



REPUBLIC OF KENYA

High Court at Nairobi (Milimani Commercial Courts)

Commercial Civil Case 2 of 2010

COMMISSIONER OF DOMESTIC TAXES.....APPELLANT

VERSUS

KENYA MALTINGS LIMITED.....RESPONDENT

RULING

1. Being dissatisfied with the decision of the Local Committee for Nairobi (hereinafter referred to as the “Local Committee”) of 9th February 2010 that the bad debt expenses incurred in the course of business were deductible, the Appellant herein lodged an appeal to this court pursuant to Section 86 (2) of the Income Tax Act Cap 470 (of the laws of Kenya).
2. The Appellant filed its Memorandum of Appeal dated 1st March 2010 and lodged in this court on 2nd March 2010 citing the following grounds:-
 - a. **The Local Committee erred in finding that the bad debt expenses were incurred in the course of business and are deductible.**
 - b. **The Local Committee erred in finding that the loans advance to the farmers by the banks was used as working capital by the Respondent to finance the production of barley.**
 - c. **The Local Committee erred in finding that repayments to the bank in the case where a farmer’s revenues failed to clear liabilities to the Respondent arose in the normal course of business and should therefore be allowable deductions under Section 15 (1) of the Income Tax Act, being expenditure incurred wholly and exclusively in the production of income from acquiring barley for resale.**
 - d. **The Local Committee erred in failing to find that the banks advanced the loans to farmers and that the Respondent were just guarantors.**
 - e. **The Local Committee erred in failing to find that the Respondent did not incur any barley debts, because once the Respondent reimbursed itself through the farmer’s loan account, there were no further obligations outstanding on the part of the farmers in as far as inputs were concerned.**
 - f. **The Local Committee erred in failing to find that losses arising out of a contract guarantee cannot be treated as business losses allowable under Section 15 (1) and 15 (2)(a) of the Income Tax Act.**

g. The Local Committee erred in failing to find that the Respondent did not advance any loan to the farmers for them to warrant any claim for bad debts.

h. The said decision was therefore bad in law.

3. Section 2 of the Income Tax Act defined a Local Committee as a “local committee established under Section 82 of the said Act.

4. The background of this matter can be discerned from the Statements of Facts filed by both the Appellant and the Respondent. In its Statement of Facts dated 1st March 2010, the Appellant stated that prior to the incorporation of the Respondent, the Respondent operated as a department of Kenya Breweries Limited (KBL) which was charged with the responsibility of procuring and processing of barley into malt.

5. The barley debts in question arose from contracts entered into between the farmers and KBL and the Respondent. Under the contract, farmers undertook to grow barley crop for sale to the Respondent and KBL and the Respondent purchased the same from the farmers. Until the barley was delivered to KBL/the Respondent, losses and damages thereto were borne by the farmers. The farmer undertook to run the whole process of growing barley from seed bed preparation, planting, application of fertiliser, spraying, taking precaution against fire, cutting, reaping harvesting, bagging, transporting and delivering the seed barley to KBL/the Respondent. The applicable prices were dependent on the grade of the barley.

6. To assist the farmers pay for the cost of seed, farm inputs, transporting and delivery of the crop to the Respondent, the Respondent at the request of the farmers, obtained financial assistance in the form of overdraft or loan facilities which the Respondent guaranteed.

7. Under the arrangement, the farmers executed Powers of Attorney in favour of the Respondent to enable it open and operate bank accounts on their behalf. The Respondent would reimburse itself for any liability for the farmer and remit any credit balance of the seed barley amount to the farmer. The principle and interest was payable by the farmers. Where the farmers failed to pay the loans, the Respondent paid the bank which loan settlement created an asset in the Respondent’s books known as “the barley debtors.”

8. In return, the Respondent would create a legal mortgage over the land, debenture over the seed barley and all other cereal crops and plantation, crops planted.

9. The Respondent inherited the assets and liabilities of KBL and consequently, the barley debts which were in the sum of Kshs 165,894,155/= were taxable on the Respondent.

10. The Appellant argued that the debts, even where not recovered, could not be written off through the profit and loss account. Further, once the Respondent reimbursed itself the monies it was owed by the farmers through the loan account, there was no further obligation by the farmers.

11. It was also the Appellant’s contention that though it may have been necessary for the Respondent to guarantee the loans by the farmers, the loss arising from the failure by the farmers to pay the loans cannot be said to have been an expense wholly and exclusively incurred in the Respondent’s business or treated as business allowances as stipulated in Section 15(1) of the Income Tax Act.

