been satisfied with the need for the Know How License and Technical Assistance Agreement and the transfer pricing arrangements supporting the content.
46. The Appellant argues that in arriving at this position, the Cabinet Secretary to the National Treasury considered all relevant factors including the functions of the parties, the risks assumed, and assets employed and concluded that the pricing arrangements as outlined in the Know-How Agreement was and is acceptable. It should also be noted that the Respondent had sight of the deliberations of the National Treasury that took place in May and June 2017 in which an officer of the Respondent was present.
47. The Appellant therefore submits that it is correct to conclude that the Respondent was aware of the National Treasury's review and the deliberations that went into arriving at the conclusion that the National Treasury is satisfied with the need for and the transfer pricing arrangement in respect of the Know How License and technical Assistance Agreement as set out in the letter dated 13 October 2017 following correspondence in the months before this letter.

48. The National Treasury issuing the said letter, the Appellant avers, the Respondent was consulted and gave concurrence to the National Treasury's satisfaction with the need for the Know How License and Technical Assistance Agreement and the Appellant's transfer pricing arrangement in respect of the Know How License and Technical Assistance Agreement.
49. It is the Appellant's assertion that the National Treasury letter is evidence that the structure and substance of the transaction and specifically the royalty paid by the Appellant were deemed to have commercial substance. This assertion is further supported by the Appellant's expert witness statement in which he quotes paragraph 3.26 of the OECD guidelines on Transfer pricing which provides that the presence of minority shareholders (such as the government of Kenya holding a 40% stake in DLR Kenya EPZ Limited which currently manufactures CBK's and other world central bank's banknotes) is demonstrative of an arm's length transaction and outcome. The Respondent cannot now be heard to say that these transfer pricing arrangements are not satisfactory as it is attempting to do in this current assessment.
50. The Appellant argues that in its transaction with CBK and in paying royalties to DLRI, placed reliance on the letter from the National Treasury. This reliance was premised on the fact that the National Treasury letter had been written following, not only a review of the Appellant's transfer pricing policy and operations, but also after concurrence with independent transfer pricing benchmarks and extensive consultations with the Respondent's officer.
51. Therefore, the Appellant avers, the Respondent's statement to the effect that payment of royalties to DLRI was a scheme designed to erode the Appellant's Corporation Tax base is completely unfounded and is in fact breach of its legitimate expectation. According to the Appellant, the existence of this letter invalidates the Respondent's assertion that this is a 'tax erosion scheme' since the contract was reviewed and accepted by the Cabinet Secretary who is the

Competent Authority for the resolution of disputes relating to cross-border transactions/international tax under the Kenya-UK Double Tax Agreement.

52. In any case, the Appellant argues, DLRI's income was taxed in the UK under higher Corporate Tax rates comparative to the Corporation Tax obtaining in Kenya. For instance, DLRI was subject to tax at a rate between 26%-28% between 2010 and 2012 while the Appellant's income tax rate was 25%. It stands to reason that there is no commercial sense or imperative to shift profits to a higher tax jurisdiction.
53. It is therefore the Appellant's submission that the Respondent is bound by the decision and position taken by its principal, the National Treasury. In any event, as the Respondent was extensively involved when the National Treasury reviewed the Appellant's Know How and Technical Assistance Agreement and related transfer pricing arrangements, the Respondent is bound by this position, which the Appellant has since placed reliance on.

e) The Respondent's computation of principal tax due, penalties and interest is erroneous

54. The Appellant asserts that the Respondent completely disregarded the 15% Withholding Tax which the Appellant correctly accounted for in respect of the royalty payment to DLRI. The Respondent's disregard of the Withholding Tax correctly accounted for and further demand for Corporation Tax on the disallowed royalty expense is a clear case of collecting tax twice on the same income.
55. The Appellant submits that at this point, disallowing the royalty payments is contradictory because the Respondent has over the past acknowledged Withholding Tax on the royalty payments. Moreover, at all material times.

The royalty payments received by DLRI were declared in the UK and subjected to the full rate of Corporation Tax. The Respondent's position to disallow the entire royalty in totality without considering the correctly accounted for and previously deducted Withholding Tax is excessive, without legal basis and in breach of good faith avoidance of double taxation as enshrined in the Kenya-UK Double Tax Agreement.

56. Further, in its assessment, the Respondent has applied a Corporation Tax rate of 30% for the period under assessment without appreciating that the Appellant was enjoying a reduced corporation tax rate of 25% in 2013 and 2014 due to its EPZ status and as clearly provided for in Paragraph 29 (f) of the Third Schedule to the Income Tax Act.

f) DLRI has paid income tax on the royalty income in the UK to Her Majesty's Revenue and Customs (HMRC) and therefore any dispute in respect of this matter is an international issue and subject to MAP under the Kenya-UK Double Tax Avoidance Agreement (DTA).

57. The Appellant submits that the Respondent has failed to consider the fact that DLRI has also paid UK income tax on the royalty income earned from the Appellant in Kenya to HMRC. Nevertheless, the Appellant, desirous to resolve the matter and eliminate double taxation has shown good faith by initiating Mutual Agreement Procedure (MAP) discussion between HMRC and the Respondent as provided for under the Kenya-UK DTA, which the Appellant believes could resolve the dispute and ensure that the Appellant and DLRI are not taxed twice.

58. The Appellant applied for MAP proceedings on 17th June 2019 and HMRC notified the Respondent of this request with a proposed a start date of 24th July 2019. The Respondent acknowledged receipt of this MAP request. However, despite its email dated 28th September 2020 acknowledging receipt

of the MAP request, the Appellant understands that the Respondent has yet to provide a position paper to HMRC despite having been asked to do so a number of times.

59. The Appellant cited **Republic v Kenya Revenue Authority Ex parte Queensway Air Service Limited Miscellaneous Application No 1231 of 2003** where the High Court ruled that the DTA takes precedence over domestic law. Therefore, the continued proceedings before the Tribunal are a breach of the provisions of the DTA between Kenya and the UK and Kenya's international obligations in respect to this DTA.
60. According to the Appellant, it paid the royalty to DLRI net of the 15% Withholding Tax as provided for in the DTA and is entitled to a tax deduction for this royalty expense. DLRI received this royalty income and subjected it to tax in the UK as demonstrated in excerpts of DLRI's UK tax returns for the period 2013 to 2019. The Appellant submits that this is the appropriate and correct manner in which the royalty payment should have been viewed and accepted.
61. The Appellant submits that it and DLRI have, by withholding the payments at 15%, fully complied with the DTA which should be sufficient without the need for MAP. However, if any challenge is to be made then MAP should be given the opportunity to consider rather than a unilateral approach from one treaty partner.
62. In conclusion, the Appellant submits that the Respondent's assessment is erroneous, based on a misapprehension of the law and facts and that it negates the Appellant's legitimate expectation with respect to the Appellant's use of DLRI's intangibles in the manufacture of banknotes.

