REPUBLIC OF KENYA
IN THE TAX APPEALS TRIBUNAL
APPEAL NO. 161 of 2017

EQUITY BANK (KENYA) LIMITED.....APPELLANT
VERSUS
THE COMMISSIONER OF DOMESTIC TAXES.....RESPONDENT

JUDGEMENT

BACKGROUND

1. The Appellant is a limited liability company incorporated in Kenya under the Companies Act, Chapter 486 Laws of Kenya and is licensed and regulated by the Central Bank of Kenya. Its principal activity is the provision of financial services.

2. The Respondent is an Officer of the Kenya Revenue Authority, hereinafter referred to as **KRA**, appointed in accordance with Section 13 of the Kenya Revenue Authority Act Chapter 469 Laws of Kenya and is charged with the mandate of assessment, collection and receipt of revenue as an agent for the Government of Kenya.

3. The Respondent carried out a tax compliance audit of the Appellant's records with regard to Corporation Tax for the 2015 year of income, Excise Duty for the period August 2013 to December 2015 and Pay As You Earn(PAYE) for the 2016 year of income.

4. On 21st June 2017 the Respondent, pursuant to the said audit issued a tax assessment in respect of the said three tax heads amounting to **Kshs1,738,969,276/=** inclusive of penalties and interest. The Appellant objected to the entire assessment vide an Objection Notice dated 21 July 2017.

5. The Respondent issued an Objection Decision dated 19 September 2017 in which it confirmed the assessment as having been properly issued and proceeded to demand the taxes in the sum of **Kshs.1,738,969,276/=**

6. The Appellant being aggrieved by the Respondent's Objection Decision lodged this Appeal. It filed a Memorandum of Appeal and the Statement of Facts on 2nd November 2017.

7. Upon service, the Respondent filed its Response on 1st December, 2017 and served the same upon the Appellant.

THE APPEAL

8. On the issue of Corporation Tax, it was contended by the Appellant that bad and doubtful debt write offs were expenditure incurred wholly and exclusively in the production of income in 2015 year of income under Section 15(2) (a) of the Income Tax Act, Cap 470, hereinafter referred to as **ITA.**

9. The Appellant submitted that the Respondent audited the bad debts written off to verify whether the write offs met the conditions set for bad debts write-offs deductible under Section 15(2)(a) of the ITA and the guidelines on deductibility of bad debts issued by the Commissioner via Legal Notice No. 37 of 2011. It argued that the Respondent erroneously concluded that the bad debts written off did not meet the conditions prescribed under Section 15(2)(a) and therefore did not qualify as tax deductible expenses. The Respondent erroneously sought to disallow the bad debts expense and demanded taxes of **Kshs.346,147,520/=** arising therefrom.

10. The Appellant contended that Section 15(2)(a) of ITA provides that a bad debt that has been incurred in the production of income shall be an allowable deduction in computing the profits chargeable to tax and further that the said Act provides that the Commissioner may prescribe such guidelines for purposes of determining bad and doubtful debts. To this end, the Respondent issued the Legal Notice which provides that a debt shall be considered to have become bad if it is proved to the satisfaction of the Commissioner to have become uncollectible after all reasonable steps have been taken to collect it, to which the Appellant adhered to.

11. The Appellant stated that the circumstances under which a debt is deemed to have become uncollectible are outlined in Paragraph 2 of the Legal Notice which are:
"(a) the creditor loses the contractual right that comprises the debt through a court order.
(b) No form of security or collateral is realizable whether partially or in full.
(c) The securities or collateral have been realized but the proceeds fail to cover the entire debt.
(d) The debtor is adjudged insolvent or bankrupt by a court of law.
(e) The cost of recovering the debt exceeds the debt itself; or
(f) Efforts to collect the debt are abandoned for another reasonable cause."

12. The Appellant maintained that all the reasonable efforts were taken to collect the said debts as envisaged under Section (15)(2)(a) of the ITA and the said Legal Notice and demonstrated how it made efforts in each of the specific bad debts that the Respondent sought to subject to tax. The Appellant therefore sought to have the tax assessment on Corporation Tax in the sum of **Ksh. 346,147,520/=** be set aside.

13. On Excise Duty, the Appellant argued that the Respondent has erroneously assessed the same amounting to Kshs.1,158,683,449/= on interest earned from Loan and Credit Evaluation (LACE) reviews, Temporary Overdrafts, Uncleared Effects, Trade Finance Income and, as well as excise duty on fees charged to the Hangar and Safety Network Program which is exempt from taxes pursuant to an agreement signed by the Government of Kenya.