12. In its Statement of Facts dated 15th April 2010, the Respondent averred that its support of the production by the small scale farmers were expenses incurred in the course of business and were therefore deductible.

13. In 2002, the Appellant conducted a tax audit of the Respondent and disallowed bad debts expenses and provisions for bad debts and raised an additional assessment of Kshs 108,789,498/=. The Respondent was aggrieved by the decision and succeeded in having it reversed on appeal at the Local Committee.

14. The Respondent stated that its business involved:-

- a. **Providing technical input into the production of barley**
- b. **Providing all requirements for cultivation of barley until it is harvested and delivered**
- c. **Providing both financial facilities and input necessary for producing the barley.**

15. It also stated that apart from processing barley to produce malt, the Respondent was entitled to contract farmers to ensure it got good quality barley and consequently, the provision of inputs to farmers on credit terms did not fall outside the scope of its business. Its interest on cultivation, production and delivery of barley was therefore not capital in nature as the loans were applied exclusively towards the purchase of inputs for barley production at its risk.

16. The Respondent further contended that once the farmer executed the Power of Attorney, they both merged as principle debtors. The Respondent bore the entire responsibility of indemnifying Standard Chartered Bank of Kenya Limited (hereinafter referred to as "the bank") in the event the barley was not delivered as it is the one that owed the bank the monies.

17. In addition, the Respondent stated that the debts proved unrecoverable because the security from which the recovery was to be made because the barley crop either failed or was not delivered.

18. In its submissions dated and filed on 17th February 2012, the Appellant itemised the following issues for determination by the court:-

- a. **Whether bad debts arising from a loan taken by a third party and guaranteed by the Respondent are allowable deductions under Section 15(1) of the Income Tax Act, being expenditure incurred wholly and exclusively in the production of income.**
- b. **Whether debts taken over from KBL whose assets formed the share of the capital of the Respondent at its inception/incorporation could be properly allowed against subsequent income upon their becoming bad or doubtful**
- c. **Whether debts incurred under a Contract of Guarantee are allowable deductions under Section 15(1) of the Income Tax Act where they are used to provide working capital and inputs for a third party.**
- d. **Whether an outstanding debt arising from a Contract of Guarantee can be properly characterised as a bad debt if the Guarantor does not actively pursue the recovery measures against the Principle Debtor set out in the guarantee agreement.**
- e. **Whether losses arising from a Contract of Guarantee can be treated as business losses allowable under Section 15 (1) and 15(2) of the Income Tax Act.**

19. I find issues Nos (a), (c), (d) and (e) more or else related and I will therefore deal with the same together. The Appellant relied on Sections 3, 15 (1) and 16 of the Income Tax Act and Legal Notice No 37 of 2011 in support of its case.

20. It argued that Section 3 empowered it to impose income tax on a person whether or not resident in Kenya.

21. Section 3(2) of the Income Tax Act gives the classes for which income tax would be charged as follows:-

- a. **Gains or profits from-**
 - i. **A business, for whatever period of time of time carried on;**

- ii. **employment or service rendered;**
- iii. **a right granted to another person for use or occupation of property**
- b. **Dividends or interest**
- c. **Pension, charge or annuity**
- d. **Deleted**
- e. **An amount deemed to be the income of a person under this Act or by rules made under this Act**
- f. **Gain accruing in circumstances prescribed in and computed in accordance with Eighth Schedule.**

22. Section 15 (1) of the Act provides that:-

“ For the purposes of ascertaining the total income of a person for a year of income, there shall, subject to Section 16, be deducted all expenditure incurred in that year of income which expenditure wholly and exclusively incurred in him in the production of that income...”

23. Section 15 (2) (a) of the Act provides as follows:-

(2)“ Without prejudice to subsection (1), in computing for a year of income the gains or profits chargeable to tax under Section 3(2)(a), the following amounts shall be deducted:-

(a) bad debts incurred in the production of those gains or profits which the Commissioner considers to have become bad, and doubtful debts so incurred to the extent that they are estimated to the satisfaction of the Commissioner to have become bad, during that year of income; and the Commissioner may prescribe such guidelines as may be appropriate for the purpose of determining bad debts under this subparagraph.”