63. Further, the Appellant avers that the Respondent's wilful neglect to respond to the MAP request and dispute resolution mechanism not only disenfranchises the Appellant and imposes double taxation on the same income, is contrary to judicial precedence as espoused in the Queensway Case but also a dereliction of its and indeed Kenya's duty and obligations under international law and the Kenya-UK DTA.

Appellant's prayers

64. The Appellant therefore prays:

- a) That the assessment of Kshs 1,106,043,698.00 and the resulting penalties and interest be vacated together with all attendant penalties and interest
- b) That the Appeal be allowed with costs to the Appellant.
- c) Any other remedies that the Tribunal deems just and reasonable in the circumstances.

THE RESPONDENT'S CASE

65. The Respondent's case is premised on the hereunder material documents and proceedings:

- i) The Respondent's Statement of Facts dated 9th January 201 together with the documents filed therewith on 11th January 2019;
- ii) The witness statement of Philip Munyao dated 16th March 2021 filed on the same day;

iii) The Respondent's written submissions dated 25th March 2021 filed on the same day together with the attached copies of legal authorities.

66. The Respondent submits that it subjected the Appellant to a Transfer Pricing audit for the period 2013 to 2017. This was after review of the Appellant's operations revealed significant royalty payments to DLRI.
67. The Respondent avers that for the period 2013 to 2017, the Appellant paid royalty to DLRI amounting to **Kshs. 2,383,928,191.00**. This, as a percentage of total sales made by the Appellant to CBK ranges from 17% to 24% as tabulated below:-

Year	2013 (M)	2014 (M)	2015 (M)	2017 (M)	TOTAL (M)
Sales to CBK (A)	3,706.00	2,350.00	1,360.00	4,296.00	12,396.00
Royalty Paid (B)	734.00	406.00	320.00	829.00	2,384.00
(A)/(B) %	20%	17%	24%	20%	19%

68. It is the Respondent's assertion that in accordance with Section 15(1) as read together with Section 18(3) of the Income Tax Act, the Respondent disallowed the royalty payments made to DLRI in years 2013 to 2017. The Respondent then issued a Notice of Assessment on Corporation Tax vide the letter dated 24th August 2018. The assessed tax was **Kshs. 1,106,043,698.00** including penalty and interest. The Appellant objected to the assessments through the letter dated 21st September 2018. Following a review of the objection letter, and in consideration of all facts in issue and the documents at hand, the Respondent issued the Commissioner's Objection Decision confirming the assessment vide the letter of 2nd November 2018.

69. The Respondent submits that the De La Rue Group engages in design, manufacture and delivery of banknotes around the world, manufacture and delivery of passports and identity solutions and manufacture and delivery of secure product identifiers. The Group owns three manufacturing sites outside the UK, which are Sri Lanka, Kenya and Malta. DLRI, a company registered in United Kingdom (UK), is a wholly owned subsidiary of De La Rue Holdings Limited (UK). DLRI's principal activities are design and development, production and sale of currency paper and currency banknotes. The Appellant purchases majority of the banknotes paper from DLRI.
70. It was the Respondent's submission that the Appellant's principal business activity is printing of banknotes and security documents. In Kenya, the Appellant manufactures and sells banknotes to Central Bank of Kenya (CBK) and security printed documents to local commercial banks and performs contract manufacturing on behalf of De La Rue International (DLRI) for export work, that is, in relation to manufacture of banknotes for other countries that DLRI holds contract with, other than the CBK. To support this the Respondent referred to the Pricing Agreement for the Sub-contracting of Intra-Group Security Printed Banknotes between DLRI and the Appellant.
71. According to the Respondent, the above agreement provides that DLRI was to enter into contracts with customers for the supply of the banknotes and sub-contract some of that work to the Appellant under the terms of the agreement. The Respondent submits that, there exists no such sub-contract between the Appellant and DLRI for manufacture of CBK banknotes, since the Appellant is the owner of the contract with the CBK. Thus, the allegation by the Appellant that it is a licensed contract manufacturer should be disregarded.

72. Having provided this background, the Respondent submits that the following are the main issues for determination:
- (a) Whether the Appellant is a Licensed Contract Manufacturer on behalf of DLRI or a Fully-Fledged Manufacturer in execution of contract between CBK and the Appellant for manufacture of banknotes;
 - (b) Whether DLRI was significantly involved in the negotiation of the CBK contracts and continued relationship with the CBK from 1991 to date;
 - (c) Whether the price of the banknote paper purchased by the Appellant from DLRI is at arm's length and thus the price includes the costs associated with the know-how to manufacture and design of the banknote paper;
 - (d) Whether the royalty payments by the Appellant to DLRI in relation to manufacture and sale of banknotes to CBK is justified, considering that the price of the banknote paper was adjudged arm's length and subsequent transfer of know-how was charged separately;
 - (e) Whether the letter by the Cabinet Secretary Treasury has any relevance to the current case;
 - (f) Whether the Respondent should have assessed tax under Section 18(3) or Section 16(1) of the Income Tax Act where the royalty payments by the Appellant to DLRI were adjudged not wholly and exclusively incurred for the production of the Appellant's income;
 - (g) Whether, the tax shortfall penalty is charged under Section 84 of Tax Procedure Act, 2015 or Section 72D of the Income Tax Act;
 - (h) Whether credit on the 15% Withholding Tax paid by The Appellant is allowable in respect of the royalty payments to DLRI;
 - (i) Whether this dispute ought to be subjected to Mutual Agreement Procedure as provided for under Kenya-UK Double Tax Avoidance Agreement (DTA).

a) **Whether the Appellant is a Licensed Contract Manufacturer on behalf of DLRI or a Fully-Fledged Manufacturer in execution of contract between Central Bank of Kenya (CBK) and The Appellant for manufacture of banknotes**

73. The Respondent submits that the Appellant is a fully fledged manufacturer and not merely a licensed contract manufacturer that has assumed minimal risk in the transaction, as claimed in the Appeal. Indeed, on its own admission in the witness statement of Titus Mukora and during cross-examination of Francis Gakuru, it was evident that DLRI played a minimal role in the operations of the contract between CBK and the Appellant neither was it privy to the contract.
74. It is the Respondent's assertion that the Appellant did not avail any evidence to indicate that DLRI was involved in negotiation of the year 2002 contract. Furthermore, no evidence was availed to show that DLRI was involved in the negotiation of the 2007 and 2009 contracts and any other stopgap contracts. Without prejudice to the above, negotiation services provided by DLRI do not warrant payment of residual royalties. The compensation due to DLRI should have been a mere "*negotiation fee*" for its negotiation services. Subsequent to the year 2002, all the contracts were entered between the Appellant and Central Bank of Kenya (CBK).
75. During the period 2010 to date, the Respondent submits, no competitive contracts were floated. All contracts were awarded to the Appellant under the stopgap arrangements. Therefore, and without prejudice to the above, DLRI was not entitled to the residual returns out of the performance of the CBK contract(s) by the Appellant.
76. The Appellant alleges that the DLRI is involved in planning of its manufacturing process and evidenced through the banknote order forms. The Respondent submits that the specifications for the banknotes are provided by

CBK and that the banknote order forms specifies the features to be included in the banknotes which were already provided by CBK in the signed contracts.