14. On whether the Appellant is liable for PAYE taxes on the Employee Share Option Plan (ESOP) benefit granted to its employees, it maintained that a benefit is only conferred under an ESOP where the employer issues new shares at no cost or at a discount and allocates them to employees so that they can vest at a further date. The Appellant contended that no benefit was conferred to its employees under ESOP which would be subject to PAYE.

15. Moreover, it was argued by the Appellant that as an employer it did not fund the subject scheme and therefore cannot have conferred a benefit to the employees. Consequently, the Appellant sought to have the tax assessment on PAYE in the sum of Kshs.234,138,308/= be set aside.

THE RESPONSE

16. On the issue of bad and doubtful debts write-off the Respondent argued that it audited bad debts write off by the Appellant to verify whether the write offs met the conditions set out for bad debts provisions under Section 15(2)(a) of the ITA and the Commissioner's guidelines on bad debts issued vide Legal Notice No. 37 of 2011.

17. Consequently, the Respondent contended that the bad debts written off relating to the thirteen customers did not meet the conditions prescribed under Section 15(2)(a) and the Legal Notice and therefore did not qualify as tax deductible expenses. The Respondent consequently disallowed the respective bad debts written off and demanded the resultant tax amounting Kshs.346,147,520/= from the Appellant.

18. The Respondent stated that the Appellant did not take all the reasonable efforts to collect the debts as envisaged in Section 15(2) (a) and the Legal Notice No.37 of 2011.

19. In respect to the excise duty, the Respondent stated that it assessed the same, amounting to Kshs.1,158,683,449/= on various fees, charges and commissions earned by the Appellant in the course of doing business.

20. The Respondent contended that Section 2 and Section 117 of the Customs and Excise Act as read together with the Fifth Schedule to the Act has set out the services subject to excise duty and the Appellant did not comply with the law.

21. The Respondent averred that excise duty on financial services was introduced vide Finance Act 2012 through amendments to part III of the Fifth Schedule to the Customs and Excise Act. The amendment was as follows under Paragraph 7 & 8 respectfully;

"Excise duty on fees charged for money transfer service by cellular phone service providers, banks, money transfer agencies and other financial institutions shall be 10%".

22. Moreover the Respondent stated that the Finance Act, 2013 made further amendment to Finance Act, 2012 by defining other fees as *"any fees,*

charges, or commission charged by financial institutions, but does not include interest." The Finance Act, 2013 also defines the financial institution to mean -*" a person licensed under(i)the Banking Act(ii) the Insurance Act..."*

23. According to the Respondent, the Appellant's financial statements for the years 2013, 2014 and 2015 categorizes the types of income earned as interest income, fees, commission, other trading income, and operating income.

24. Furthermore, the Respondent argued that in the Financial Statements of the Appellant for the years 2013, 2014 and 2015, the revenues are categorized under the temporary overdrafts, un-cleared effects, trade finance income and fees charged to Hunger Safety Network fall under fees, commissions and other trading income. The revenue streams that have been subjected to excise duty by the Respondent fall under fees, commissions and other trading income as envisaged under the Customs and Excise Act, The Finance Act, 2013 and the Excise Duty Act, 2015.

25. The Respondent submitted that fees, commissions and other charges, levied in addition to loan interest, cannot be defined otherwise by the Appellant since doing so would contravene The Banking (Amendment) Act, 2016 which capped loan interest charges at four percentage points above the Central Rate (CBR).

26. It was the Respondent's assertion that on 28 August 2007, the Central Bank of Kenya in conjunction with the financial sector conducted a survey on banking charges and lending rates in Kenya. In the survey, the Central Bank notes that the costs that a borrower may be charged, in addition to interest, include commitment fees, facility fees, processing fees, early repayment fees, negotiation fees, valuation fees, insurance, appraisal fees and legal fees. This is an indication that in the banking industry, interest charge which is accounted for separately cannot be confused with the other charges.

27. Furthermore, the Respondent contended that the Kenya Bankers Association (KBA) who the Appellant is a member of released 'A customer Guide to Banking in Kenya' wherein they have detailed the various fees and costs associated with loan facilities.

28. The Respondent reiterated that the Finance Act, 2013 is explicit on the definition of the word 'other fees' which includes fees, charges, and commissions charged by financial institutions.

29. The Respondent maintained that the only income explicitly exempted from excise duty, by the Finance Act, 2013 and Excise Duty Act 2015 are interest and insurance premium or premium based on related commissions and other services under part B of the latter Act.