24. The exceptions of the deductions not allowed are shown in Section 16 of the Act which provides as follows-

(1) Save as otherwise expressly provided, for purposes of ascertaining the total income of a person for a year of income, no deduction shall be allowed in respect of :-

- a. **Expenditure or loss which is not wholly and exclusively incurred by him in the production of the income;**
- b. **Capital expenditure, or any loss, diminution or exhaustion of capital**

(2) Notwithstanding any other provision of this Act, no deduction shall be allowed in respect of :-

- b. **expenditure or loss which is recoverable under any insurance, contract or indemnity.**

25. The import of the Legal Notice No 37 of 2011 is that the Commissioner of Income Tax must be satisfied that that all efforts have been made to collect a debt. He must be convinced that the same has become uncollectable for him to declare it a bad debt. In addition to that, a bad debt becomes a deductible expense only if it is wholly and exclusively incurred in the normal course of business.

26. The Appellant submitted that the Respondent was not carrying out an ancillary trade of lending monies to the farmers. It argued that it was not in the Respondent’s normal business activities to lend such monies like **in Reid’s Breweries Co Ltd vs Male (1891) 3TC279** where a brewing company gave loans to tenants and customers. Consequently, the barley debts were not debts wholly and exclusively incurred

in the production of income.

27. It further argued that the Barley debts were a loss or diminution of capital rather than an expenditure which in addition to capital exhaustion were disallowed under Section 16 of the Income Tax Act.

28. On its part, the Respondent averred that the amount of such advance or payment to the extent to which it was not recoverable from the proceeds of the crop would be a debt and owing to the Respondent and thus become recoverable. The Respondent was categorical that it was responsible to the Bank for any outstanding debts and that the guaranteed was only by way of security.

29. The Respondent relied on Clause 10 of the Model Agreement between itself and the farmer to show that the amounts it did not recover became debts. The said clause read in part:-

(b) If the Company.....of the Farmer's goods, services and financial facilities;

(i) Any advance or payment under the Company together with interest thereon will be recoverable in the first instance out of the proceeds of the crop. In the event of the proceeds of the crop being insufficient to cover any advance or monies paid under the provision of this clause, the amount of such advance or payment to the extent to which it is not recovered from such proceeds shall be a debt due and owing by the farmer to the Company and forthwith recoverable."

30. The Respondent admitted that although the facts of the Reid's case were distinguishable from this case, it was clear that the court held that the loans were not investments or fixed capital but that the same represented circulating capital employed in lending money and hence the losses were allowable.

31. As has been stated by the Appellant in paragraph 22 (b) of its submissions dated 17th February 2012, the loans advanced to the farmers was working capital. In paragraph 23 of the said submissions, the Appellant further pointed out that the Respondent would act as a guarantor where the farmer sought financial assistance in the form of overdraft of loan facilities to pay for the cost of the seed, farm inputs, transportation and delivery of the crop to the Respondent. This cannot in any way be said to have been capital expenditure which for all purposes and intent must be an asset and appear on the opposite side of debits in the Respondent's accounts.

32. In his Statement of Facts, the Appellant has admitted that the Respondent at the request of the farmers, obtained financial assistance in the form of overdraft or loan facilities which the Respondent guaranteed. Towards this end, the Respondent relied on the Supreme Court of India case of **S.A Builders Ltd vs Commissioner of Income Tax Appeals (Appeal Civil No 5811 of 2006)** where the court held that:-

"It has consistently been held that the expression " for purposes of business" includes expenditure voluntarily incurred for commercial expediency and it is immaterial if a third party benefits thereby..."

33. In **Usher's Wiltshire Brewery Limited and Bruce (1915) A.C. 433 at page 473** also cited by the Respondents, the court held that:-

" The balance of profits or gains of trade is struck by settling against the receipts of all expenditure incidental to trade which is necessary to earn them, and by applying, in computation, the ordinary principles of commercial trading."

34. I have considered the holding in **Hancock vs General Reversionary and Investment Company (1919) 1K.B. 25** where Lush J said at page 37 that:-

"...the proper test to apply is this; was the expenditure incurred in order to meet a continuing business demand, in which case it should be treated as an ordinary business expense and an admissible deduction or was it an expenditure incurred once and for all in which case it should be

treated as capital outlay...”

35. In **Commissioner of Income Tax vs Robson & Another E.A (1970) 213**, the Commissioner-General of Income Tax appealed on the ground that the losses were not incurred wholly and exclusively for in the production of the Respondent’s income. Sir Charles Newbold P, Duffus V.P. and Spry JA (dissenting) allowed the appeal when they held that the losses were not incurred in the production of the Respondent’s professional income and were therefore not allowable as deductions. The judges held that the losses were capital losses and therefore not allowable as deductions under Section 15 of the Income Tax Act.