77. The Respondent avers that during the period, 1966 - 1985 Kenyan banknotes were printed by Bradbury & Wilkinson, UK, which was later acquired by Thomas De La Rue and Company Limited in 1986. Since then and up to the year 1991, DLRI provided currency-printing services to CBK. Following the acquisition, DLRI was not involved in any tendering, negotiations and contractual process with CBK since there was a long-standing relationship with Bradbury & Wilkinson. In 1991, Thomas De La Rue and Company Limited and CBK entered into a 10-year agreement for supply of 170 million pieces of banknotes each year. The Agreement became effective in 1993. The banknotes were produced at the new factory established at Nairobi. In 1992, the Appellant was established in Kenya to operate currency and security printing business. This was a requirement under the above Agreement.
78. On 5th December 2002, the Appellant entered into a ten (10) year's *Banknotes Production and Supply Agreement with Central Bank of Kenya (CBK)*. However, in March 2003, the contract was cancelled to allow for competitive binding. Upon cancellation of the Agreement dated 5th December 2002, the Appellant was granted temporary contract extensions under stopgap orders. On 4th May 2006, CBK floated an international tender for the design, manufacture and supply of 1.71 billion new-look banknotes for three (3) years. The Appellant did not bid for the tender, but DLRI bid for it and won the tender with a view to printing the banknotes (new-look banknotes) at its Malta plant. However, the CBK delayed the commencement date for the above contract until January 2018. Following the intention of the Government to form a Joint Venture with DLRI the Agreement signed on 4th May 2006 was cancelled in year 2007.

79. The Respondent submits that DLRI competitively bid for and was awarded the above contract. Therefore, it argues, the contract is not relevant in the instance case since the parties are different, that is the Appellant and CBK. The Appellant cannot rely on the year 2018 contract that was won and awarded to DLRI to evidence that DLRI held the customer relationship with CBK. Furthermore, there is no evidence to indicate that this contract was sub-contracted to the Appellant and thus the Appellant becoming a Licensed Contract Manufacturer.
80. It is the Respondent's submission that the Appellant's allegation that it was a contract manufacturer for both banknotes manufacture for the CBK and the banknotes manufacture for other DLRI customer central bank is erroneous. The Respondent submits that the Appellant was only a contract manufacture in relation to banknotes manufacture for other DLRI customer central banks. In relation to the CBK banknotes, the Appellant was the contract owner and manufactured the banknotes under its own name.
81. The Agreement dated 14th December 2007 between CBK, and the Appellant provides at clause 12.3 that:

“A person who is not a party to this Agreement shall have no right to enforce any of the terms of this Agreement or otherwise and no party to this Agreement can declare itself a trustee of the rights under it for the benefit of any third party.”

The Respondent submits that the above clause defines the Appellant as the bona fide owner of the contract thus a fully-fledged manufacturer. There is no evidence to indicate that the Appellant assigned its rights under the above-mentioned contracts to DLRI and thereafter licensed to contract manufacture. Further, there is no contract between the Appellant and DLRI for contract manufacturing of banknotes sold to CBK during this period.

82. The Respondent reiterates that the Appellant has not met the threshold to be a licensed or contract manufacturer. It has not demonstrated that it is in line with the OECD Transfer Pricing Guidelines, 2017 which defines a contract manufacturer at Paragraph 7.40 as follows:

“Another example of an activity that may involve intra-group services is manufacturing or assembly operations. The activities can take a variety of forms including what is commonly referred to as contract manufacturing. In some cases of contract manufacturing, the producer may operate under extensive instruction from the counterparty about what to produce, in what quantity and of what quality. In some cases, raw materials or components may be made available to the producer by the counterparty. The production company may be assured that its entire output will be purchased, assuming quality requirements are met...”

83. The Respondent also relied on Paragraph 9.50 of the OECD Transfer Pricing Guidelines, 2017 which states:

“Assume an Appellant, which is a member of an MNE group, used to operate as a “full-fledged” manufacturer and distributor..., The Company purchased raw materials, manufactured finished products using tangible property and intangibles that belonged to it or were rented/licensed to it, performed marketing and distribution 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.”

84. The Respondent’s witness confirmed that design work was done and paid for separately by CBK and therefore CBK became the proprietor of the design. It must also be noted that all design specifications would come from CBK. Therefore, the Appellant cannot fund the Group’s Research and Development (R&D) through payment of royalties for future use. The R&D applied by DLRI has been paid for through the transfer price of the banknotes

paper from DLRI. Future R&D has no correlation to the manufacture of the CBK banknotes, since all the design works were specified in the CBK contract and paid for. The contract between CBK and the Appellant is also clear on who assumes the risk both of the inventory and the pricing risk.

85. On the issue of the Appellant utilizing DLRI's legal team, the Respondent submits that the Appellant has not provided evidence to indicate use of the legal team under the CBK contract. No dispute whatsoever arose under the CBK contract, and the Appellant has never been sued by CBK on any non-performance of the contract to warrant use of DLRI legal team. A fact that has not been disputed.
86. The Respondent further submits that a full-fledged manufacturer that possesses routine intangibles bears a range of risks associated with those activities, such as product liability, warranty, capacity utilization, market demand and pricing risks. An entrepreneur manufacturer earns returns on routine functions (including routine manufacturing operations) and on its contribution toward valuable intangibles. Therefore, the Appellant cannot claim to be a licensed manufacturer and is in fact and indeed a fully-fledged manufacturer.
87. According to the Respondent an analysis of the contracts with the CBK shows that the Appellant carries with it potential risks such as quality/product risk, inventory risk for the period between after production and before delivery of the banknotes, safe custody risk for the designs, artworks, films, engraved dies, plates and other origination materials for the banknotes. Clause 6.2 of the June 2009 Agreement specifies that:

“In the event that the banknotes delivered by the company do not meet the agreed specifications, the company shall print and deliver, at its cost, the replacement banknotes thereof within a time frame agreed upon with the Bank. The rejected banknotes shall be destroyed at the earliest opportunity...”