30. In respect of PAYE on ESOP, The Respondent stated that the Appellant operates an ESOP whereby the employees are given an opportunity to

acquire the bank's shares at discounted prices. Eligible employees are invited to take up the offers when they are opened. The shares allotted and taken up are held for a period of five years after which the same are vested to the respective employees.

31. The Respondent averred that on 2 August 2005 the Appellant established an employees' share scheme for the purpose of encouraging the holding of shares in the company by or for the benefit of the employees of the company and its subsidiaries.

32. The Respondent submitted that this therefore conferred a taxable benefit to the respective employees and that the offer of shares below the prevailing market price confers a benefit to the beneficiaries.

33. According to the Respondent the Appellant offered shares to eligible employees in 2011 which vested in 2016. On the vesting date the bank did not subject the benefit to PAYE in accordance with the Income Tax Act.

34. The Respondent stated that pursuant to Section 5(5) of the ITA which brings to charge the value of such benefits in respect to ESOPs that are registered with the Commissioner of Income Tax, the taxable value of the benefit is the difference between the market value per share and the offer price per share at the date the option is granted by the employer.

35. Furthermore, the Respondent averred that Section 5(5)(a) of ITA provides that the benefit under ESOPs shall be considered to have accrued to the employee either at the time the option vests in the employee or when the option is exercised by the employee, whichever is earlier. In the instance case, it stated that the benefit should be charged on the employees in 2016 being the end of the vesting period.

36. In conclusion on the issue of PAYE the Respondent submitted that the PAYE assessment on benefits derived from the ESOP in the sum of **Kshs.234,138,308/=** was proper and the Tribunal ought to affirm the same.

ISSUES FOR DETERMINATION

37. The Tribunal having carefully considered the parties' pleadings and documentation as filed together with the written and oral submissions is of the respectful view that the issues for its determination are as hereunder;

    a) Whether bad and doubtful debts written off by the Appellant were tax deductible expenses pursuant to Sec. 15(2)(a) of the Income Tax Act as read with Legal Notice No.37 of 2011;
    b) Whether income earned in form of fees from loan and credit evaluation reviews are subject to excise duty;
    c) Whether income earned on temporary overdraft facilities offered to the Appellant's customers are subject to excise duty.

d) Whether income earned on advance to the Appellant's customers relating to the un cleared cheque are subject to excise duty;
e) Whether income earned from letters of credit, bank guarantees, invoice and bill discounting are subject to excise duty;
f) Whether fees charged by the Appellant to programs run by donor organizations in conjunction with the Government of Kenya which programs are expressly exempt from taxes by virtue of a financing agreement between the Government of Kenya and the Government of the United Kingdom, are subject to excise duty; and
g) Whether the Appellant is liable for PAYE on the ESOP benefit accruing to the company employees.

ANALYSIS AND FINDINGS

a) Whether bad and doubtful debts written off by the Appellant were tax deductible expenses.

38. The Tribunal after hearing both parties' submissions, the law pertaining thereto and the authorities cited, finds it imperative to make its analysis on each customer separately as provided in the parties' pleadings and documentation. The same are as hereunder;

i) Loan to Jetlink Express Limited (Amount written of - Kshs.771,560,780/=)

39. On or about November 2010, the Appellant advanced a term loan facility of US $ 9, 400,000 to JEL to be used primarily for the completion of construction of a hangar, the purchase of two commercial airplanes (registration numbers 5Y-JLB and 5Y-JLE), and to fund working Capital.

40. Subsequently, and at the request of JEL, the Appellant agreed to restructure the facility so as to:-
a) remove the approval to utilize the facility for purchase of the commercial aircraft;
b) take over the facility with Imperial Bank and convert the overdraft with the Appellant into a term loan, and
c) to provide working capital to JEL.

41. JEL provided the following securities to the Appellant to secure the above facility:-
a) Debenture dated 23rd February 2011 creating security by way of a fixed charge over all the assets of JEL (save for the assets specifically exclude under the Debenture) to secure a maximum principal amount of up to US $ 9,400,000 plus interest and other sums;
b) Assignment in favour of the Appellant dated 23rd February 2011 of all receivables due to JEL from the International Air Transport Association (IATA) pursuant to the global Billing and Settlement Plan System.

c) Charge dated 23 February over all the issued shares in the capital of JEL created by Kiran Patel and Elkana Aluvale securing a maximum principal amount of US $9,400,000 plus interest and other sums;
d) Charge dated 23 February 2011 over the deposits held in several accounts to be maintained by JEL with the Appellant and securing a maximum principal amount of US $9,400,000 plus interest and other sums; and

42. Furthermore, Corporate Guarantee and Indemnity dated 23 February 2011 was created by Jetlink Holdings Ltd to secure the obligations of JEL with the Appellant. This was supported by a first ranking legal charge for US $ 4,000,000 over aircraft hangar and office block on a 2 acre plot at Jomo Kenyatta International Airport (JKIA), LR NO. 21919, Nairobi.