36. As was also held in **Income Tax vs T Ltd (No 2) EA (1971) 569**, for expenditure to be deductible under circulating capital, it must have been incurred for the direct purpose of producing profits.

37. According to the Black’s Law Dictionary Free online Legal Dictionary 2nd Edition, the following terms have been defined:-

a. capital asset has been defined as:-

“An asset that is set to generate income and one that depreciation is claimed usually.”

b. capital loss is defined as :-

“The amount by which the purchase price of an asset exceeds the selling price; the loss is realised when the asset is sold.”

c. capital expenditure is described as follows:-

“A capital expenditure is incurred when a business spends money either to buy fixed assets or to add the value of an existing fixed asset with a useful life beyond the taxable year.”

38. Expenditure resulting into an asset procured in a “once for all payment” would be considered as capital outlay. In this case, the expenses by the Respondent herein were not of the once for all payment which could be treated as capital outlay but rather they were incurred to meet a continuing business demand.

39. The essence of taxation is to tax income after deducting all the expenses. Profits can only be ascertained when the accounts are made up. As can be seen in Section 3(2) of the Income Tax Act, it is gains and profits that the Appellant would be entitled to tax on the Respondent’s income.

40. It is imperative that the real reason of the expenses be looked at to determine whether the same amounted to capital expenditure or expenses wholly or exclusively incurred for the production of income. The entry of the barley debts as capital in the books when the Respondent took over the barley debts from KBL does not in itself make the expenses capital losses when it encountered difficulties in collecting the debts to amount to capital losses which are not allowable deductions for taxation purposes.

41. The Respondent’s act of facilitating advancement of monies to the farmers was not an investment of capital. It was a necessary expense that should have been taken into account before ascertaining its profits and losses. I would agree with the Respondent’s that the giving of inputs and services was an ordinary activity in production of barley seed which was the business the Respondent was engaged in the production of its income.

42. On the question of guarantees, the Appellant relied on the case of **Jennings vs Barfield & Barfield [1962] 2 ALL ER 956** in which it was held that the giving of guarantees for deposits on houses and leases was a general or ordinary activity of solicitors therefore losses from this were expenses wholly and exclusively incurred in the production of income.

43. The Appellant also cited **Madan Gopal Bagla vs Commissioner of Income Tax, West Bengal (1956) S.C.R. 551: (1956) S.C.J. 668: 2 M.L.J. (S.C) 60 1.T.R. 174** where it was contended that it was the usual custom in Bombay for merchants to borrow from banks on the joint security of each other and that the loss incurred by the appellant therein was a loss incurred in the business. The Supreme Court held that the custom set up did not mean that the mutual accommodation by businessmen was necessarily an ingredient part of that custom.

44. I have carefully considered the submissions by the Appellant and the Respondent on the issue of Contract of Guarantee and the documentation placed before me and find that the relationship of the repayment of the loans was between the Respondent and the Bank. It was not a contract of guarantee between the Respondent and the farmers. Who was to repay the loans if the farmers did not pay up? The Respondent guaranteed the bank that all the loans taken up by the farmers would be paid back. This is what the Appellant acknowledged in its documentation before me when it stated that where the farmers failed to pay the loans, the Respondent paid the bank and created an asset in its books known as “barley debts”.

45. A perusal of the Statement of Accounts from the bank attached to the Respondent’s Statement of Facts shows the account holder as having been “KBL Barley A/C” with the names of the respective farmers appearing under description. There does not appear to have been any privity of contract between the farmers and the bank. Indeed there is no evidence placed before me to suggest or imply that there was a contract between the Bank and the farmers. It is for that reason that I do not find favour in the Appellant’s submissions that no deduction shall be allowed in respect of expenditure or loss which is recoverable under any insurance, contract or indemnity as the same is not relevant in the circumstances of this case.

46. To the contrary, in the absence of any proof by the Appellant, I am persuaded by the Respondent that when the farmers failed to pay the monies, the Respondent had to pay up and follow up the debtor farmers. Where it was unable to recover the monies, these debts could only be referred to as “bad debts” because for all purposes and intent they were bad debts.

47. The Appellant has argued that according to Guideline (1) of Legal Notice No 37 off 15th April 2011, that a debt could not be declared bad until it had been proven to the satisfaction of the Commissioner of Income Tax that the debt had become uncollectable after all reasonable steps had been made to collect it. Under Guideline (2) of the said Legal Notice, it has stipulated the circumstances under which a debt could be deemed to have been uncollectable. One of these instances was when there was no form of security or collateral which was realisable whether partially or in full.