88. The Respondent submits that pursuant to the contract with CBK, the Appellant takes all the risks and obligations under the contract by carrying out all the economically significant activities and taking on the significant risks in the business and therefore should be characterized as a fully-fledged manufacturer. The Appellant has not demonstrated how DLRI takes on any of the risks or manages and controls those risks on behalf of the Appellant. It therefore follows that the company is not justified to reallocate any of the risks to DLRI.
89. In response to the Appellant's witness statement's (Mr. Titus Mukora) assertion that there is no bar to a fully-fledged manufacturer paying a third party for IP right, the Respondent submits that a fully-fledged manufacturer can only pay for specific IPs that have been evidenced and transferred and the same creates value to the manufacturer. Notably, DLRI wants the Appellant to pay for, such items, as the De La Rue Trademark, Brand and Name that they do not need or use in the manufacture of the CBK banknotes. In the instance case, the IP has no economic value to the Appellant.
90. It is the Respondent's assertion that the Know How License and Technical Assistance Agreement is a sham and is not aligned to the conduct of the parties to the CBK contract. Notably, the CBK contracts were signed by the Appellant, therefore the royalty agreement cannot purport to appoint the Appellant as licensed contract manufacturer of the CBK banknotes.
91. The Respondent submits that it is not in contention that DLRI owns certain IP. However, it submits that any transfer of the IP was embedded in the cost of banknote paper and was remunerated at arm's length. Therefore, any further charge in the form of "royalties" amounts to duplicated charges.

b) Whether DLRI was significantly involved in the negotiation of the CBK contracts and continued relationship with the CBK from 1991 to date.

92. It is the Respondent's submission that the Appellant has not provided evidence to indicate that DLRI was involved in the negotiation of the CBK contracts including the stopgap contracts. The evidence by the Appellant that DLRI negotiated the years 2018 and 2019 contracts is irrelevant in the current case, since the contracts were signed between DLRI and the CBK.
93. The Respondent avers that the Appellant developed the marketing intangible, that is, *customer relationship*, with the CBK and has sustained this relationship over the years as evidenced by the contracts entered there-in. Under the audit period, the relationship is between the Appellant and the CBK, since the contracts were signed by the two parties. Without prejudice to the above, the Respondent submits that the Appellant, in-fact, was involved in the development and enhancement of De La Rue Group image (brand) in Kenya by holding positive relationship with the CBK and ensuring timely performance of the contracts. If, the Appellant failed to deliver the contracts, the Group would have been blacklisted, or more. Thus, it argues, it is the Appellant that should be compensated for its function under DEMPE of the De La Rue Group intangibles.
94. The Respondent submits that Clause 1.9 of the contract between the Appellant and CBK, relied on by the Appellant, does not invalidate the Appellant as being a fully-fledged manufacture. If, in any instance, the Appellant was unable to deliver the order to CBK and the same was sub-contracted, a sub-contract fee would apply and not a royalty payment to DLRI.
95. The Respondent does not dispute that payments were made to DLRI. It however argues that this does not invalidate the functions performed, risks assumed under the CBK contracts by the Appellant and its character as **fully-fledged manufacturer**. Furthermore, taxation is not based on flow of money,

or where the revenues are paid. The Respondent submits that the monies paid to DLRI also accrued interest which was declared by the Appellant.

c) Whether the price of the banknote paper purchased by the Appellant from DLRI is at arm's length and thus the price includes the costs associated with the know-how to manufacture and design of the banknote paper

96. The Respondent denies that there are any intangibles that accrued in the production of CBK banknotes that are not included in price of banknote paper, such as, print features and manufacturing processes. Furthermore, the Appellant has failed to identify the specific intangibles it purports to use in the printing of the notes, the dates these inventions were made, by whom, where and when the purported inventions were registered.
97. The Respondent submits that the Appellant purchases banknotes paper for the manufacture of Kenyan currency exclusively from DLRI. The Agreement between CBK and the Appellant provides the specification in relation to the banknote paper size, design, quality and security features to be embedded. The Appellant purchases bank note paper with all the security features already embedded in it. This implies that the cost associated with the know-how to manufacture and designing the banknote paper is already factored in the costing of the paper sold to the Appellant.
98. It is the Respondent's assertion that the security features as provided by the CBK remained the same over the years as contracted for. Therefore, the Appellant could not have introduced additional features on the banknotes they did not own. It is alleged that the Kenyan banknote has over 120 security features; the Appellant has not evidenced that the same were included under the CBK Contract. Even if the Kenyan banknotes have 120 security features, these features were specified by the CBK. In fact, most are patented by the CBK, as they are unique to the Kenyan Banknotes.

99. The Respondent avers that the transfer pricing policy document (“TP document”) specifies that the Appellant selected an external Comparable Uncontrolled Price (CUP) method to benchmark the price of the banknote paper. That in instances where there was shortage of capacity in DLRI paper mills, the Appellant purchased from third party suppliers for the same specification and in varying volumes. Thus, the price paid for paper by the Appellant was based on CUP method, which represents an arm’s length price.
100. According to the Respondent, the Appellant indicated that the print and process intangibles includes ink mixing, printing of multiple features and both the front and back of banknotes with close registration (alignment), machine setup, drying and paper cutting; and that these are DLRI’s proprietary knowledge utilized by the Appellant. The Appellant has however not demonstrated how this know-how was transferred from DLRI, by whom and when.
101. The Respondent refers to Paragraph 6.17 of the OECD TP Guidelines, 2010 which specifies that:
- “The compensation for the use of intangible property may be included in the price charged for the sale of goods when, for example, one enterprise sells unfinished products to another and, at the same time, makes available its experience for further processing of these products. Whether it could be assumed that the transfer price for the goods includes a licence charge and that, consequently, any additional payment for royalties would ordinarily have to be disallowed by the country of the buyer, would depend very much upon the circumstances of each deal and there would appear to be no general principle which can be applied except that there should be no double deduction for the provision of technology...”*
102. The Respondent referenced Paragraph 6.105 of the OECD TP Guidelines, 2017 which it avers further amplified on the above and clearly provides that if the price of the IP is included in the value of the product, no separate

royalty will be payable for the IP. Paragraph 6.20 of the OECD TP Guidelines, 2017 defines know-how as:

“Know-how and trade secrets are proprietary information or knowledge that assist or improve a commercial activity, but that are not registered for protection in the manner of a patent or trademark. Know-how and trade secrets generally consist of undisclosed information of an industrial, commercial or scientific nature arising from previous experience, which has practical application in the operation of an enterprise. Know-how and trade secrets may relate to manufacturing, marketing, research and development, or any other commercial activity. The value of know-how and trade secrets is often dependent on the ability of the enterprise to preserve the confidentiality of the know-how or trade secret...”

d) Whether the royalty payments by the Appellant to DLRI in relation to manufacture and sale of banknotes to CBK is justified, considering that the price of the Banknote Paper was adjudged arm’s length and subsequent transfer of know-how was charged separately.

103. According to the Respondent, it requested for supporting evidence from the Appellant to prove additional support and know-how that it received from DLRI, but the evidence availed did not indicate the intangibles used. In particular, the Appellant could not provide evidence of use of trademarks and copyrights due to DLRI, patents used or design work.

