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Tax & Legal Alert

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Tax Appeal Tribunal ruling

Loan principal written off as bad debt not tax allowable

The Tax Appeal Tribunal ("TAT" or "the Tribunal") in Premier Credit Limited v Commissioner of Domestic Taxes (Tax Appeal No. E1149 of 2024) ("the Judgment") held that the principal element of a loan written off as bad debt is not allowable for tax purposes.

In the Judgment, the Tribunal argued that the principal element of a loan is capital in nature in accordance with the Income Tax Act ("ITA"), IFRS 9 and Legal Notice 37 of 2011, commonly known as the 'Guidelines on Allowability of Bad Debts'. As such, any loss arising from unrecoverable principal is a capital loss and cannot be claimed as a tax-deductible expense. According to the judgment, only the interest, fees, and penalties portions, which are recognised as income, may be considered for deduction where it becomes uncollectable.

In this alert, we provide a brief background of the tax dispute, the parties' arguments, and our view on what the Tribunal's determination means for the financial services sector and taxpayers in general.

Background

The Kenya Revenue Authority ("KRA") conducted an audit of Premier Credit Limited's ("The Appellant") tax affairs for the period 2018 and issued a Corporate Income Tax ("CIT") assessment of KES 138,438,726. The Appellant objected to the assessment after settling the amount not in dispute. The KRA partially allowed the objection and issued an objection decision. Upon appeal against the objection decision, parties pursued resolution of the dispute via the Alternative Dispute Resolution ("ADR") framework. This culminated in the execution of a partial ADR agreement under the following terms:

- Principal taxes amounting to KES 35,641,262 were undisputed and therefore deemed due and payable;
- Principal taxes of KES 30,132,515 arising out of the disputed treatment of bad debt expense were referred back to the Tribunal for determination.

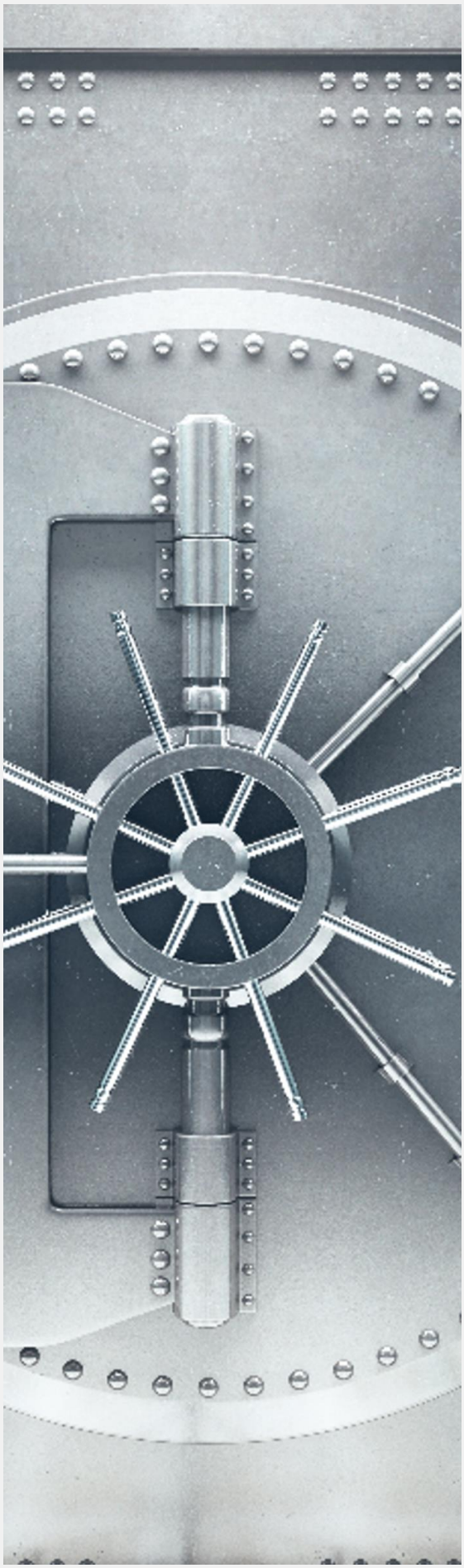
The Tribunal proceeded to adjudicate on the issue of the treatment of the principal element of a loan write-off from a bad debt perspective. The deliberations before the Tribunal and the final outcome are as outlined below:

