REPUBLIC OF KENYA

IN THE HIGH COURT OF KENYA AT NAIROBI

COMMERCIAL & ADMIRALTY DIVISION

INCOME TAX APPEAL NO. 16 OF 2017

DELMONTE KENYA LIMITED............................ APPELANT

Versus

THE COMMISSIONER OF DOMESTIC TAX.........................RESPONDENT

JUDGMENT

1. Amongst the questions to be answered in this Appeal is the manner in which foreign exchange losses incurred by Delmonte Kenya Limited **(the Appellant or DKL)** in the settlement of foreign currency denominated loans by way of share issue should be characterized.

2. DKL is a limited liability company incorporated in Kenya. Its core activity is the cultivation, processing and sale of pineapples and a range of nonalcoholic beverages. From the year 2001 DKL took out loans denominated in US dollars and GB pounds from a related party namely Delmonte International Incorporation **(Delmonte International)**. Delmonte International is a company incorporated

in Panama. These loans were unsecured and interest free. As at 31st December 2008 the total outstanding loans amounted to USD 28,251,615.62 and GBP 1,464,272.89.

3. Over the years, as the loans subsisted, DKL prepared its financial statements on an annual basis. The statements were prepared on the basis of the local currency being Kenya shillings. Whatever balance there was in respect to the loans was translated into Kenya shillings applying the prevailing exchange rates. As there would be fluctuations in the strength of the Kenya shilling in relation to the two foreign currencies, the prevailing exchange rate at the point of preparing the various annual returns would differ from the exchange rate at the point of taking the loans.

4. The process of translating the outstanding loans resulted in foreign exchange gains or losses depending on the prevailing exchange or conversion rate. Whatever gains or losses were made were deferred from year to year and not taken as deductions for tax purposes. As at 31st December 2008, the unrealized foreign exchange losses on the loans amounted to Kshs. 401,261,996/-.

5. On 27th November 2009, the Directors of DKL resolved as follows:-

CONVERSION OF LOAN TO EQUITY

1. It is **RESOLVED** that the company agrees to assignment from Del Monte International, Inc, to Del Monte Kenya Holdings of loans totaling $28,287,507.00 and GBP 1,464,272.89;

   It is **RESOLVED** that the company agrees to offset Kshs.2,396,637,50 equivalent to $31,891,38 as of November 27, 2009 of inter-company receivables from Del Monte Kenya Holdings, Inc against these loans;

2. **ALLOTMENT OF SHARE AND SHARE CERTIFICATES**

   "It is **RESOLVED** that the Company agrees to issue 41,625 ordinary shares of Del Monte Kenya Limited to Del Monte Kenya Holdings, Inc. in exchange for the loans of $28,255,615.62 and GBP 1,464,272,89";

3. **SHARE CERTIFICATE**

   It is **RESOLVED** that the Company Seal, duly authenticated, be fixed to Share of Kshs.20/= each in the name of Del Monte Kenya Holdings, Inc.

6. The Appellant accounted for the unrealized exchange rate differences resulting from the revaluation of the loan balance in each year until the liability was settled. In consequence, DKL passed an adjustment of Kshs. 401,261,996/- in its year 2009 tax computation. As he would in ordinary course, the Respondent audited the accounts of DKL for the years 2009 to 2011. Following that audit the Respondent raised an additional income tax assessment in which it disallowed DKL's foreign exchange loss adjustments. That assessment was confirmed on 16th September 2013 and resulted in additional taxes of Kshs. 60,828,537/- and Kshs.161,481,213/- for the years of income 2010 and 2011 respectively.

7. Aggrieved by this assessment, DKL preferred an appeal against it being Tax Appeal No. 81 of 2015. It is the decision of the Tax Appeals Tribunal dated and delivered on 7th December 2016 that is the subject of the current proceedings.

8. In that decision, the appeal was partially successful and the losses regarding the offsetting of receivables amounting to USD 31,891 against the foreign loan were allowed. However, in respect to the

more substantial grievance, the Tribunal held in favour of the Respondent.

9. In arriving at that decision, the Tribunal had framed 2 issues for determination: -

   i) When foreign exchange differences are realized.

   ii) Whether foreign exchange losses arising on conversion of a debt to equity is an allowable expense.

10. The first issue did not seem controversial and the Tribunal held that differences arising out of realization of a debt are revenue and are taxable if there is a gain and allowable if there is a loss. In addition, such losses or gains are recognized only when they are realized. Another observation made by the Tribunal was that realization of the loan can occur not only when the debt is paid in cash but also if extinguished through payment in kind or exchange of goods or services, conversion of debt to equity or even amortization against receivables between the parties.