43. As a result of the facility restructuring referred to above, the aircrafts were never acquired by JEL and no aircraft mortgage was registered in favour of the Appellant. JEL subsequently faced major financial challenges and was unable to meet its obligations to its creditors leading to a winding up petition filed against it in 2013.

44. There were numerous other secured creditors with claims against JEL amounting to US $42,424,644.69 and Kshs.41,199/= which undermined the Appellant's ability to realise the securities provided by JEL.

45. According to the Appellant it made every effort to realise the securities that it could liquidate to settle the outstanding loan facility as follows:

a) Corporate guarantee and indemnity by Jetlink and indemnity by Jetlink Holdings Limited (JHL). The Appellant was able to successfully dispose the assets under the item and recovered US $ 2,000,000.
b) Charge over deposits held in three bank accounts maintained by JEL with Equity Bank Kenya Limited (EBKL). JEL maintained a number of accounts with the Appellant which were overdrawn by the time the loan was written off. As a consequence, no amount could be offset from the accounts.
c) Deposits held in an account in South Sudan. The funds were not sufficient to settle the claims of the ranking creditors. In addition, the Government of the Republic of South Sudan had in place a moratorium prohibiting transfer of funds out of South Sudan. From the time JEL went into liquidation process to date, the moratorium has not been lifted and the financial position has not changed. The Appellant was therefore unable to access the said funds.
d) Debenture creating security by way of fixed charge and floating charge over all the assets of JEL. The Appellant was precluded from disposing the assets of JEL because of the winding up petitions filed by the various creditors and their competing claims.
e) Assignment of all receivables due to JEL from IATA pursuant to the global Billing and Settlement Plan (BSP). At the time of the

default, IATA did not hold any funds on account of JEL that could be paid to the Appellant owing to the fact that JEL had stopped all operations in November 2012 at which time there were no receivables available with IATA on account of JEL.

f) Aircraft mortgages over aircraft bearing registration numbers 5Y-JLB AND 5Y-JLE.As pointed out in 36 above, following a loan restructuring to exclude the purchases of the two aircrafts, JEL did not acquire the aircrafts and as a result no aircraft mortgage was registered in favour of the Appellant.

g) Charge over shares in JEL held by the two directors of JEL. The value of the shares in JEL was insignificant and no proceeds would be realizable from their sale.

46. Consequently, the Appellant submitted that in accordance with Section 15(2) (a) of the ITA and Legal Notice No. 37 of 2011, reasonable efforts to recover the debt was demonstrated.

47. In respect of this customer, the Respondent maintained that the Appellant was not justified in writing off the respective debts as recovery efforts were not exhausted especially on the securities held to secure the debts and therefore it was of the view that the Appellant did not demonstrate that all assets were followed up.

ii) Loan to Stout Minerals Limited (Amount written off - Kshs.19,742,319.57)

48. The Appellant advanced a loan facility to Stout Minmetals Limited (SML) to finance the mining of minerals in Kilifi County. The SML Facility was structured on the basis of a standby letter of credit for US $620,373.13 issued by Hong Kong and Shanghai Banking Corporation (HSBC) in favour of SML under some conditions that entitled the Appellant to recover the amount advanced to SML under the SML Facility (together with accrued interest) and to release the balance (if any) to SML.

49. SML mined the minerals in Kenya which did not have minimum content requirements of the seller. The consignee rejected the minerals and, accordingly, the verification Documents were not delivered to HSBC. Consequently, the standby letter of credit issued by HSBC lapsed and could not be honoured. As a result of the above, no funds were remitted into the designated account leading to a default by SML.

50. The Appellant explored the possibility of creating a charge over the licence issued by the Mines and Geology Department. The Appellant, due to various restrictions was not in a position to use the mining license for any purpose including debt set off.

51. The personal guarantees from the directors were never rectified in favour of the Appellant as the letter of credit was considered as sufficient security to cover the debt. In addition, an investigation by the Appellant discovered that the directors had relocated from Kenya to the Democratic Republic of Congo.

52. As a result of the foregoing, the Appellant submitted that reasonable efforts were made to recover the debt which proved futile.