Appellant's case

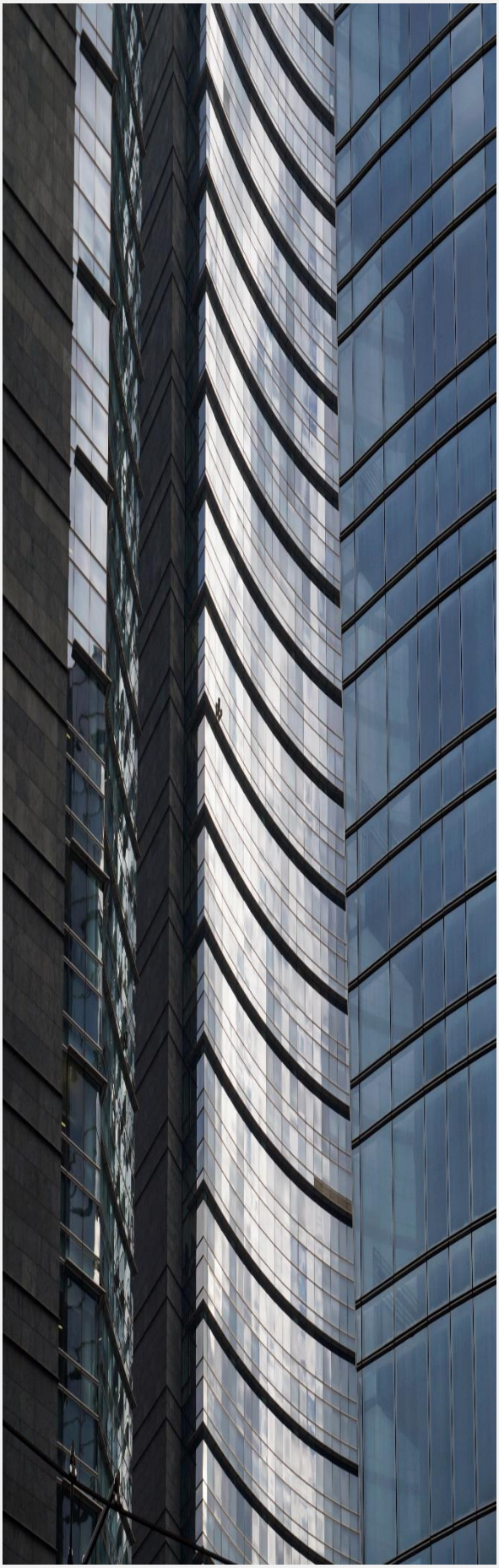
- The Appellant argued that the KRA erred in disallowing deductions for bad debts relating to principal loan amounts written off, maintaining these were incurred wholly and exclusively in the production of income and should be deductible under Section 15 of the ITA and Legal Notice 37 of 2011.
- The Appellant asserted that all required procedures for classifying and writing off bad debts were followed, including reasonable steps to recover the amounts, and that internal policies were aligned with legislative requirements.
- The Appellant specifically challenged the KRA's reliance on Paragraph 4 of Legal Notice 37 of 2011 and sought a declaration from the Tribunal that the said paragraph is ultra vires on account of it being contrary to Section 15(2)(a) of the ITA.
- The Appellant relied on various authoritative pieces of jurisprudence, including *Commissioner of Income Tax v Kencell Communications Limited* ("the Kencell case"), *Stanbic Bank Kenya Limited v Kenya Revenue Authority,* and *XYZ Holdings (PT) Ltd v Commissioner for the South African Revenue Service.* In essence, these cases distinguish between capital and revenue expenditure based on the purpose and nature of the expense, arguing that the principal loan amounts written off are revenue losses incurred in the ordinary course of business and should be an allowable deduction.

Respondent's case

- The Respondent argued that the principal amounts of loans written off by the Appellant as bad debts are capital in nature and, as such, are not allowable for tax. The Respondent relied on Paragraph 4 of Legal Notice 37 of 2011, which expressly prohibits the deduction of bad debts of a capital nature and emphasised that only interest, fees, and penalties that are revenue in nature may be considered for deduction if proven uncollectable.
- The KRA further contended that Section 15 of the ITA, which allows certain deductions, must be applied subject to Section 16 (1)(b) of the ITA, which specifically prohibits deductions for capital expenditure.
- The KRA took note that the Appellant is licensed by the Central Bank of Kenya ("CBK") as a microfinance institution. As such, the Appellant is required to adhere to the CBK's minimum capital requirements. The KRA contended that principal sums



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lent out arises from the available capitalisation and therefore ought to be considered capital in nature.

- The KRA concluded that the principal element of a loan represents a capital asset for the lender and if it becomes irrecoverable, writing it off constitutes a capital loss.
- The KRA argued that by relying only on Section 15 of the ITA, the Appellant ignored the restriction in Section 16 of the ITA that disallows deductions for losses of a capital nature. Therefore, the Appellant's interpretation was incomplete and contrary to the structure of the law, which requires both sections to be read together to determine what is deductible and to ensure that capital losses are not claimed as allowable expenses.