11. The Tribunal concluded that foreign exchange losses or gains are realized when there is a permanent cessation of an obligation to pay

or receive foreign currency and not by mere translation of denomination of currency of debt.

12. On the second question the Tribunal found that even though the foreign exchange losses were connected to change in equity they are not a kind that is allowable.

13. In the Appeal filed before this Court on 9th February 2017, DKL raises the following grounds:-

    1. **The Tribunal erred in law by concluding that the foreign exchange losses, which had accrued in prior years due to the translation of the Appellant's foreign currency denominated loans into Kenya Shillings, and which losses were only realized upon settlement of the outstanding loans of USD 28,255,616 and GBP 1,464,272 by way issue of shares, were capital in nature and therefore not deductible for tax purposes.**
    2. **The Tribunal erred in law by failing to consider and apply the provisions of section 4A of the Income Tax (ITA) which expressly allows for the deduction of foreign exchange losses incurred by a business without any**

reference to the manner in which they arise. Specifically, section 4A(1) provides that;

> "a foreign exchange gain or loss realized on or after 1 January 1989 in a business carried on in Kenya shall be taken into account as a trading receipt or deductible expense in computing the gains and profits of that business for the year of income in which that gain or loss was realized;
>
> Provided that;
>
> (i) No foreign exchange gains or loss shall be taken into account to the extent that taking that the foreign exchange gain or loss into account would duplicate the amounts of gain or loss accrued in any prior year of income'.

Section 4A(1) and its proviso do not expressly or implicitly exclude taking into account foreign exchange losses realized on the conversion of debt to equity.

3. The Tribunal erred in law by failing to consider that under Section 4A (1) (ii) of the ITA, foreign exchange gains or losses realized in relation to debt, which like equity is a balance sheet item, are tax deductible expenses.

4. The Tribunal erred in law by applying the provisions of 16(1)(b) of the ITA notwithstanding that Section 16(1) expressly states that the section applies subject to other provisions of the ITA as follows;

   'save as otherwise expressly provided...'

5. The Tribunal erred in law by relying on the provisions of Section 15(2)(s) and section 15(2)(ss) of the ITA. The former section provides for the deductibility of expenses incurred in the issuance of shares to the general public and the latter section provides for the deductibility of incidental costs on the listing of shares on a securities

exchange. The Appellant carried out neither of these transactions hence the sections do not apply.

6. **The Tribunal erred by holding that the Appellant;**

   "...was required to surrender more shares from the same amount of currency at the date of conversion of the loan than they would have if the conversion occurred on the date the loan was issued".

   The amount capitalized is equal to the amount of debt outstanding ie. USD 28,255,616 and GBP 1,464,272. The foreign exchange loss realized is separate and distinct from these amounts and no shares were issued as a result of and in respect to foreign exchange losses.

7. **The Tribunal erred in failing to find that the Respondent amended its pleadings without leave.**

14. As the Court turns to evaluate the argument made by parties and to determine the Appeal, one matter needs to be dealt with in prefatory.

15. One of the grievances of DKL is that the Tribunal erred in failing to find that the Respondent had amended its pleadings without leave.

Elaborating on this, DKL asserts that in reaching the controversial assessment, the Respondent stated that the basis of its decision was Sections 15(2) and 16(1) of the Income Tax Act (**ITA**). No reference being made to section 4A. DKL argues that the Respondent's position mutated at the appeal before the Tribunal when it made the argument that the loss of foreign exchange had been claimed contrary to the provisions of Section 4A of the ITA.

16. The Respondent does not perceive any difficulty. The Respondent submits that as the appeal was mainly anchored on the provisions of Section 4A of the ITA, that warranted a Reply. This did not require the pleadings to be amended and that the Respondent did not seek to amend or introduce new issues.

17. The Court has looked at the documents, pleadings and submissions before the Tribunal and makes this observation. The amended assessment of 20th September 2013 is the bone of grievance by the Appellant. It is evident from the contents of the letter that the assessment was founded on the provisions of section 15(2)(s), 15(2)(ss) and 16(1) of the Act. When DKL appealed against the decision it

invoked the provisions of section 4A of the Act and faulted the Respondent's reliance on section 16(1).

18. In the submissions dated 8th March 2016 before the Tribunal, the Respondent put in considerable effort arguing that as there was no actual conversion of Kenya shillings into foreign currency, the foreign currency losses were not tax deductible under section 4A(1).