53. The Respondent maintained that the Appellant's write off of the loan amount (Kshs.19,742,319.57) was contrary to section 15 and 16 of the Income Tax Act.

iii) Loan to Nyanza Shuttles Limited- Amount written off - Kshs.9,086,970.027

54. The Appellant advanced a loan to the Nyanza Shuttles Ltd(NSL) to finance the purchase of two new buses from CMC Motors Limited(CMC). NSL contracted CMC to supply the buses manufactured in Germany but instead sold an inferior model manufactured in India. NSL instituted a suit against CMC regarding the purchase of the two buses.

55. The two buses, due to maintenance problems, were grounded leading NSL to default on the facility. The Appellant hired an auctioneer to dispose of the two buses in an attempt to recover the debt. The buses had been used to secure the facility. The two buses had been delivered for repairs at the CMC where they remained.

56. Due to the higher ranking legal right by CMC as bailee in possession, and taking into consideration an ascertained poor offer price for the buses (Kshs.400,000/=), the Appellant determined that there was no chance of recovering the facility as the proceeds therefrom would not have been sufficient to pay CMC's claim. The Appellant maintained that reasonable recovery efforts were made and the write off was in accordance with Sec. 15(2)(a) of the ITA read together with Legal Notice No.37 of 2011

57. The Respondent maintained that the Appellant did not demonstrate that all reasonable steps were taken to recover the outstanding debt since by the time of making the write of, the security in the form of the two buses was still not disposed of. In writing off the NSL debt, the Appellant was in contravention with the provisions of Section 15 (2)(a) of ITA read together with Legal Notice No.37 of 2011.

iv) Loan to Munyeki Agricultural Marketing Unit Self Help Group (MAMU) - Amount written of Kshs 6,373, 946.20

58. The Appellant granted loan facilities to farmers for on-lending to members to finance the purchase of seeds and fertiliser. The terms of the facility were that the farmers would sell their produce to Midland Company Limited (MCL) at a pre-agreed price and MCL would repay the Appellant loans taken by the individual farmers.

59. A dispute arose among the members of MAMU which impeded the production and supply of potatoes to MCL leading to a default on loan repayment by the farmers in the self-help group. The Appellant made various attempts to recover the loan including seeking Government

intervention through the Ministry of Agriculture, Livestock and Fisheries. Auctioneers were also engaged but no funds were recovered.

60. The Appellant asserted that the loan was advanced to MAMU collectively and that vigorous recovery efforts were made through MAMU. The Appellant maintained that the cost that would have been involved in pursuing recovery from each individual member would exceed the recoverable amount. MAMU comprised of over 180 members only known to officials of the self-help group. The Appellant wrote off the debt when it became abundantly clear that MAMU was unable to recover the loans from the individual farmers.

61. The Respondent submitted that the Appellant did not demonstrate that all the recovery efforts had been exhausted before writing off the debts from the individual farmers.

v) Loan to Amani Farmers Community Based Organization (Kshs.3, 787,495) and to Vumilia Community Based Organization (Kshs.3,197,459/=)

62. The Appellant advanced loans to small scale farmers through group/community based organizations to farm several parcels of land on a block basis. The facility was such that a single loan was advanced in respect of a block and guaranteed by the individual block members.

63. In the case of Amani Farmers, the purpose of the loan was to fund maize seed multiplication to supply Bura Farmers Management (BFM) which was contracted directly by Kenya Seed Company (KSC) as the main grower for the whole scheme. Amani farmers delivered their seeds to KSC on behalf of BFM. Without the knowledge of the farmers BFM had accrued debts due to KSC. KSC proceeded to recover the debt owed by BFM. Consequently, Amani Farmers were not paid for their produce leading to default on the Appellant's loan.

64. In the case of Vumilia, the farmers were engaged in maize farming in Bura Irrigation Scheme under the BFM contract. They borrowed funds from the Appellant for land preparation, purchase of fertilizer, operation and maintenance, detailing and post-harvest handling. As in the case of Amani Farmers, Vumilia were also not paid on account of KSC recovering outstanding debts from BFM.

65. The Appellant maintained that it had no contractual agreement with BFM or KSC and could therefore not enforce collection of the loan against these entities. While the aggregate amount owed was Kshs. 6,984,954 individual farmers owed small amounts. On this basis the Appellant held that the cost of recovery against specific members would outweigh the amount in default and the exercise would therefore be uneconomical.