48. This court is not hearing the matter in its original jurisdiction but rather in the appellate stage. It would therefore not be possible to interrogate whether or not the Respondent was able to realise its securities over the farmers’ barley crop. Making a determination on this issue would clearly be exceeding the mandate and scope of this reference.

49. Suffice it to state that I reject the Appellant’s submissions that the bad debts were not expenses incurred in the course of business and that they were wholly and exclusively incurred by the Respondent in the production of its income. From the submissions and the documentation before me, it is evident that the barley debts did not relate to a loss, diminution or exhaustion of capital not allowed as deductible expenses in Section 16 of the Income Tax Act for the reasons given hereinbelow. They were an expenditure solely incurred for the production of the Respondent’s income.

50. The Respondent provided technical input into the production of barley. It provided all requirements for the cultivation of barley until it was harvested and delivered. It provided both financial facilities and inputs necessary for producing the barley.

51. The Respondent could very well have been the one that cultivated the barley crop but instead it partnered with the farmers to do so on its behalf to enable it sell the barley to KBL and make profit. This could not have been a capital expenditure as it was not a one off expense which could be referred as an

asset. It is irrespective which party was incurring the business expenses to produce the income that the Respondent was deriving from its business of selling barley to KBL.

52. It appears to me that the custom, habit and usual practise of the Respondent in earning profits included facilitating the farmers to cultivate the barley crop and endure delivery to it. Contracting farmers to ensure the Respondent got good quality barley for sale was not outside the scope of its business.

53. I am in agreement with the Respondent that where it recovered the monies, this would form part of its income which was liable to be taxed. I find that taxing the amount due on the barley debts would amount to double taxation to the detriment of the Respondent. It would be taxed first on the misconception that the expenses it incurred were capital loss or expenditure not wholly or exclusively incurred in the course of the business for the purpose of production of its income and secondly after the profits or losses had been entered in its books.

54. Guideline (4) of the said Legal Notice is clear that it is only bad debts that were of a capital nature which would not be an allowable expense thereby envisaging a situation that there could be bad debts which are not necessarily capital in nature but similar to what I have found in this case, which were deductible in accordance with Section 15 (1) of the Income Tax Act.

55. In the premises foregoing, I find as follows:-

- a. That the Local Committee was correct when it found that that the bad debt expenses by the Respondent were incurred in the course of business and were deductible.
- b. The Local Committee was correct in finding that the loans advance to the farmers by the banks were used as working capital by the Respondent to finance the production of barley.
- c. The Local Committee was correct in finding that repayments to the bank in the case where a farmers' revenues failed to clear liabilities to the Respondent arose in the normal course of business and were therefore allowable deductions under Section 15 (1) of the Income Tax Act, being expenditure incurred wholly and exclusively in the production of income from acquiring barley for resale.
- d. The Local Committee was correct in finding that the banks advanced the Respondent money and it was liable to pay the loans which the farmers failed to pay.
- e. The Local Committee was correct in finding that the Respondent incurred barley debts.
- f. The Local Committee was correct in finding that losses suffered by the Respondent were allowable deductions under Section 15 (1) and 15 (2) (a) of the Income Tax Act.
- g. The said decision by the Local Committee was therefore not bad in law and in fact.

56. The Appellant admitted in paragraph 21 of its Further submissions dated and filed on 23rd July 2012 that the Local Committee did not make a determination as to whether the debts taken over from KBL whose assets formed the share of the capital of the Respondent at its inception/incorporation could be properly allowed against subsequent income upon their becoming bad or doubtful. As I pointed out hereinabove, this court is not sitting in its original jurisdiction but rather as an appellate court. It is for that reason that I will not make a determination of this issue as the same was not an issue that was determined by the Local Committee and for which this court would be called upon to consider on appeal.

57. Having said the above, I am therefore definitely not persuaded by the Appellant's submissions that the expenses incurred by the Respondent were not wholly and exclusively incurred for the production of its income. I have stated hereinabove that the expenses were not capital losses as had been submitted by the Appellant. Consequently, the expenses were allowable deductions in accordance with Section 15 (1) and Section 15 (2) (a) of the Income Tax Act.

58. For all the reasons aforesaid, I hereby dismiss all the grounds of appeal of the Commissioner of Income Tax with costs to the Respondent.

59. Orders accordingly.

DATED and **DELIVERED** at **NAIROBI** this 12th day of April 2013

J. KAMAU

JUDGE