19. I would think that because DKL's case was primarily founded on the application of section 4A of the Act, the Respondent was perfectly entitled to make the counter arguments. The Tribunal's duty was to consider these rival submissions and further, whether sections 15(2) and 16(1) of the ITA which were relied on for the assessment were relevant to the dispute. As will become apparent in the course of discussing that decision, that is exactly what the Tribunal did. This Court does not agree that the approach by the Respondent altered or widened the scope of the issues that had initially arisen at the assessment.

20. This Appeal is filed under the auspices of Section 53 of The Tax Procedures Act as read with section 32 of the Tax Appeals Tribunal Act. The former reads;

"S. 53. Appeals to High Court

A party to proceedings before the Tribunal who is dissatisfied with the decision of the Tribunal in relation to an appealable decision may, within thirty days of being notified of the decision or within such further period as the High Court may allow, appeal the decision to the High Court in accordance with the provisions of the Tax Appeals Tribunal Act, 2013 (No. 40 of 2013)".

21. The scope of an appeal to the High Court such as this is circumscribed by the provisions of 56(2) Of the Tax Procedures Act to be on questions of law only.

22. These proceedings invite the Court to interpret various provisions of the ITA. On issues of construction of a statute that imposes tax, the Court of Appeal in Kenya **Kenya Revenue Authority v Republic (Exparte Fintel Ltd) [2019] eKLR** reminds that the proper approach is that set out in the decision of **Mangin V Inland Revenue Commissioner [1971] AC 739**. The Court of Appeal said;

"...the words are to be given their ordinary meaning, looking only at what is clearly said. There is no room for any

intendment. There is no presumption so to tax. Nothing is to be read in, nothing is to be implied. One can only look fairly at the language used...... In that process, the court is under a duty to adopt an approach that produces neither injustice nor absurdity; in other words, an approach that promotes the purpose or object underlying the particular statute albeit that such purpose or object is not expressly set out therein."

23. Restating another rule of construction, the Court of Appeal further stated;

> **"A statute ought to be looked at, in the context of its enactment and as a whole as opposed to picking and choosing words in isolation. "No part of a statute and no word of a statute can be construed in isolation. Statutes have to be construed so that every word has a place and everything is in its place." So said the learned Judges of the Supreme Court of India in Reserve Bank of India V. Peerless General Finance and Investment Co. Ltd., 1987 SCR (2) 1.**

See also The Engineers Board of Kenya V. Jesse Waweru Wahome & others Civil Appeal No 240 of 2013.

24. This Court will remain faithful to these canons of interpretation.

25. Central to the discussion herein is section 4A of the ITA which provides as follows:-

4A. Income from businesses where foreign exchange loss or gain is realized

(1) A foreign exchange gain or loss realized on or after the 1st January, 1989 in a business carried on in Kenya shall be taken into account as a trading receipt or deductible expenses in computing the gains and profits of that business for the year of income in which that gain or loss was realized: Provided that—

(i) no foreign exchange gain or loss shall be taken into account to the extent that taking that foreign exchange gain or loss into account would duplicate the amounts of gain or loss accrued in any prior year of income; and

(ii) the foreign exchange loss shall be deferred (and not taken into account)—

(a) where the foreign exchange loss is realized by a company with respect to a loan from a person who, alone or together with four or fewer other persons, is in control of that company and the highest amount of all loans by that company outstanding at any time during the year of income is more than three times the sum of the revenue reserves retained earnings and the issued and paid up capital of all classes of shares of the company; or

(b) to the extent of any foreign exchange gain that would be realized if all foreign currency assets and liabilities of the business were disposed of or satisfied on the last day of the year of income and any foreign exchange loss so deferred shall be deemed realized in the next succeeding year of income.

(1A) For the avoidance of doubt accumulated losses shall be taken into account in computing the amount of revenue reserves.

(2) The amount of foreign exchange gain or loss shall be calculated in accordance with the difference between (a times r1) and (a times r2) where—

a is the amount of foreign currency received, paid or otherwise computed with respect to a foreign currency asset or liability in the transaction in which the foreign exchange gain or loss is realized;

r1 is the applicable rate of exchange for that foreign currency ("a") at the date of the

transaction in which the foreign exchange gain or loss is realized;

r2 is the applicable rate of exchange for that foreign currency ("a") at the date on which the foreign currency asset or liability was obtained or established or on the 30th December, 1988, whichever date is the later.

(3) For the purposes of this section, no foreign exchange loss shall be deemed to be realized where a foreign currency asset or liability is disposed of or satisfied and within a

period of sixty days a substantially similar foreign currency asset or liability is obtained or established.

(4) For the purposes of this section—

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

"company" does not include a bank or a financial institution licensed under the Banking Act (Cap. 488);

"all loans" shall have the meaning assigned in section 16(3);

"foreign currency asset or liability" means an asset or liability denominated in, or the amount of which is otherwise determined by reference to, a currency other than the Kenya Shilling.