66. The Respondent was not satisfied that the Appellant made all the effort for recovery of the debts by the individual farmers and subjected the bad debt write-offs to tax.

vii) Loan to Stanley Kimani Gichia (Amount written off - Kshs.2,304,824/=)

67. The Appellant provided a loan facility to SK Gichia for developing his business. When the borrower defaulted on the loan the Appellant sold the security items, a prime mover and a trailer. Unable to recover the balance of the loan the Appellant wrote off the remaining amount.

68. The Respondent maintained that the Appellant did not demonstrate any other efforts to try and recover the outstanding debt before write off in line with the provisions of Section 15(2)(a) of the ITA and Legal Notice No.37 of 2011.

viii) Loan to Harmo Engineering and Building Contractor (Amount written off - Kshs. 1,731,352/=)

69. The Appellant granted a loan facility to Alison Zephania Mogere trading as Harmo Engineering to fund working capital requirements and purchase a motor vehicle. The borrower defaulted in servicing the loan facility after his business lost major contracts. The Appellant consequently sold the borrower's motor vehicle and Safaricom shares that the borrower had acquired. The borrower did not have any other assets known to the Appellant and hence wrote off the balance of the loan owed.

70. The Respondent maintained that the Appellant has not demonstrated any other effort to try and recover the outstanding debt before write off.

iii) Loan to Clarion Merchandise (Kshs.5,419,093.26),Collmark Trading Agencies(Kshs.2,650,220.98) and Capitrade Merchants Limited (Kshs3,211,830/=)

71. The Appellant granted temporary accommodation on cheques to the borrowers to accommodate cash flow. In each of the cases, the businesses experienced financial difficulties which led to default on the facilities. The Appellant made formal demands for the settlement of the debts making various recovery attempts including hiring auctioneers and having the debtors listed with the Credit Reference Bureau (CRB). Efforts to recover the debts were unsuccessful and the Appellant was therefore forced to write off the debts.

72. The Respondent maintained that the Appellant did not demonstrate that recovery efforts had been exhausted before the write off.

ix) Loan to Telia Communication Limited (Amount written off – (Kshs.5,188,276.75)

73. The Appellant provided a business loan to Telia Communications Ltd (TCL) against the security of a motor vehicle. When TCL defaulted on the loan, the Appellant disposed of the subject security and was able to recover only part of the loan balance. TCL did not have any other assets

known to the Appellant. The sole director has been suffering from a prolonged illness. The Appellant was therefore unable to make any further recoveries and consequently had to write off the balance of the loan. The Respondent maintained that no legal cause or any other recovery effort was undertaken to recover the debt.

x) Loan to Samuel Kazungu Kambi (Amount written off - Kshs 1,850,555)

74. The Appellant provided an overdraft facility to S.K Kambi who maintained an active account with the Appellant that was unsecured and on default, the Appellant was only able to recover the debt from funds deposited in the Customer's account. Upon demand, the customer disputed the amount of the outstanding balance on the grounds that repayments he had made exceeded the facility amount granted.

75. On the basis that the customer had made significant payments towards the facility, and in an effort to ensure as much recovery as possible, the Appellant entered into a One Time Settlement Agreement in which S K Kambi was allowed to pay a lump sum of a percentage of the debt which mainly comprised of interest, in full and final settlement of the debt..

FINDINGS ON THE ISSUES:

a. **Whether bad and doubtful debts written off by the Appellant were tax deductible expenses.**

76. The Tribunal found out that the Appellant prepared the 2015 Financial Statements, the subject of the review by the Respondent, in accordance with the International Accounting Standards (IAS).

77. Moreover, the Tribunal noted that the Appellant followed the prudential guidelines issued by the Central Bank of Kenya (CBK/PG/04 of January 2013) in the provisioning for bad and doubtful debts. The guidelines under paragraph 3.9 on write off of loan / advances state:

'This is normally evident at a stage where:-

a. **The institution loses control of the contractual rights that comprise the loan as determined by a court of law.**
b. **All forms of securities or collateral have been called, realised, but proceeds failed to cover the entire facility outstanding.**
c. **The institution is not able to collect or there is no longer reasonable assurance that the institution will collect all the amounts due according to the contractual terms of the loan/advances agreement.**
d. **The borrower becomes bankrupt.**
e. **The efforts to collect the debt are abandoned for any other reason."**

78. The Respondent did not raise any doubts that the Appellant complied with the IAS and the Prudential Guidelines of the Central Bank of Kenya in provisioning for bad and doubtful debts in the respective year of income.

