Taxpayer victory in dispute on taxation of foreign exchange losses

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The High Court has given its decision in Income Tax Appeal No.16 of 2017 *Delmonte Kenya Limited v. The Commissioner of Domestic Tax*. In allowing the appeal, the High Court has determined that foreign exchange losses realised through the conversion of debt to equity are tax deductible under section 4A of the Income Tax Act (ITA).

From the 2001 year of income, the appellant took out unsecured, interest-free loans denominated in USD and GBP from a foreign related party. The loans were used to finance its day-to-day business requirements. As at December 2008, the total outstanding loans amounted to US$28,251,615.62 and £1,464,272.89.

As required by Kenyan law, the appellant prepared its annual financial statements in Kenyan Shillings for each year of income. At this point, it would translate the outstanding balances on these foreign currency loans into Kenyan Shillings. This process resulted in foreign exchange losses or gains, depending on the prevailing exchange rate. The appellant deferred the unrealised foreign exchange gains and losses for tax purposes in each year of income and, as at 31 December 2008, the total cumulative unrealised foreign exchange losses amounted to KShs 401,261,996.

In November 2009, the appellant resolved to clear the outstanding loan balances by:

- converting a large portion of the debt into equity by issuing ordinary shares; and
- offsetting a small part of the outstanding debt amount against inter-company receivables.

At this point, the appellant treated the previously unrealised foreign exchange losses of KShs 401,261,996 as realised and took a deduction of this amount in its tax computation for the 2009 year of income.

The Kenya Revenue Authority (KRA) conducted an audit of the appellant's business covering the 2009-2011 years of income. At the conclusion of the audit, KRA issued an assessment in which it disallowed the deductions taken by the appellant in respect of the realised foreign exchange losses. The basis of the assessment was that the foreign exchange losses had not been realised and, furthermore, were capital in nature and therefore not tax deductible. The assessment was subsequently confirmed on 16 September 2013.

The appellant appealed KRA's assessment at the Tax Appeals Tribunal (Tribunal) on the basis that:

- settling the outstanding loan balances through conversion of debt to equity and offsets against receivables had caused the previously unrealised forex losses of 401,261,996 to be realized; and
- being a realised foreign exchange loss, the full amount of KShs 401,261,996 was tax deductible based on section 4A of the ITA.

KRA, on the other hand, argued that the manner in which the debt was settled did not result in the realisation of the foreign exchange losses and that the conversion of debt to equity was a transaction that is "capital" in nature and therefore not tax deductible under section 16 of the ITA which sets out deductions not allowed for tax purposes. KRA also argued that it was not one of the capital transactions provided as being deductible under section 15 of the ITA which also provides for tax allowable deductions.

The Tribunal held that foreign exchange losses were realised upon the permanent cessation of the obligation to pay the debt. This was tantamount to "payment" of the debt. It followed that both the conversion of debt to equity, as well as offsetting amounts against receivables, resulted in the realisation of the foreign exchange losses.

The Tribunal, however, went on to find that the conversion of debt to equity was capital in nature and therefore the foreign exchange losses in this respect were not tax deductible. Being aggrieved by this finding, the appellant appealed to the High Court on the basis that section 4A of the ITA does not in any way restrict the nature of realisation.

The High Court has allowed the appeal, determining that foreign exchange losses realised through the conversion of debt to equity are deductible under section 4A of the ITA. There is no express or implicit restriction on the manner in which realisation occurs.

What this decision means for you

Taxpayers may rely on section 4A of the ITA to make tax deductions of realised foreign exchange losses as long as they do not fall under the existing provisos.

The court has pointed out that section 4A of the ITA as currently worded does not limit the nature of realised foreign exchange losses to be taken into account and gone as far as recommending legislative changes to remedy this. Parliament may take the High Court’s cue and pass amendments to this effect.

This is yet another decision where the courts have considered and applied the principle of strict interpretation of tax laws. The court has done this to reach a rational outcome that achieves consistent results, irrespective of the perceived advantage to taxpayers or to the KRA.

KRA has a right to appeal the decision to the Court of Appeal but, unless and until this decision is overturned, it will apply to both taxpayers and KRA.

Read the full decision of the High Court here.

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