26. There is consensus that as at 31st December 2008, DKL had incurred unrealized foreign exchange losses on the loans in the sum of Ksh.401,261,990/=. So as to settle the entire debt, DKL resolved to offset intercompany receivable amounts of USD 31,891.00 due from DMKH and the balance amounting to USD 28,255,616 and GBP 1,464,272.00 through issuance of 41,625 ordinary shares of 20 each and a share premium of Kshs.2,303,839,000/= to DMKH. The

argument by DKL and accepted by the Tribunal is that the payment of the outstanding loan through the offset of receivables and issuance of share capital was an event of realization of the foreign exchange losses.

27. The Tribunal was fully cognizant that foreign exchange loss or gain is realized not by mere translation of the denomination or currency of the debt but when there is a permanent cessation of an obligation to pay or receive foreign currency. The Tribunal then drew from the decision of Majanja J. in **Republic vs. Kenya Revenue Authority Ex-parte Fintel Ltd** where the Judge expressed his view of how the word 'paid' should be construed in the ITA. Perhaps to be noted at this point is that in an appeal from the High Court decision, the Court of Appeal took a wider view of the word 'paid' which it expressed as follows;

> **The Income Tax Act has given the word "paid" a technical as opposed to an ordinary definition. Tax law is ever changing, complicated and highly technical. That is why we, with respect disagree with the learned Judge for insisting that "upon payment" must only convey the meaning that money**

or some valuable thing was delivered. He gave the phrase a very narrow construction. In the context of the Income Tax Act, payment is deemed to have been made even when no money has passed over. We therefore reject the contention that it was not practical to deduct and remit the tax without first actually paying the interest to the contractor. Although section 35(5) requires that where withholding tax is payable, the tax payer must "deduct" and remit the amount so deducted to the Commissioner, the sense in which the word "deduct" is used, as an accounting term refers to the act or process of subtraction of an item or expenditure from gross income to reduce the amount of income subject to income tax. This need not be done physically or practically but as a book entry.

28. Nonetheless in respect to the matter at hand even the more restricted construction was good enough as parties agree that offsetting the loan by way of receivables and issue of share capital amounted to payment of the loans. The Tribunal correctly reached a decision that

the loss of Kshs. 401,261,990/= which had occurred as a result of foreign exchange conversion had been realized within the contemplation of the section 4A of the ITA. I do not hear the Respondent to be contesting the correctness of this finding.

29. That preliminary issue having been settled the scope of the dispute considerably narrowed. The singular issue both before the Tribunal and this Court is how the foreign exchange losses realized by DKL was to be treated.

30. The argument by DKL now, as it was at the Tribunal, was that the wording of section 4A of the Act was clear and unambiguous. The realized foreign exchange gains or losses are to be taken either as trading receipts or deductible expenses in determining a tax payers taxable profits. This Court was asked to find that section 4A applies to all realized gains and losses without considering the manner in which the realized gains or losses arose.

31. That proposition is not accepted by the Respondent who argues that section 4A recognizes only those gains or losses that are actually realized in respect to gains or profits from a business and not losses attributable to share capital transactions. It is asserted that the

Tribunal was correct in holding that where the currency gains or losses were incurred in connection with the purchase of an investment then the difference on the currency change on realization is capital gain or loss on the investment as expenditure on contraction or increase in equity and is reflected in the balance sheet and not in the profit and loss account.

32. The Respondent calls into aid the provisions of Section 16(1) of the ITA which reads:-

> **S.16(1) Save as otherwise expressly provided, for the purposes of ascertaining the total income of a person for any year of income, no deduction shall be allowed in respect of—**
>
> **(a) any expenditure or loss which is not wholly and exclusively incurred by him in the production of the income;**
>
> **(b) any capital expenditure, or any loss, diminution or exhaustion of capital.**

33. It is argued that by dint of these provisions the only expenses which are deductible are those wholly and exclusively incurred in production of the income. The Respondent submits that the losses incurred by DKL in respect to the equity conversion do not meet the

criteria set out under section 4A and are therefore not allowable. It being argued that DKL was required to surrender more shares for the same amount of currency at the date of conversion than they would have if the conversion occurred on the date the loan was issued. It was pressed that such an expense can only be treated together with the equity (reducing the share premium) and as such is a capital expense which is not deductible under the provisions of section 16(1)(b) of the Act.