79. The Tribunal noted the similarities in requirements for provisioning for bad and doubtful debts under the Prudential Guidelines of the Central Bank of Kenya and the Legal Notice No.37 of 2011 issued by the Commissioner of Income Tax.

80. Upon reviewing the thirteen respective customer loans, the subject of this appeal, the Tribunal found out that all the facilities were related to the business transactions of the Appellant. In addition, the customers were not related to the Appellant in any other manner, other than for business purposes.

81. The Tribunal, in analysing the respective customer loans, found that the Appellant strove to collect its debts using reasonably available means under the circumstances of each facility, save for one customer as shown above.

82. In the ascertainment of total taxable income for a year of income one is allowed to deduct all the expenditure wholly and exclusively incurred by the person in the production of that income under Section 15(1) of the ITA.

83. Bad and doubtful debts expenses are allowed under Section 15(2)(a) which states:-

"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 the year of income and the commissioner may prescribe such guidelines as may be appropriate for the purposes of determining bad debts under this sub paragraph."

84. The Commissioner issued guidelines in this respect through Legal Notice No.37 of 2011 paragraph (2) the relevant paragraph, of which is reproduced above.

85. The Tribunal found out that the debts may have been previously written off or provided for and the respective deductions claimed for tax purposes are, in some cases, recovered. Under the circumstances, the recoveries are reported by the Appellant as taxable income on realisation.

86. The Tribunal notes that the test of reasonableness was highlighted in the case of **Soma Properties Limited v HAYM (2015)** where the court stated as follows:-

"reasonable and reasonably...is a standard measured against the care to be exercised by a reasonably prudent person in all circumstances including the practice and usages prevailing in the community and the common understanding of what is practicable and what is to be expected. The standard of reasonableness is not one of perfection."

87. In view of the cited case, and taking into account the relevant legislation to wit, Section 15(2) (a) of the ITA and The Commissioner's guidelines in this respect through Legal Notice No.37 of 2011 Paragraph (2), the relevant paragraph, the Tribunal finds that the bad and doubtful debts provisions are tax deductible expenses in twelve of the thirteen specific cases as shown above. Consequently, the bad and doubtful debts written off by the Appellant are tax deductible expenses which were unlawfully subjected to Corporation Tax, save for the facility extended to the customer referred to as Samuel Kazungu Kambi.

88. In respect of the said loan to one, Samuel Kazungu Kambi, the customer was allowed to pay a lump sum of a percentage of the debt which mainly comprised of interest, in full and final settlement of the debt. The Tribunal notes that though this is a normal business practice in the banking industry in this instance case, we find that the overdraft was unsecured, assets of the customer were not followed up for recovery and neither was the customer found and or declared bankrupt.

89. In the circumstances, the Tribunal agrees with the Respondent that the Appellant did not demonstrate to the satisfaction of the Tribunal that enforcement machinery had been exhausted to collect the outstanding debt. Consequently, the Tribunal makes a finding that the write off of this loan did not meet the criteria set under Legal Notice No. 37 of 2011 and the Respondent was justified in bringing it to charge in respect to Corporation tax.

90. On **EXCISE DUTY**, the following issues as outlined above beg our determination;

b. **Whether income earned in form of fees from loan and credit evaluation reviews are subject to excise duty;**
c) **Whether income earned on temporary overdraft facilities offered to the Appellant's customers are subject to excise duty.**
d) **Whether income earned on advance to the Appellant's customers relating to the un cleared cheque are subject to excise duty;**
e) **Whether income earned from letters of credit, bank guarantees, invoice and bill discounting are subject to excise duty;**
f) **Whether fees charged by the Appellant to programs run by donor organizations in conjunction with the Government of Kenya which programs are expressly exempt from taxes by virtue of a financing agreement between the Government of Kenya and the Government of the United Kingdom, are subject to excise duty.**

91. Cognizant of the fact that there is a similar case involving the parties on similar issue of Excise Duty pending determination in the High Court of Kenya at Nairobi, to wit, **COMMERCIAL AND TAX DIVISION, CIVIL SUIT NO. E175 OF 2019, KENYA BANKERS ASSOCIATION VS. THE CABINET SECRETARY FOR NATIONAL TREASURY, THE ATTORNEY GENERAL AND KENYA REVENUE AUTHORITY** and with concurrence of the parties herein the Tribunal has hereby decided that in order to

avoid duplicity of proceedings and determinations it will defer the analysis and ruling on the issue until the matter is fully determined. The Tribunal will therefore not delve into the issues hereinabove on said the tax head.

g) Whether the Appellant is liable for PAYE on the ESOP benefit accruing to the company employees.