104. The Respondent submits that since the cost relating to technical assistance from DLRI was recharged separately to the Appellant, the Appellant cannot create a further liability in respect of the same payments under the guise of a royalty. This was further confirmed by the Respondent’s witness during the hearing. According to the Respondent the Appellant did not avail any evidence to indicate that DLRI was involved in the process of manufacture of the banknotes sold to CBK. Nevertheless, the Appellant has employed highly

- skilled quality control workforce who ensures that the printed banknotes conform to the design and the specifications stated under the CBK contract.
105. It is the Respondent's assertion that the Appellant buys raw materials and semi-finished banknotes printing paper on its own account and holds inventories of the raw materials and finished bank notes. Thus, it bears the risks associated with both holding inventories and selling banknotes, including pricing risk. The contract between DLRI and the Appellant does not provide any indemnity from CBK claims in respect of defective bank notes that may be occasioned by DLRI's lapse on the part of the DLRI's purported technology. Further, the Appellant carries out all the economically significant activities.
106. The Respondent argues that the Appellant has over time created marketing intangible in the form of the contract relationship with the CBK. As a trusted partner of the government of Kenya, it is the Appellant that contracts with CBK and thus owns the marketing intangibles, *i.e.*, customer relationship. Previous long-term agreements between the Appellant and the CBK have contained provisions for biannual review and over time the Appellant has managed to sustain this relationship with CBK. The Appellant has highly skilled workforce who have been working with them for over ten years and are continuously trained on new and improved method of manufacture and quality control. It also invests in training its labour force. Furthermore, the Appellant owns all the specialized manufacturing equipment.
107. The Respondent reiterates that the Appellant owns all intangibles including the development, enhancement, maintenance, protection and exploitation (DEMPE) of the intangibles employed in the fulfilment of the CBK contract.
108. With respect of the Know-how and technical assistance agreement between the Appellant and CBK, the Respondent submits that there is no unique IP contributed by DLRI as the Appellant has established the know-how over the many years of experience in the business. Further, the Respondent notes that the company has not discussed or provided an analysis of the marketing

intangible owned, developed and maintained by DLRI for the Kenyan market.

109. The Respondent avers that prior to the know-how agreement, the Appellant was still able to manufacture the banknotes and had been retained by CBK to carry out all functions towards delivery of printed banknotes for a long time. The processes and risks inherent in the business did not change after the signing of the agreement with DLRI. Thus, it argues, the Appellant assumes all the entrepreneurial risks associated with the manufacture for the banknotes sold to CBK.
110. It is the Respondent's assertion that on 1st April 2010, the Appellant for the first time entered into a Know How Licence and Technical Assistance Agreement with DLRI. Accordingly, DLRI was to "grant" the Appellant a non-exclusive license to use the licensed know-how in the field of use of manufacture, have manufactured and to sell, or otherwise supply banknotes to CBK. The TP policy indicates that the Appellant selected Transactional Net Margin Method (TNMM) to benchmark the arm's length return for the company after payment of the residual royalty to DLRI on sales to CBK. The reward for the Appellant was on full cost plus a mark-up of 11% after payment of the residual royalty on sales to CBK.
111. The Know How Licence and Technical Assistance Agreement provides that:
"The know-how shall include, as reasonably required in the licensed manufacture and sale of licensed products to the Central Bank...."
The Respondent therefore reiterates that the contract for manufacture of bank notes is between the Appellant and CBK. At no point did DLRI license the Appellant to manufacture bank notes on its behalf as alluded to by the Appellant.
112. The Respondent further avers that as a result of the Appellant operating in Kenya since the year 2002, carrying out the same functions and taking on full rights, obligations and risks under its contract with CBK and also as it is

undisputed that prior to the 2010 agreement, no royalties were paid to DLRI; it therefore follows that the introduction of a “royalty” charge was a scheme designed to erode the tax base of the Appellant as the company was at the time subject to a Corporate Tax rate of 25% and four years later was to increase to 30%.

113. It is the Respondent’s assertion that the Appellant has overtime created marketing intangible in the form of the contract relationship with the CBK. As a trusted partner of the government of Kenya it is the Appellant that contracts with CBK and thus owns the marketing intangible, *i.e., customer relationship* since the year 2002. These long-term agreements between the Appellant and the CBK contain provisions for bi-annual review and the Appellant has over time managed to sustain this relationship with CBK and cannot therefore be paying royalty to DLRI. Hence, the contract and long-term relationship with CBK is a key value driver in the business.
114. The Respondent avers that though the Agreement between DLRI and the Appellant specifies that the Appellant may from time to time make request from DLRI for the specified know-how, the Respondent notes that no such requests were made by the Appellant to DLRI for the period under review.
115. The Respondent cited Paragraph 6.133 of the OECD TP Guidelines which provides that:

“... in matters involving the transfer of intangibles or rights in intangibles it is important not to simply assume that all residual profit, after a limited return to those providing functions, should necessarily be allocated to the owner of intangibles. The selection of the most appropriate transfer pricing method should be based on a functional analysis that provides a clear understanding of the MNE’s global business processes and how the transferred intangibles interact with other functions, assets and risks that comprise the global business. The functional analysis should identify all factors that contribute to value

creation, which may include risks borne, specific market characteristics, location, business strategies, and MNE group synergies among others. The transfer pricing method selected, and any adjustments incorporated in that method based on the comparability analysis, should take into account all of the relevant factors materially contributing to the creation of value, not only intangibles and routine functions.”

116. The Respondent submits that the Appellant purchases printing hardware and software from the Group and claims either these expenses in its tax computations as capital allowances or a direct expense in form of recharges to the Group. It therefore follows that any further compensation of intangibles that are already embedded when purchasing the machines or recovered through recharges for software is a double charge.
117. On the IP from DLRI used, the Appellant states that the know-how license grants those patents, trademark, copyrights, manufacturing know-how and marketing intangibles to be used in the manufacturing and hence DLRI deserves all the residual profit from the business. The Respondent reiterates that banknote features were specified by the client, in the contract with CBK and are therefore not IP from DLRI. The Appellant has not demonstrated that the technology in the hardware and software has not been paid for by the Appellant through the payments made for the purchase of machinery and payments for the software.
118. The Appellant alleges that DLRI supports it in the functions of sales, training, shipping/logistics, equipment procurement, health and safety, systems, quality contract and procurement. The Respondent submits that these are not IPs from DLRI, and that the Appellant performs the above functions in-house.
119. On the trademarks and marketing intangibles, the Respondent denies that there is any evidence of the marketing activities done by DLRI in Kenya or how those activities have enabled the Appellant to obtain and maintain the relationship with CBK over the years. In fact, CBK has been a customer of the

Appellant since 2002, long before the know-how agreement was entered into. Further, the marketing of the brand name benefits the shareholders at the parent company and the Appellant is only part of that group. The use of a group name, a right which is granted in the corporate law-based articles of incorporation, is a non-chargeable expense. Furthermore, there is no registered trademark that the Appellant utilizes for the purpose of production and supply of the currencies. The bank note does not feature any trademark of De La Rue Group and therefore the Appellant has nothing to pay for.