34. A contention was also made that although the foreign exchange losses incurred by DKL were connected to change in equity they are not of a kind allowable under sections 15(2)(s) and 15(2)(ss) of the ITA. Section 15(1), 15(2)(s) and 15(2)(ss) read:-

> **S.15(1) Deductions allowed**
>
> **(1) For the purpose of ascertaining the total income of any person for a year of income there shall, subject to section 16 of this Act, be deducted all expenditure incurred in such year of income which is expenditure wholly and exclusively incurred by him in the production of that income, and where under section 27 of this Act any income of an accounting**

period ending on some day other than the last day of such year of income is, for the purpose of ascertaining total income for any year of income, taken to be income for any year of income, then such expenditure incurred during such period shall be treated as having been incurred during such year of income.

S.15(2) (s) expenditure of a capital nature incurred in that year of income by a person on legal costs and other incidental expenses relating to the authorization and issue of shares, debentures or similar securities offered for purchase by the general public.

S.15(2) (ss) expenditure of a capital nature incurred in that year of income by a person, on legal costs and other incidental expenses, for the purposes of listing on any securities exchange operating in Kenya, without raising additional capital.

35. As I turn to consider these conflicting positions it helps to reproduce the portion of the decision that has triggered the Appeal;-

> **26. The Tribunal then addressed itself to the question as to whether loss incurred through conversion of debt to equity was an allowable deduction. The Tribunal determined from the evidence adduced that the full debt was amortized against receivables and the balance converted into equity. This process was clearly contained in the Appellant's books of account. No evidence was produced by the Appellant to show that the conversion of the debt to equity was an independent transaction to justify their argument that the transaction was independent transaction and therefore ought to be treated as tax deductible. The tribunal does not agree with the Appellant's assertion that the conversion of debt and the consequential foreign exchange losses claimed. The Tribunal then proceeded with its deliberations taking into consideration, that the conversion of the balance of the loan into shares and the amortization of the same against receivable were related transactions.**

27. The Tribunal is of the view that where currency gains or losses were incurred in connection with the purchase of an investment, the gain or loss of the currency change on realization is a capital gain or loss. This is included as part of the total capital gain or loss on the investment as expenditure on contraction or increase in equity and is reflected in the balance sheet and not in the profit and loss account where expenses incurred in the ordinary course of business are recorded. The tribunal is of the view that a transaction moves together with its connected expenses and as such all expenses related to conversion of the loan must be treated together as after all, it was a matter of fact and law that it was the Appellants money from the same loan.

28. The resultant question therefore which the Tribunal must ask itself and determine is whether, currency exchange loss is such an expense and whether such an expense did occur? The Tribunal holds the view that a loss did occur to the Appellant as they were required to surrender more shares for the same amount of currency at the date of

conversion of the loan than they would have if the conversion occurred on the date the loan was issued. Such an expense can however only be treated together with the equity and as such is a capital expense. Capital expenses are not deducted as provided for in Section 16(1) (b) of the ITA which states that:

> ***"Save as otherwise provided, for purposes of ascertaining the total income of a person for a year of income, no deduction shall be allowed in respect of ...(b) Capital expenditure, or any loss, diminutions or exhaustion of capital".***

36. In respect to the portion of the loan that was retired by conversion payment for receivables the Tribunal expressed itself as follows;-

> **30. Turning on to the portion of the loan that was amortized through conversion payment for receivables, the Tribunal finds payment for receivables as an expense incurred in ordinary course of business. Therefore, the discharge of an obligation in such a manner should be treated as an allowable expense for purposes of computing tax. The**

Tribunal therefore holds that currency losses incurred in the discharge of debt through what was owed as receivables is a deductible expense.

37. It also has to be remembered that in reaching these findings the Tribunal had held that the payment of the loans through conversion to receivables created a cessation of the obligation to pay foreign currency and was therefore an event of realization. DKL are happy about this position and the Respondent did not cross appeal on it. This is notwithstanding that the bulwark of its submissions before the Tribunal was that in the absence of actual cash outflow, realization could not be presumed to have happened within the meaning of the provisions of section 4A of the ITA. I take it therefore that the Respondent accepts the Tribunal's finding that a foreign exchange loss had been realized through both payment against receivables and conversion into equity. The substantial portion being the latter. It is therefore somewhat puzzling the Respondent re-agitated this point at the Appeal. It not being an issue for determination, the Court finds it unprofitable to discuss it and proceeds on the basis that the finding of the Tribunal in that respect is uncontested.

38. As the finding of the Tribunal was that capitalization of a substantial portion of the Debt was an event of realization of the foreign exchange loss, a central issue has to be whether the manner in which the realization was achieved mattered in taxing DKL. Put simply, was the realization through payment against receivables to be treated differently from that of conversion of the debt to equity?

