

# TAT rules on allowable expenses - bad debts and public relations expenses

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The Tax Appeal Tribunal (TAT or “the Tribunal”) Lagos Zone has ruled, in *NPF Microfinance Bank PLC (NPF or “the Company” or “the Appellant”)* and *Federal Inland Revenue Service (FIRS or “the Respondent”)*, that bad debts (which have been proven to be bad) are allowable for tax deductions and are not subject to the discretion of the FIRS’ Board while disallowing unsubstantiated Public Relations (PR) Expense.

## Background of the Case

NPF, a financial services institution offering banking products and services to both serving and retired members of the Nigerian Police Force as well as the general public, had classified bad debts, overdraft facilities and PR expenses as allowable expenses for Companies Income Tax (CIT) purposes. This decision was based on Section 24 of the CIT Act Cap C21 LFN 2004 (as amended) (CITA).

The FIRS, during its audit of the Company’s 2017-2018 years of assessment (YOAs), disallowed the said expenses and issued Notices of Additional Assessment and Demand Notes. NPF duly objected to the FIRS’ assessment on the basis that the FIRS’ position was inconsistent with Section 24 of the CITA, which allows for tax purposes, expenses that are wholly, exclusively, necessarily, and reasonably (WREN) incurred to generate turnover. The FIRS, declaring that it had acted within the confines of the law, issued a Notice of Refusal to Amend (NORA) despite ongoing reconciliation between the two parties.

Dissatisfied with the FIRS’ rejection of the Company’s position and the issuance of the NORA, NPF filed an Appeal before the TAT seeking for the deduction of the expenses and a ruling that the FIRS infringed on its rights to fair hearing given the circumstances of the case.

## NPF’s Argument

The NPF argued that the FIRS had incorrectly and unlawfully calculated CIT and other taxes on expenses that, according to the relevant tax laws, should have been considered allowable. The Appellant, relying on the provisions of Section 24(f) of the CITA and considering the unsecured nature of loans granted by microfinance banks, explained that overdraft facilities had become bad and provided documentary evidence to prove numerous unsuccessful efforts made to recover the facilities. The Appellant submitted that it was challenging to provide the documents (death certificates and bankruptcy orders) required by the Respondent due to the unresponsiveness of the debtors. Furthermore, it argued that the CITA did not specify any documentary requirements.

The NPF further stated that the Central Bank of Nigeria (CBN) Prudential Guidelines was relevant for the purpose of determining loan loss provision. Further, the Company maintained that it had relied on the International Auditing Standards (IAS) 39 in correctly differentiating between collective impairments and specific impairments.

On the deductibility of PR expenses, the Appellant argued that they were in respect of advertisement expenses, which were validly incurred in generating the Company’s turnover. Therefore, in line with Section 24 of the CITA, they should be treated as tax-deductible.

The Appellant further argued that, based on the provisions of Section 69 and 76 of the CITA, FIRS infringed on its right to fair hearing by issuing the notices of additional assessment and notice of refusal to amend was premature as the parties were still involved in reconciliation meetings.

## FIRS' argument

The FIRS argued that, where overdraft facilities and debts were still capable of being recovered, they should be deemed disallowable. Citing Section 24(f) of the CITA, the FIRS stated that its discretion that the said debts had become bad and uncollectible was a condition precedent for treating such expense as an allowable deduction for tax purposes. The FIRS maintained that the Company's engagement of recovery agents, as well as inability to provide documents such as records of Board Credit Committee and death certificates of some debtors demonstrated a clear failure to prove that those debts were bad. The FIRS further argued that there was no evidence of non-performance by the debtor concerning payment of the receivables and the recovery agents continued to recover some of those debts.