120. On the manufacturing know-how, the Respondent submits that it is not in contention that the Appellant has manufacturing know-how with the operation of its local manufacturing facilities. In fact, the Appellant has highly skilled workforce who have been working with the company for over ten years and are continuously trained on new and improved method of manufacture and quality control. The TP policy document fortifies this by stating that the Appellant has manufacturing know-how associated with the operation of its local manufacturing facilities. The Appellant pays a management fee on the transfer of know-how from the seconded DLRI employees. These employees bring the know-how for which the Appellant pays for.
121. The Respondent further submits that the materials, banknote paper, the plates and ink, used in the manufacture of the CBK banknotes were sourced from DLRI at arm's length. Furthermore, some features noted in the banknote are as a result of the printing machine specification and the type of the ink applied, such as, the feel of the banknote, of which the IPs were embedded in the transfer price of the above materials.

e) Whether the letter by the Cabinet Secretary Treasury has any relevance to the current case.

122. The Respondent submits that the letter from the National Treasury does not apply to the Appellant in this case. The letter does not address itself on the

issue of taxability of royalties but seeks to govern the relationship between parties in the yet to commence currency printing contract entered between DLRI and the CBK. It cannot therefore be assumed that it would apply to the contract between the Appellant and CBK.

123. Furthermore, the letter is dated 13th October 2017 whereas the royalty in question relates to period July 2013 to June 2017. It is worthwhile noting that the letter does not state that it would apply retrospectively. During the hearing, the Respondent's witness confirmed that the letter did not have any bearing on the audit period herein as had been stated in the Objection Decision dated 2nd November 2018. It is also clear that this letter referred to a new contract between CBK and DLRI and did not in any way refer to the taxability of royalties.
124. The Respondent argues that the National Treasury letter cannot be interpreted as a decision, tax law, or a directive to KRA. The letter has not referenced any Section of the Income Tax Act or Tax Procedures Act. If the Respondent were to take the letter as the Appellant would wish, this would amount to Advance Price Ruling whereas there is no legal framework for such.
125. The Respondent submits that the Appellant's allegation that the Respondent's officer was involved in the deliberation of the National Treasury that took place in May and July 2017 is not supported. Nonetheless, it is not unusual for the Respondent to work in conjunction with Ministries where such discussions take place. However, any focus on tax and the outcome thereof is well documented and communicated to all parties. In the instant case, the Appellant has not produced any evidence/minutes of the alleged meeting and the resolutions passed to support its claim that the Respondent okayed the transaction.

126. Further to the above, the Respondent avers, no decision taken by the National Treasury was communicated to the Respondent on taxation of royalties and whether it had vacated retrospectively the tax on royalties charged on the purported transfer of the IPs.

f) Whether the Respondent should have assessed tax under Section 18(3) or Section 16(1) of the Income Tax Act, where the royalty payments by the Appellant to DLRI were adjudged not wholly and exclusively incurred for the production of the appellant income.

127. The Respondent submits that it disallowed the royalty payments by the Appellant to DLRI under Section 16(1) of the Income Tax Act for the following reasons:

(a) That the allowability of expense is governed by Sections 15 and 16 of the Income Tax Act (ITA). Section 18(3) of the Income Tax Act is applicable in testing the price charged on controlled transactions between Associated Enterprises.

(b) That provision of the Transfer Pricing policy is a requirement of the Income Tax Act (Transfer Pricing) Rules, 2006 that set out the controlled transactions between the Associated Enterprises and the pricing for the same.

(c) Article 13(4) of the UK/Kenya Double Taxation Agreement states that:

“Where, owing to a special relationship between the payer and the recipient or between both of them and some other person, the amount of the royalties paid, having regard to the use, right or information for which they are paid, exceeds the amount which would have been agreed upon by the payer and the recipient in the absence of such relationship, the provisions of this article shall apply only to the last-mentioned amount. In that case, the excess part of the payments shall

remain taxable according to the law of each Contracting State, due regard being had to the other provisions of this Agreement.”

(d) That clear grounds for disallowing the royalty payments were provided in the Commissioner’s Objection Decision of 2nd November 2018. The Appellant has not provided any evidence to indicate the transfer of the IP licensed by DLRI and how the same was applied to manufacture the banknotes sold to CBK. Thus, a third party will not be willing to pay for the IPs with no benefit(s) accruing.

128. The Respondent therefore determined that the transfer price of the banknote paper purchased from DLRI at arm’s length and included the cost of the intangible applied to manufacture the paper. Paragraph 6.17 of the OECD TP Guidelines, 2010 specifies that:

“...Whether it could be assumed that the transfer price for the goods includes a licence charge and that, consequently, any additional payment for royalties would ordinarily have to be disallowed by the country of the buyer...”

129. Therefore, the Respondent relied on the provision of Section 15 and 16 of the Income Tax Act to examine whether the royalty payments were expenditure were wholly and exclusively incurred for production of the Appellant’s income.

g) Whether, the tax shortfall penalty is charged under Section 84 of Tax Procedure Act, 2015 or Section 72D of the ITA.

130. The Respondent denies that it wrongfully and irregularly imposed a tax shortfall penalty under Section 84 and reiterates that penalties are charged on any unpaid taxes under Section 72D of the Income Tax Act. Section 72D states that:

“Where any amount of tax remains unpaid after the due date a penalty of twenty percent shall immediately become due and payable. ...”

h) Whether credit on the 15% Withholding Tax paid by the Appellant is allowable in respect of the royalty payments to DLRI.

131. The Respondent submits that Section 10 of the Income Tax Act provides that payment(s) made by a resident person to a person (resident or non-resident) in the nature of royalty (in this case), the same is an income derived in Kenya and tax is deductible per the provision of Section 35(1)(b) of the Income Tax Act. The royalty payments to DLRI were charged tax at the rate of 15% as per the provision of Article 13(2) of the UK/Kenya Double Taxation Agreement.
132. The Respondent further notes that Section 10 of the Income Tax Act specifies that, for the purpose of Income Tax 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 royalty or natural resource income ... the same shall be deemed to be income which accrued in or was derived from Kenya. Therefore, Withholding Tax is applicable on royalty payments as per the provision of Section 35(1) of the Income Tax Act and Article 13(2) of the UK/Kenya Double Taxation Agreement.
133. It is the Respondent's submission that Article 13(2) of the UK/Kenya Double Taxation Agreement specifies that royalty payments made by a resident person in Kenya to a resident of UK, are subject to tax in Kenya at the rate of tax not exceeding 15 per cent of the gross amount of the royalties.
134. The Respondent submits that there is no nexus between payment of Withholding Tax on a qualifying expense as per the provision of Section 35 of the ITA and the allowance or non-allowance of an expense under Section 15 and 16 of the ITA and payment. No provision in the Income Tax Act allows for credit on Withholding Tax paid on an expense adjudged not to have been incurred wholly and exclusively for the production of income. Regardless, "a

corresponding adjustment” should be made on amounts already paid to DLRI as royalties as guided by Para 4.66 of the OECD TP Guidelines, 2017.

i) Whether this dispute ought to be subjected to Mutual Agreement Procedure as provided for under Kenya-UK Double Tax Avoidance Agreement (DTA)

135. The Appellant filed a request dated 17th June 2019 with the HMRC seeking for the matter to be resolved through the Mutual Agreement Procedure (MAP) on the basis of the DTA between Kenya and the United Kingdom. The Appellant then filed a Notice of Motion at the Tribunal seeking for the matter at the Tribunal to be stayed pending completion of the MAP provided for under Article 29 of the DTA.
136. It was the Respondent’s assertion that the Tribunal delivered a ruling dated 29th January 2021 stating that there is nothing that prevents the MAP from running concurrently with the Tribunal’s proceedings. It was determined that the Appeal before the Tribunal should proceed for determination on its own merit notwithstanding the MAP which has been initiated at the instance of the Appellant.
137. The Respondent submits that the MAP is still on-going and should not bar the hearing of this dispute under TAT proceedings.