Tribunal's determination

The TAT set out the following issues for determination:

a) Whether Paragraph 4 of Legal Notice 37 of 2011 is ultra vires and contrary to Section 15(2)(a) of the ITA.
b) Whether the Respondent erred in finding that the principal loan amount of a bad debt is capital in nature.
c) Whether the Respondent erred in disallowing bad debts.

- On the first issue, the TAT acknowledged that it lacked jurisdiction to determine whether Paragraph 4 of Legal Notice 37 of 2011 was ultra vires or inconsistent with the ITA, as its mandate is limited to hearing appeals against tax decisions and not reviewing the validity of regulations.
- On the second issue, being the substantive issue at hand, the Tribunal ruled that the principal element of a loan is a capital asset for a lender. The Tribunal determined that when a loan is advanced, the principal is recorded as a financial asset, not as income. If the principal is not recovered and is written off, this constitutes a capital loss that Section 16 of the ITA expressly prohibits from being deducted for tax purposes.
- According to the Tribunal, only the interest portion that is recognised as income may be considered for deduction if it becomes uncollectable.
- The Tribunal clarified that Paragraph 4 of Legal Notice 37 of 2011 specifically disallows the deduction of bad debts of a capital nature such as principal loan amounts. In contrast, Paragraph 2 of the Legal Notice allows for the deduction of bad debts only to the extent that they are revenue in nature, such as irrecoverable interest, provided the taxpayer has taken all reasonable steps to recover the debt.
- The Tribunal considered international jurisprudence, including but not limited to *Sutlej Cotton Mills Ltd v Commissioner of Income Tax (India)* and *BFH vs Comptroller of Income Tax [2013] SGHC 161 (Singapore High Court, as cited in Kencell)* illustrating the persuasive value of jurisprudence arising from comparable jurisdictions. Referring to the Singaporean and Indian case laws, the Tribunal considered:
  - Criteria that ought to be considered in distinguishing capital from revenue expenditure including the purpose, manner and consequence of the expenditure.
  - The test applicable in distinguishing between fixed and circulating capital. The Tribunal heavily relied on the latter in concluding that the principal element of a loan is capital in nature for a lending institution.
- The Tribunal emphasised that the principal amount remains a balance sheet item and is only reduced upon repayment,

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whereas interest is recognised as income.

- Ultimately, the Tribunal upheld the KRA's position, finding that principal loan amounts written off as bad debts are capital in nature and not allowable as tax deductions.

Our view and conclusion

The distinction between revenue and capital expenditure for tax purposes has been a hotly contested issue. The decision by the Tribunal appears to have placed greater weight on the accounting treatment in determining the tax treatment of the loss in relation to the principal loan amount. While accounting treatment is an important indicator, it is neither the sole nor decisive factor in determining tax treatment. As explained by the Court in *Strick V Regent Oil Co Ltd*, accounting treatment may be informative but does not determine the consequences for tax in terms of what is capital or revenue in nature. In this regard, the ruling appears to depart from existing precedent, and in particular, tests that have been laid out by courts to aid in the determination of what constitutes revenue or capital expenditure from a tax perspective, taking into account the nature of trade carried out by the taxpayer.

A body of jurisprudence has developed over time to aid in this determination. Of particular relevance to taxpayers engaged in lending business is the determination of the Court in *Reid's Brewery Co. Ltd. v Male [1891] 2 QB 1, DC,* which is colloquially known as the precursor to the 'enduring benefit of trade' test, crystallised in the case of *British Insulated and Helsby Cables Ltd v Atherton [1926] AC 205*. This test considers three factors: The nature of the asset or advantage obtained, the purpose of the expenditure, and recurrence.

Where applied to persons carrying on the business of lending money, as was the case in the Reid's Brewery case, it was established that losses incurred in the furtherance of this business, i.e., principal sums deemed irrecoverable as bad debts, ought to carry a revenue character as opposed to a capital nature. This position aligns with international best practice. For instance, in the UK, Australia, and South Africa, among other countries, the loss of principal is tax-deductible.

Also crucial to note is that the Tribunal's determination in the present case, aside from departing from established jurisprudence, departs from its own decisions in *Fourth Generation Capital Limited v Commissioner for Domestic Taxes (Tax Appeal No. 1253 of 2024)* and *Branch International Limited v Commissioner for Domestic Taxes (Tax Appeal No.290of 2025)* despite the facts being similar. In these cases, the Tribunal recognised that for a money-lending business, the principal advanced is not fixed capital but rather circulating capital (the stock-in-trade) of the business to the extent that the principal is repeatedly deployed in the ordinary course of business to generate income, much like inventory for a retailer.

Going forward, the existence of these contradictory Tribunal decisions highlights the urgent need for legislative or judicial clarification; otherwise, taxpayers are exposed to inconsistent tax treatments.

Should you wish to discuss this further, kindly feel free to contact any of the contacts in the publication or your usual Deloitte contact, who will be more than glad to offer you guidance and assistance



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