

**THE REPUBLIC OF UGANDA
IN THE HIGH COURT OF UGANDA AT KAMPALA
COMMERCIAL COURT DIVISION**

HCT-00-CC-CA-0013-2012

NATIONAL WATER AND SEWERAGE CORPORATION ...APPELLANT

VERSUS

THE COMMISSIONER GENERAL UGANDA REVENUE AUTHORITY...RESPONDENT

BEFORE: HON. MR. JUSTICE M. W. MUSENE

JUDGMENT

The basic bond of contention in this case between National Water and Sewerage Corporation and the Commissioner General Uganda Revenue Authority is whether the conversion of a debt into equity attracts tax on the interest.

The Appellant was represented by M/s Birungi Barata & Associates, while the Respondent was ably represented by the legal services Board Affairs Department of Uganda Revenue Authority.

The brief background to this appeal is that the appellant owed the Government of the Republic of Uganda a long term debt which constituted a principal amount of Ushs84,99 billion and accumulated interest of Ushs68.6 billion. By February 2008, the long term debt owed by the Appellant to the Government was Ushs153.59 billion.

Overtime, the interest component of the long term debt had been accounted for by the appellant in its tax returns and accounts as expenditure which was deductible for tax purposes. Before conversion, the correct position for tax accounting was not in dispute.

In February 2008, the government responding to the appellant's need for further funding resolved through the House of Parliament to convert and did convert its long term debt in the sum of Ushs153.59 billion into equity. The government dully sought a share certificate for the amount of capitalization which was dully issued by the Appellant.

On 30.3.2010, the Appellant requested the Respondent to refund withholding tax of Ushs1,557,074,000 which it claimed accumulating since 2005. In the same letter, the Appellant claimed to have accumulated a tax loss of Ushs243,068,769,000 dating back to 1998 when the company allegedly made the last Taxable profits. In accordance with law, the respondent audited the Appellant for the for the years 2005 – 2009 to establish the validity of the refunds and whether no domestic tax liabilities were owed to the Respondent. One of the Tax head audited was Corporation Tax which is the gist of this Appeal. Furthermore and upon the comprehensive audit which began in the final quarter of 2010 it was found that the Appellant had accumulated tax loses of Ugsx243 billion as at June, 2009 due to the following reasons:

- (a) Tax losses of Ushs40,038,320,000 in the appellant's books that were carried forward since 1999.
- (b) Capital allowance claimed on donor funded capital assets amounting to Ushs153,649,955,000/=
- (c) The conversion of government loans into equity in National Water and Sewerage Corporation. The loans had a carrying value of Ushs153 billion only comprising principal and interest of Ushs85 billion respectively. During the scheduling memorandum it was also agreed that due to the conversion, there was accumulation of Ushs68.6 billion interest taxable in the year 30.6 2007, but which was disallowed in the Respondents tax computation.

The respondent raised an assessment on Ushs153,59 billion to which the appellant objected. The respondent then adjusted its position and maintained that corporation tax was due against the appellant on the interest component of the long term debt that had been capitalized in the sum of Ushs68.6 billion. The respondent then assessed the Appellant to corporation tax in the sum of Ushs17,455,684,037 which the appellant objected to hence the filing of this appeal under section 100 of the Income Tax Act. The ground of the tax was that the

respondent erred in law when it made the decision that the interest expense of Ushs68.6 billion earlier claimed by the appellant became taxable when it was converted into equity by the government of the Republic of Uganda. The issue for determination at the scheduling conference was:

Whether the interest expenses of Ushs68.6 billion earlier claimed by the Appellant became assessable to tax when it was converted.