The Respondent’s Prayers

138. The Respondent therefore prays that:
- a) The Appellant’s Appeal be dismissed for lack of merit.
 - b) The Respondent’s confirmed Assessment be upheld.
 - c) The Respondent be awarded the costs of the Appeal

ISSUES FOR DETERMINATION

139. After considering the submissions by both parties, along with the documents filed by each party in support of its case as well as the evidence of the witnesses, the Tribunal is of the view that the issues for determination are as follows:

- i) Whether the Appellant is a Licensed Contract Manufacturer for DLRI or a fully-fledged manufacturer in the execution of the contract with CBK
- ii) Whether DLRI owned essential intangible assets and provided essential know-how and technical assistance to the Appellant to perform the functions under its contract with CBK.
- iii) Whether the price of the bank note paper purchased by the Appellant from DLRI is an arm's length price which includes the cost associated with the know how to manufacture and design the bank note.
- iv) Whether the letter by the Cabinet secretary of the National Treasury created a binding decision on the Respondent.
- v) Whether credit on the 15% Withholding Tax paid by the Appellant is allowable in respect of the royalty payments to DLRI and whether the Respondent applied the correct Corporation Tax rate in arriving at the amount assessed.
- vi) Whether the dispute ought to be subjected to Mutual Agreement Procedure as per the Kenya-UK Double Tax Avoidance Agreement

ANALYSIS AND FINDINGS

- i. **Whether the Appellant is a Licensed Contract Manufacturer for DLRI or a full-fledged manufacturer in the execution of the contract with CBK**

140. According to the OECD TP Guidelines, the determination of whether the Appellant was a contract manufacturer, or a full-fledged manufacturer

depends on the role(s) undertaken under the contract, ownership of the assets required to perform these roles under the contract as well as the (economically significant) risks assumed by the Appellant. A contract manufacturer simply performs manufacturing functions, does not own valuable tangible or intangible assets and does not make any significant or unique contribution to the process and the end product. A contract manufacturer also incurs relatively lower levels of risk in their transactions.

141. The full-fledged manufacturer may be responsible for activities such as production planning, input procurement, supply chain management, quality control, long term capacity utilization planning and potentially selling to third-party customers. The full-fledged manufacturer also bears a range of risks associated with those activities, such as product liability, warranty, market demand and pricing risk.
142. The contract manufacturer is instructed by its principal on what to produce, in what quantities and what quality it should produce. It bears very low risk as to quality of the product when delivered to the final customer. Further, an assurance should exist from the principal that all the products manufactured by the contract manufacturer shall be purchased by the principal.
143. In this case, the Tribunal is not convinced that the Appellant acted as a contract manufacturer on behalf of DLRI for the following reasons:
 - a) The contract for manufacture has been entered directly between the Appellant and the CBK;
 - b) The quantities to be produced as per the contract are agreed directly between the Appellant as a party to the contract and CBK. There is nothing to indicate that there was another principal (such as DLRI) who guaranteed to purchase all the banknotes produced by the Appellant;
 - c) There is no evidence that DLRI is a party to the contract or that it bears significant risk in the event of non-performance of the contract by the Appellant. In fact, the sample agreements provided explicitly state that the Appellant shall bear the risk in case the banknotes are damaged or destroyed,

lost or stolen and even where forged banknotes enter into circulation as a result of the negligent actions or omissions of the Appellant.

144. The Tribunal is of the view that the Appellant has not successfully demonstrated that DLRI carried out activities such as production planning, input procurement, supply chain management, quality control, long term capacity utilization planning and potentially selling to third-party customers or that it bore the risks associated with those activities, such as product liability, warranty, market demand and pricing risk.

ii. Whether DLRI owned essential intangible assets and provided essential know-how and technical assistance to the Appellant to perform the functions under its contract with CBK

145. The Appellant has argued that DLRI owns valuable assets that were necessary for the fulfilment of the contract between the Appellant and CBK. In particular, that DLRI carried out research and development and therefore owned the product and process IP. It further listed various support services that it provided such as sales, training, equipment procurement, systems and security audits etc.

146. The Appellant further argued that DLRI held the customer relationship with CBK since it has been significantly involved in the contract for the manufacture of banknotes for CBK from the onset and subsequent negotiations leading up to the signing of the contract between the Appellant and CBK. It further argued that payments under the contract were paid directly to DLRI rather than the Appellant.

147. On review of these facts the Tribunal was not satisfied as to the nature of technical assistance that was provided under the Know-how Licence and Technical Assistance Agreement relied on by the Appellant or that indeed the existence of the customer relationship between DLRI and CBK would warrant the payment of the royalties determined under that contract.

148. The Tribunal is not convinced of the Appellant's contention that the Appellant does not have any capacity to manage the legal details or indeed all of the services that it lists as being provided by DLRI. The Appellant's organogram submitted in its own documents shows that it has departments and personnel who carry out roles such as production planning and logistics, security and risk audits, engineers and quality assurance managers, operations managers and human resources. No evidence has been submitted to show the exact technical services that were carried out by DLRI, above and beyond the normal operations of the Appellant.

iii. Whether the price of the bank note paper purchased by the Appellant from DLRI is an arm's length price which includes the cost associated with the know how to manufacture and design the bank note

149. Based on the above analysis, we find that there were no service or intangible assets that warranted a separate charge for a royalty. Indeed, as the Respondent has pointed out that all security features relating to the banknotes were already incorporated on the paper purchased by the Appellant from DLRI to be used to print the banknotes under the contract that the Appellant had with CBK. Further the features to be included in the banknotes was held by CBK. Thus, it is unclear what which IP the Appellant received from DLRI.

150. It was also noted that any management assistance provided such as secondment of employees of DLRI was compensated by payment of a management fee by the Appellant.