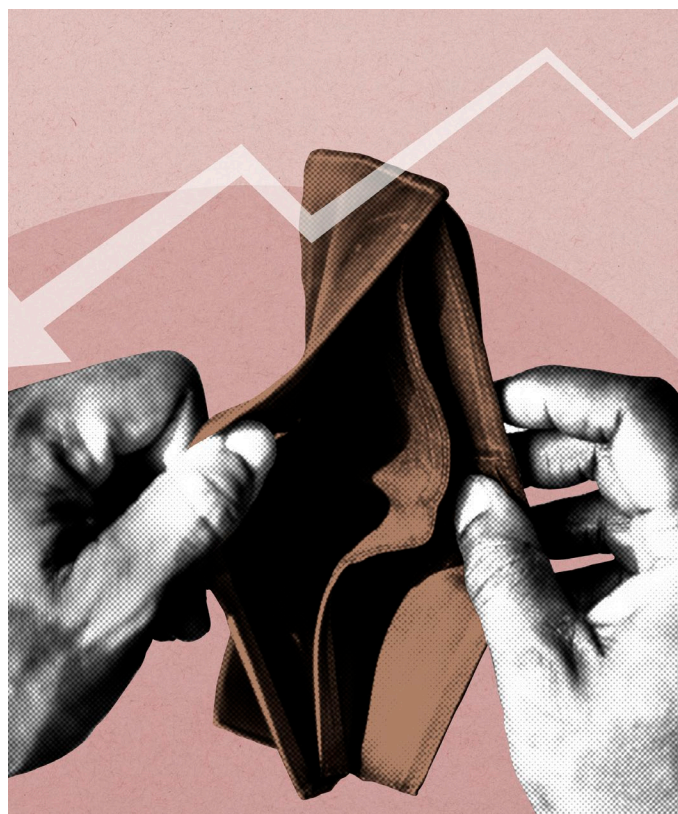
On issue two, the FIRS argued that the expenditures tagged "PR Expense" could not satisfy the WREN test and submitted that the onus was on the Appellant to prove that the PR expenses were wholly, reasonably, exclusively, and necessarily incurred in generating the Company's profits.

Finally, the FIRS asserted that there was no legal basis to argue that the NORA was issued prematurely. The FIRS drew support from the case of *Oando Trading & Supply Limited vs. FIRS*, which established a 90-day deadline for the Respondent to issue a NORA. It emphasized that the timing of issuance, whether on the initial day or first hour of the 90-day period set by the referenced decision, was inconsequential. The FIRS maintained that it was unfounded to assert that the Respondent lacked legal or factual basis.

## Issues for Determination

Based on the prayers and arguments submitted by the parties, the TAT adopted the Appellant's issue for determination as follows:

- i. *Whether the Respondent acted wrongly when it disallowed for tax purposes, the provision for bad debt (sic) and overdraft facilities on the Appellant's 2017-2018 YOAs, which is inconsistent with section 24 of the CITA;*
- ii. *Whether the Respondent erred in law when it failed, refused and neglected to treat "PR Expense" incurred by the Company on advertisement, as an allowable expense;*
- iii. *Whether the Respondent infringed on the Appellant's right to fair hearing when it issued Notices of assessment, demand notes and a NORA despite the ongoing reconciliation between the parties, as well as failing to give the Appellant the statutory time to object before issuing notice of assessment.*



## TAT's decision

After considering the arguments of both parties, the TAT held that:

- i. Bad debts must be proved by the Taxpayer to have become bad while doubtful debt is deductible when it is established to the satisfaction of the Board of the Respondent. Although the CBN Regulation provides a template for provisioning in respect of performing and non-performing risk for Microfinance Banks in Nigeria, the power to allow bad debts remains with the CITA. However, once a debt has been proven to be bad, the discretion of the Respondent's Board is immaterial. Furthermore, the absence of death certificates or bankruptcy orders, etc. cannot be the basis for disregarding the classification of the loans as bad. Having decided that a debt is bad in line with the CBN Regulation together with other steps taken to recover the loans, the TAT decided that the Appellant was on the right footing. Thus, the TAT ruled in favor of the Appellant.
- ii. For an expense to qualify for deduction, it must satisfy the WREN test as specified in the Section 24 of CITA. In addition, such expense must pass the test of Section 27 of CITA. The inference is that where an expense is specifically disallowed under section 27 of CITA, it cannot be deductible. Thus, to be deductible, an expense must pass both tests. The Company's PR expenses passed the Section 27 test leaving the WREN test as the final test to determine its qualification as an allowable expense. The critical determinant for the Tribunal was whether the expense was necessary. For an expense to be necessary, the Taxpayer must prove that it would be inimical to the continued existence of the Company.

Moreover, the documents submitted by the NPF did not offer clarification regarding the precise nature of the expenses involved.

The TAT clarified that the WREN test does not exempt the Taxpayer from the obligation to furnish evidence of the exact allowable amount; instead, it compels the Taxpayer to do so. The Tribunal, therefore, ruled that the PR expense was not tax deductible and resolved the issue in favor of the Respondent.

- iii. The issuance of a letter of intent does not diminish the Appellant's right to fair hearing. The timeline specified in section 69 of CITA does not apply to tax audit report and is, in fact irrelevant to the fair-hearing stipulated in the section since tax audit precedes notice of objection to an assessment. Moreover, the Respondent is not legally prohibited from raising assessments anytime during the tax year regardless of any ongoing reconciliation.