39. But even before attempting to answer that question, the Court deems it necessary to deal with an issue it raised with the parties at hearing. I asked the parties to address me on whether the losses or gains contemplated in section 4A are in the nature of capital or revenue or both.

40. DKL takes the position that it applies to all realized gains and losses regardless of how they arise. On the other hand, whilst it had initially submitted that the provisions apply to both (see paragraph 39 of its submissions of 23rd February 2018), the Respondent seems to have had a change of heart. In further submissions it posits that this section relates to section 3(2) (a) (i) as regards to determination of gains and profits from business chargeable to Tax. This latter section provides;

S. 3(2) Subject to this Act, income upon which tax is chargeable under this Act is income in respect of—

(a) gains or profits from—

(i) any business, for whatever period of time carried on;

41. This Court is further asked to find that, save for instances provided in section 15 where deductions are allowed on capital expenditure ,section 16(1)(b) disallows deductions on capital expenditure or any loss, diminution or exhaustion of capital.

42. In support of this position, the Respondent referred the Court to the following guidance applied in India;

<u>Ascertain whether the Exchange Fluctuation is on Revenue /Capital Account</u>:

Exchange fluctuations arises on Revenue Account:

The exchange fluctuations which are not related to acquisition, installation, disposition of any capital asset, such fluctuations are treated to arise on Revenue Account. For example, the realized/unrealized exchange fluctuation

gain/loss which have been arisen on transaction with Trade Receivables, Trade Payables, Working Capital ECBs (External Commercial Borrowings) etc. are fluctuation impacts on Revenue Account.

Exchange Fluctuations arises on Capital Account:

The exchange fluctuations which are related to acquisition, installation, disposition of any capital asset, such fluctuations are treated to arise on Capital Account. For Example, the realized/unrealized exchange fluctuation gain/loss which have been arisen on capital creditors, outstanding ECBs taken for acquisition/installation of any capital assets etc. are fluctuation impacts on Capital Account.

43. The Respondent then strongly argued that foreign exchange gain or loss on repayment of money lent will always be a capital gain or loss(see for example ,Gibb J in **Commercial and General Acceptance v FC Of T(1977)137 CLR 373**);

"I incline to think that an exchange gain or loss on the repayment of moneys lent will always be a capital gain or loss, and can never be taken into account in the assessment of income".

44. If this Court were to venture an opinion on this issue then it prefers to lean on side of the proposition that exchange fluctuation arises on revenue account when **it is not related** to acquisition, installation, disposition of a capital asset, and on the converse the fluctuation is on the capital account. On this I agree with the Respondent. And I must observe that before the Tribunal, DKL took a not too dissimilar position when it argued that foreign exchange loss or gain must be allowable, regardless of how it arose provided the foreign currency is used in the course of business. I take this to mean of a revenue nature. On this matter the Court accepts the view of the Supreme Court of India in **Sutlej Cotton Mills Ltd Vs Commissioner Of Income Tax** Civil Appeals nos.1847 & 1848 of 1972 where it held;-

"...sovereign power extrinsic to the business, the loss could not be said to spring from the business of the assesse. Whether

the loss suffered by the assessee was a trading loss or not would depend on the answer to the question, whether the loss was in respect of a trading asset or a capital asset. In the former case, I would be a trading loss but not so in the latter. The test may also be formulated in another way by asking the question whether the loss was in respect of circulation capital or in respect of fixed capital. This is the formulation of the test which is to be found in some of the English decision. It is, of course, not easy to define precisely what is the line of demarcation between fixed capital and circulating capital, but there is a well-recognized distinction between the two concepts. Adam Smith in his Wealth of Nations described "fixed capital" as what the owner turns to profit by keeping it in his own possession and "circulating capital" as what he makes profit of by parting with it and letting it change masters. "Circulating capital" means capital employed in the trading operations of the business and the dealings with it comprise trading receipts and trading disbursements, while "fixed capital" means capital not so employed in the business, though it may be used for the

purposes of a manufacturing business, but does not constitute capital employed in the trading operations of the business. Vide Golden Horse Shoe (New) Ltd. vs Thurgood (1933) 18 Tax Cases 280(CA). If there is any loss resulting from depreciation of the foreign currency which is embarked or adventured in the business and is part of the circulating capital, it would be a trading loss, but depreciation of fixed capital on account of alteration in exchange rate would be a capital loss. Putting it differently, if the amount in foreign currency is utilized or intended to be utilized in the course of business or for a trading purpose or for effecting a transaction on revenue account, loss arising from depreciation in its value on account of alteration in the rate of exchange would be a trading loss, but if the amount is held as a capital asset, loss arising from depreciation would be a capital loss. This is clearly borne out by the decided cases which we shall presently discuss.