151. As such, the Tribunal finds that any technical support or IP provided by DLRI to the Appellant was fully compensated in the price charged by DLRI for the paper on which the banknotes were to be printed.

iv. **Whether the letter by the Cabinet secretary of the National Treasury created a binding decision on the Respondent**

152. The Appellant sought to rely on the letter from the National Treasury dated 13th October 2017 in which the Cabinet Secretary for Finance stated that it was satisfied with the terms of the Know-how Licence and Technical Assistance Agreement.

153. The Tribunal took time to keenly peruse this letter from the National Treasury. It was noted that the letter referred to the Business Transfer Agreement in which the National Treasury (which was a party to the Agreement) was required as a condition precedent to ascertain that it was satisfied with the terms. The letter stated thus:

“..having confirmed in writing that it is satisfied with the terms of any Know How Licence and Technical Assistance Agreement and Pricing Agreement for the sub-contracting of Intra Group Security Printed Banknotes (whatever name is given to such contracts) between De La Rue International Limited (or any other De La Rue Group Company) and the Company whether such contracts be existing and be part of the Transferred Contracts under this agreement or proposed to be entered into’

154. A review of the letter indicates that the said letter was written on 13th October 2017 in compliance with this condition precedent to state that it is *satisfied with the terms of the Know How Licence and Technical Assistance Agreement and Pricing Agreement for the sub-contracting of Intra Group Security Printed Banknotes, subject to the revisions that were agreed to and documented between yourselves and ourselves.*

155. The Appellant appears to be arguing that the National Treasury, via this letter has acknowledged the existence of the Know How Licence and Technical Assistance and further, that it is content with the price that has been determined therein for the payment of the royalties. This is, in our view an extrapolation of the contents of the letter.

156. The said letter was written in 2017 whereas the audit that forms the basis of the case at hand relates to an audit for the period 2013-2017. It is unclear how this contract applies to the assessment at hand.
157. Further, Article 210 of the Constitution of Kenya, 2010 provides that:
“(1) No tax or licensing fee may be imposed, waived or varied except as provided by legislation.”
158. Accordingly, any agreements or decisions made by the National Treasury that relate to taxation, whether imposing tax or exempting tax must be backed by or based on the law. An agreement by the government that for instance provides for an exemption of taxes can only, by law, be effective if such exemption is provided for under the First Schedule the Income Tax Act and subsequently gazette into law.
159. Based on the submissions made by the parties, it is at once clear that the question of know-how, technical assistance and the amount of royalties payable-as it pertains to the tax payable and a finding of the National Treasury as to the pricing of this royalty payment is a technical transfer pricing issue. In the mind of this Tribunal, an agreement by the National Treasury to this particular provision, particularly on the royalty amount payable could only be for purposes of determining whether this was a suitable price.
160. The averment that the National Treasury examined and was satisfied with the need for and the transfer pricing arrangement in respect of the Know How License and technical Assistance Agreement the contents would amount to what is known in International Transfer Pricing parlance as an Advance Pricing Agreement. The Glossary of Terms in the Transfer Pricing Guidelines defines an Advance Pricing Agreement to mean:

“An arrangement that determines, in advance of controlled transactions, an appropriate set of criteria (e.g. method, comparables and appropriate adjustments thereto, critical assumptions as to future events) for the determination of the transfer pricing for those transactions over a fixed period of time. An advance pricing

arrangement may be unilateral involving one tax administration and a taxpayer or multilateral involving the agreement of two or more tax administrations.”

161. The Appellant has not demonstrated that the National Treasury or indeed the Respondent reviewed all the aspect of the Know how license and technical assistance or that it reviewed the amount of royalties payable and satisfied itself that on reviewing the price between these related parties, it determined that this was a suitable transfer price. Even if this was the case, the issuing of an Advance Pricing Agreement must be couched in law under the Tax statutes and would be under the purview of the Respondent. Despite the Appellant’s averments to the contrary, Advance Pricing Agreements have not been incorporated into the Kenyan tax laws. As such, it would be impossible for one to not only claim its existence but for this Tribunal to apply it.
- v. Whether credit on the 15% withholding tax paid by the Appellant is allowable in respect of the royalty payments to DLRI and whether the Respondent applied the correct corporation tax rate for the year 2014 in arriving at the amount assessed**
162. The Appellant argues that the Respondent is seeking to benefit twice. Having received withholding tax on the royalty payment made to a non-resident person (DLRI) it is now seeking to add back and tax the entire amount at the Corporation Tax of 30% and charge it on the Appellant. The Appellant argues that this treatment is contradictory and goes against the good faith avoidance of double taxation as enshrined in the Kenya-UK Double Tax Agreement.
163. It is the Tribunal’s view that Withholding Tax is deducted on income that is earned by another party and is therefore a tax charged on the party that receives the income. In this case, the Withholding Tax was incurred by DLRI although it was withheld by the Appellant. Such a tax cannot be offset against

the tax charged or sought to be charged on the Appellant who is a separate legal entity and a different taxpayer.

164. While this may result in a double taxation on the same amount, the adjustment to be made cannot be done for the benefit of the Appellant as the Withholding Tax was only accounted for by it but was actually a liability suffered by DLRI. We concur with the Respondent that the rules of international tax and the Transfer Pricing Rules in particular provide for a corresponding adjustment to be made that would allow DLRI to seek redress from the Tax Authority in its place of residence.
165. With regard to the applicable Corporation Tax rate, the Respondent has neither disputed nor presented any argument rebutting that the Appellant, in its status as an EPZ enterprise, still enjoyed a reduced rate of 25% during part of the period under audit, that is, the year 2014. As the Appellant was an EPZ Enterprise during this period, then the Corporation Tax rate that was applicable at the time should also have been applied by the Respondent in the assessment. The amount assessed should therefore be adjusted accordingly to apply the correct tax rate in determining taxes due from the year 2014.
- vi. **Whether the dispute ought to be subjected to Mutual Agreement Procedure as per the Kenya-UK Double Tax Avoidance Agreement**

166. The above question was considered in great length by this Tribunal when raised as a Preliminary Objection by the Appellant. The Tribunal shall not belabour on this matter further and the Ruling issued on 29th January 2019 is applicable with regard to this issue. Suffice it to say, nothing in the OECD and UN commentaries require that MAP proceedings take precedence over local proceedings.

FINAL DECISION

167. Based on the findings above, the Appeal is partially allowed, and the Tribunal makes the following Orders:-

- (a) The principal tax, penalties and interest demanded in respect of the Objection Decision dated 2nd November 2018 are due and payable.
- (b) The Respondent shall amend the taxes demand to cater for the lower rate applicable in the year 2014.
- (c) Each party shall bear its own costs.

168. It is so ordered.

DATED and DELIVERED at NAIROBI this 4th day of June, 2021.

**ERIC NYONGESA WAFULA
CHAIRMAN**

**CATHERINE N. MUTAVA
MEMBER**

**ABRAHAM K. KIPROTICH
MEMBER**

**GABRIEL M. KITENGA
MEMBER**

**ELISHA NJERU
MEMBER**