Ultimately, the matter is resolved partly in the Appellant's favor and the Respondent is directed to reevaluate the Appellant's tax liabilities in accordance with the judgement

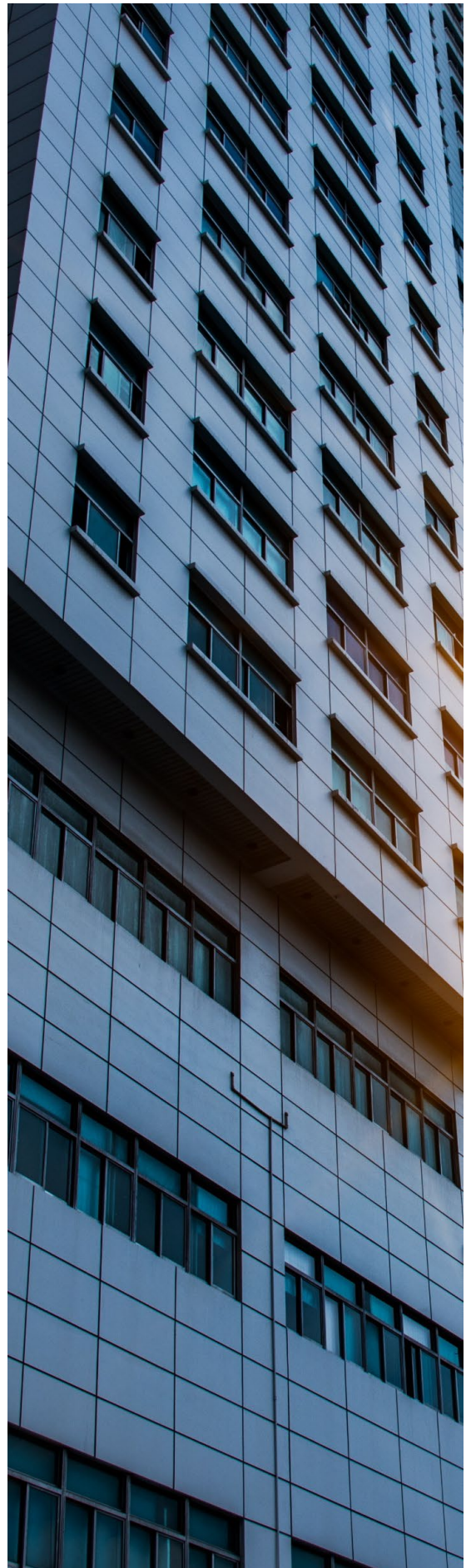


## Comments

The TAT's decision provides much-needed clarity on the tax treatment of bad debt. Based on the ruling, once a debt has been proven to be bad under the provisions of CITA, the discretion of the FIRS Board becomes immaterial. This resolution dispels any ambiguity surrounding the powers of the FIRS in determining the status of a bad debt. It is a significant step in ensuring that Taxpayers have a clear understanding of their responsibilities and rights in this context. The judgment also resolves the contentious matter of the absence of documents such as death certificates or bankruptcy orders in the process of debt classification. The ruling affirms that the absence of these documents should not be the basis for disregarding the classification of loans as bad debts. Rather, it encourages a more practical and flexible approach to assessing the status of debt. This approach acknowledges the complexities of real-world financial transactions and recognizes that a more balanced interpretation of evidence can be applied.

However, the TAT appears to be saying that provision for doubtful debt can **only** qualify for tax deduction based on the discretion of the FIRS Board. This will trigger some controversies. The expectation is that the exercise of discretionary powers must be done not only within the ambit of the law but also in accordance with the principles of fairness, impartiality and justice. On this basis, a decision made in accordance with the regulations issued by the relevant regulator should suffice for this purpose. Thus, the FIRS must consider such regulations in making its determination. It will be interesting to see how the court will rule on this matter if brought before it.

The TAT's decision to uphold the FIRS's position on Public Relations expenses underscores the need for expenses to be properly substantiated to satisfy the "WREN" test. It is not just enough to provide a schedule of the expenses. The accompanying documents must speak for themselves and leave no one in doubt as to the nature of the expenses incurred. Furthermore, taxpayers must not only assert that an expense qualifies for deduction, but they must also prove the amount that is deductible. The key take-away is that clear and unambiguous documentation will ensure that cases presented before the Tribunal are transparent and support the positions of the asserting party. However, vagueness or ambiguity can lead to unfavorable outcomes.



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