45. On the related issue but specifically on foreign currency loans, the Court takes the view that whether to consider it as a fluctuation

arising on revenue or capital depends on the nature and use of the loan. This is explained in the following guidelines issued in the Statement of Practice by Her Majesty's Revenue and Customs;-

> **"Nothing in FA 1998 Section 42 or in the case law regarding the computation of trading profits requires the distinction between capital and revenue items to be decided other than by reference to principles well established in tax case law. In computing trading profits for tax purposes, the question whether a loss or profit on exchange on a foreign currency loan made to the taxpayer is respectively an allowable deduction or assessable receipt is determined by the nature of the loan and whether it is to be properly regarded as a capital or current liability. The case law (Such as Marine Midland and Beauchamp v F W Woolworth plc (1989) STC 510, 61 TC 542) shows that the distinction between capital and current liabilities is essentially between loans providing temporary financial accommodation and loans which can be said to add to the capital of the business. The answer in**

any particular case must turn on its facts and circumstances, which have to be considered in detail".

46. Indeed, as pointed out by Counsel for DKL, the notion that gains or losses on repayment of a foreign currency loan will always be treated as a capital gain or loss was revisited by Gibb J himself with the following wiser holding;

> **"The view which I expressed in Commercial and General Acceptance Ltd v Federal Commissioner of Taxation (1977) 137 CLR at p 377, that an exchange gain or loss on the repayment of moneys lent will always be a capital gain or loss, must, on reconsideration, be rejected. In a case such as the present the gains and losses do not have the same character as the repayments that produced them, and, considered separately, but in the light of all the circumstances, are seen to be revenue in character".**

(In **Avco Financial Services Ltd V Federal Commissioner Of Taxation** (1982) 150 CLR 510)

47. Yet having had made the foregoing observations, I note that in the matter at hand the Tribunal itself held that payment of the loans through conversion to receivables and share capital was an event of realization of a foreign exchange loss of **a revenue nature.** DKL is contented with that holding and the Respondent, on the other hand, did not cross appeal it. It would in fact have been preposterous to hold that the loan retired by receivables led to a revenue loss and that by share issue was a capital loss when the repayment was of a debt of single nature. Such segregation would be artificial and unjustified. I therefore take it that the holding of the Tribunal that the foreign exchange loss was on the revenue account is common cause.

48. Now, the question begs whether there is legal anchor for a subsequent finding by the Tribunal that "loss incurred through conversion of debt to equity" was not an allowable deduction. For its importance I reproduce the view of the Tribunal expressed thus;

> **28. The resultant question therefore which the Tribunal must ask itself and determine is whether, currency exchange loss is such an expense and whether such an expense did**

occur? The Tribunal holds the view that a loss did occur to the Appellant as they were required to surrender more shares for the same amount of currency at the date of conversion of the loan than they would have if the conversion occurred on the date the loan was issued. Such an expense can however only be treated together with the equity and as such is a capital expense. Capital expenses are not deducted as provided for in Section 16(1) (b) of the ITA which states that:

> ***"Save as otherwise provided, for purposes of ascertaining the total income of a person for a year of income, no deduction shall be allowed in respect of …(b) Capital expenditure, or any loss, diminutions or exhaustion of capital".***

49. The Respondent argues that while the foreign exchange loss may well be revenue in nature, the circumstances here militate against treating it as allowable. First, the loan that was paid off was a facility between related parties. Further, that the issuance of shares was not

a business activity of DKL which is an agricultural company and there was no evidence to show that the conversion of the debt to equity was independent of the issuance of shares. Lastly, DKL was required to surrender more shares for the same amount of currency at the date of conversion of the loan than they would have if the conversion occurred on the date the loan was granted.

50. This Court is not told that the ITA bars the extinguishment of a foreign currency denominated debt by conversion of the debt to equity. For purposes of whether or not there is a foreign exchange loss or gain, I have understood the law to be that the loss or the gain is on the disposal of an asset or satisfaction of a liability and not the means in which the loss or gain is realized. Just as noted by the Tribunal, the Court is alive to the fact that the loan was between related parties, a loan from a parent company to a subsidiary. It is therefore possible that the related parties could choose to extinguish the debt at a point or time when DKL would obtain a big advantage on account of foreign exchange loss. Yet this Court is not told that such timing infracts on any law. And I must wonder if the parties here would stick to their positions if realization through the conversion of debt to

equity would have yielded a foreign currency gain and not a loss as in this case.

51. Once the Tribunal characterized the entire foreign exchange loss incurred by DKL as revenue in nature then it would not be conceivable for it to apply the provisions of section 16 (1) (b) to hold that capital expenses are not deductible.