92. Employee Share Option Plan (ESOP) is the subject matter of the PAYE demand. The Tribunal finds it imperative to analyse the documentation as provided by the parties.

93. Equity Bank Kenya Limited (EBKL) established an ESOP in 2005 for the purpose of encouraging and facilitating the employees of the company, and that of its subsidiaries, to acquire shares in the company. In this connection, EBKL paid the first Kshs.1,000 in pursuit of this cause. The Tribunal noted the salient features as hereunder;

a) The ESOP's Settlement Deed is dated 29 August 2005.
b) In 2005, Africa Microfinance Fund (AMF) elected to dispose of the shares it had at the Appellant Company. AMF at that time was one of the main shareholders of EBKL.
c) The Appellant asserts that the ESOP purchased all the shares of AMF using funds obtained from eligible employees and a loan from British American Insurance Company Limited (BRITAM). In addition, the funding for the shares, including procuring the loan from BRITAM, was obtained without financial assistance from the Appellant.
d) Paragraph 4.1.8 of the Settlement Deed gave power to the trustees to borrow or raise money for the purposes of acquiring shares.
e) The borrowing of money from BRITAM by the ESOP and the acquisition of AMF shares were not contested by the Respondent during the proceedings.
f) Under the rules of the ESOP, only eligible employees of EBKL and its subsidiaries were to acquire units in the ESOP. A unit in the ESOP was equivalent to a share in EBKL.
g) Paragraph 2.3 of the ESOP Rules gave the trustees power to fix the unit prices.
h) Paragraph 14 of the Rules gave the trustees the power to account for tax, duties or other dues on any income benefit payable under the Rules.

94. The Respondent maintained that the Appellant operated an ESOP through which an eligible employee was given an opportunity to acquire the bank's shares at discounted prices. The Respondent avers that ESOP units were made available to eligible employees at significant discounts. The assertion of the Respondent on the offer of the units to eligible employees at discounted prices was not contested by the Appellant in the respective submission nor during the hearing.

95. Furthermore, the Respondent submitted that the Appellant offered shares to eligible employees in 2011 which vested in 2016.On vesting of the shares, the Appellant did not account for PAYE as provided pursuant to Section 5(5) of ITA.

96. The Tribunal found that the establishment of the ESOP by EBKL in 2005 did not confer a taxable benefit to the eligible employees under Section 5(5)(a) of the ITA. Further, the Tribunal found that the funding and purchase of AMF shares by the ESOP did not also confer taxable benefits to the employees under Section 5(5)(a).

97. The Tribunal however found that ESOP units were granted to, and subsequently vested on, eligible employees at discounted prices, a matter which was not contested by the Appellant.

98. In an ESOP, a tax benefit arises on vesting under Section 5(5) (a) of ITA. The value of the benefit is the difference between the market price per share and the offer price per share at the date an option is granted.

99. The trustees of the ESOP were to account for PAYE on the staff benefit as envisaged under Rule 14. An employer, in this instant case, the Appellant should deduct and remit to the Respondent tax on staff benefits under Section 37 of the Income Tax Act.

100. Consequently, the Tribunal finds that the Appellant is liable for PAYE on the ESOP benefit to its employees.

FINAL DECISION

101. The upshot of the above is that the Appeal partially succeeds and the Tribunal makes the following Orders;

i) The Respondent's Tax Assessment vide its Objection Decision dated 19thy September 2017 in respect to **Corporation Tax** in the sum of Kshs.346,147,520/= is hereby set aside.

ii) The Respondent's Tax Assessment vide its Objection Decision dated 19th September 2017 in respect to **PAYE** in the sum of Kshs.234,138,308/= is hereby upheld.

iii) The Respondent's Tax Assessment vide its Objection Decision dated 19th September 2017 in respect of **Excise Duty** in the sum of Kshs.1,158,683,449/= is hereby deferred, in abeyance to await the outcome of the decision of the High Court in respect of the pending suit relating to similar issues and parties, being Commercial and Tax Division Civil Case No.E175 OF 2019.

iv) Each party shall bear its costs.

102. Orders accordingly.

DATED and DELIVERED at NAIROBI this 8th day October 2019.

In the presence of:- Samuel Gekara .....for the Appellant

Chelangat Mutai .....for the Respondent

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JOSEPHINE K. MAANGI
CHAIRPERSON

.....

RICHARD ROTICH
MEMBER

.....

TANVIR ALI
MEMBER

.....

GEOFFREY KARUU
MEMBER

.....

DELILAH K. NGALA
MEMBER