52. In reaching this decision the Court does not doubt the wisdom in the remarks of Lord Fraser in **Willingale (Inspector of Taxes) and International Commercila Bank Ltd A.C [1978}834;**

> **"it is well established that "the question of what is or is not profit or gain must primarily be one of fact, and of fact to be ascertained by the tests applied in ordinary business", *Sun Insurance Company Office v Clark* [1912] A.C 443m 455 *per* Viscount Haldane. But that general rule is subject to the exception that where ordinary commercial principles run counter to the principles of income tax they must yield to the latter when computing profits or gains for tax**

purposes. In *B.S.C Footwear Ltd, v Ridgway* [1972] A. C. 544, 552G Lord Reid said;

> **"The application of the principles of commercial accounting is, however, subject to one well-established though non-statutory principle. Neither profit nor loss may be anticipated. A trader may have made such a good contract in year one that it is virtually certain to produce a large profit in year two. But he cannot be required to pay tax on that profit until it actually accrues".**

53. Yet in construing fiscal or tax legislation, the Court is obliged to reach an outcome which is not only rational and just but achieves consistent results when applied. Once applied, the parties must let the chips fall where they may regardless of whether the advantage falls to the tax collector or tax payer. I have to think that the Tax payer in this instance took advantage of a lacuna in statute and chose to retire the debt by conversion into equity at a point when it would reap a benefit. But I have to ask, again, if for whatever reason realization of the foreign exchange by the same means (that is, issuance of shares)

gave rise to a gain and not a loss, would the Respondent be willing to live by the formula it proposes? If so, it would mean that although there was a foreign exchange gain and therefore a taxable income, the tax payer would by parity of the reasons advanced by the Respondent argue that the gain should be treated as capital in nature because of the manner in which the debt was extinguished and should not be brought to charge. Such an outcome would be inimical to the spirit of section 4A.That outcome would be absurd.

54. The Court holds that the solution may lie in legislative intervention. Given that this is a tax statute, the provisions of the Act needs to expressly provide that no foreign exchange loss is deemed to be realized if an asset or liability is disposed of or settled in certain circumstances or by certain means, like in this case, by conversion of the debt by issue of shares by a subsidiary to the parent company. The proviso to section 4A already sets out certain instances where foreign exchange loss or gain is not to be taken into account. Perhaps there is need to lengthen the list. In this regard, there some learning to be made from the provisions of the UK Finance Act 1996 which are

explicit that certain gains and losses from loan relationships are not deductible.

55. In making arguments in respect to the English statute, Counsel for the Respondent made reference to section 84A (3) read with section 84A (4) as excluding any amount that is carried to or sustained by a reserve maintained by a company. The provisions read;

> **(3) The reference in subsection (1) (b) above to charges and expenses incurred for the purposes of a company's loan relationships and related transactions does not include a reference to any charges or expenses other than those incurred directly;**
>
> **a) In bringing any of those relationships into existence;**
>
> **b) In entering into or giving effect to any of those transactions;**
>
> **c) In making payments under any of those relationships or in pursuance of any of those transactions; or**

d) In taking steps for ensuring the receipt of payments under any of those relationships or in accordance with any of those transactions.

(4) Where;

a) Any charges or expenses are incurred by a company for purposes connected;

i With entering into a loan relationship or related transactions, or

ii With giving effect to any obligation that might arise under a loan relationship or related transaction,

b) At the time when the charges or expenses are incurred, the relationship or transaction is one into which the company may enter but has not entered, and

c) If that relationship or transaction had been entered into by that company, the charges or expenses would be charges or expenses incurred as mentioned in subsection (3) above,

Those charges or expenses shall be treated for the purposes of this Chapter as charges or expenses in relation to which debts may be brought into account in accordance with subsection (1) (b) above to the same extent as if the relationship or transaction had been entered into.

56. For the reasons given I allow the Appeal and set aside that part of the decision of the Tribunal the held that the Appellant is not entitled to deduct the loss incurred on the portion of the loan extinguished through conversion of the debt to equity and disallowed the Currency losses in respect of the balance of USD 28,255,616 and GBP 1,464,272. Instead the Appeal of the Appellant before the Tribunal is hereby allowed.

57. Costs here and before the Tribunal shall be borne by each party. I make this order because I do not consider the arguments made and issues raised by the Respondent both at the Tribunal and here to be a trifle.

Dated, Signed and Delivered in Court at Nairobi this 20th Day of December 2019.

F. TUIYOTT

JUDGE

PRESENT;

Kiragu Kimani & Ochieng for the Appellant

Chabala holding brief for Oundo for the Respondent

Court Assistant: Nixon