The Advocates on both sides made lengthy submissions which will be summarised for purposes of this judgment. For the Appellant, it was submitted that conversion of a debt into equity does not give rise to business to business income and that neither did the government of Uganda satisfy any business debt on behalf of National Water and Sewerage Corporation nor did it cancel its loan. They further submitted that accrued interest on the loans converted into equity would not be recouped expenditure as provided under S.62 of the Income Tax Act. a sum paid interest becomes a debt obligation in addition to the principal loan. And that the interest would be deemed a recouped expenditure, is the debt was cancelled, which was not the case. The appellants relied on support documents which included;

- (a) The Resolution of NWSC Board of directors,
- (b) An extract from the cabinet meeting held on 30.5.2007
- (c) Certificates of Capitalisation from the Permanent Secretary Ministry of Water and Environment and one from Permanent Secretary /secretary to Treasury.

The Respondent on the other hand submitted that income tax is chargeable on any person who has chargeable income, and that chargeable income is determined by the marching gross income in the total deduction allowed by law. They further urged that it is not a bad debt especially in the books of the Appellant who is a tax payer and that is also not a loss as those two categories would only apply to the lender and not the appellant who borrowed. It was further submitted for the Respondent that as a result of the restoration, recovery or regaining of the interest amount, the already deducted expense would have to be added to back the profit and loss account of the Appellant in the year of income in which the income is recovered. Counsel for the Respondent added that the act of converting the appellant's debt to equity had the effect of restoring a tax

payer's chargeable income to its original state before the removal of the deductible expenditure, which is covered by S. 62 of the income Tax Act. And further that S. 62 gives the Commissioner General the right to deem previously deducted expenditure which has been recovered as income.

Counsel for the Respondent quoted **the case of H. M. Inspector of Taxes Vs Tatter Sall (1939) 71 TR 316 (CA)**, and referred to Lord Greene's decisions that the Taxability of a receipt was fixed with reference to its character at the moment it was received. They concluded that interest income is income because it had been claimed as trading expense and is now re coupled.

The court has considered and taken into account the submissions by both sides. The Appeal is made under the provisions of section **100 of the Income Tax Act**

Section 100 of the Act provides:-

- (1) A tax payer dissatisfied with an objection decision may at the election of the tax payer;
 - (a) Appeal the decision to the high court; or
 - (i) An appeal under subsection (i) to the High Court shall be made by lodging a notice of Appeal with the Registrar of the high Court within forty five days after service of the objection decision.
- (2) A person who has lodged a notice of appeal with the Registrar of the High Court shall within five working days of doing so serve a copy of the notice on the commissioner.
- (3) An appeal to the High Court under subsection (I) may be made on questions of Law only and the notice of appeal shall state the question or questions of law that will be raised on appeal.

Based on the provisions above stated, I find that this is a proper appeal before this court as the question involved is purely based on law, notably interpretation of some provisions of the Income Tax Act. And for avoidance of doubt, I re-instate the provisions of section 62 of the income Tax Act which has been referred to in the submission by both sides.

62. Recouped Expenditure

(1) Where a previously deducted expenditure, loss or bad debt is recovered by the tax payer, that amount recovered is deemed to be the income derived by the tax payer in the year of income to which the deduction is related.

(2) For purposes of subsection (i) deduction is considered recovered upon the occurrence of an event which is inconsistent with the basis for deduction. Section 62 (i) presupposes the following:

(i) recovery of a previously a deducted expenditure, loss or bad debt.

(ii) it is recovered by a tax payer

(iii)the recovered amount is deemed income in the year of income in which the tax payer receives it and

(iv)The recovered amount takes the character of income to which the deducted related.

Subsections 3 – 62 (3) emphasizes that a deduction is considered recovered upon the occurrence of an event which is inconsistent with the basis for deduction. From this section it is necessary to define the word or term “**recovery**” The income Tax Act does not define the term but I shall use the definition given in **Black’s Law Dictionary** as submitted by both counsels on either side. The term is defined as regaining or restoration of something lost or take away. The presumption in this definition is that, what a party gets (again) was originally taken away or was deemed lost.

So, as far as the present case is concerned, the respondent contends that the appellant has a long term debt which had not been paid by the Government of Uganda and while computing its tax liability, for the year ended 30.6.2007, it was an allowable deduction. It is further the contention of the Respondent that when the government converted the long term debt into equity, the appellant recovered the debt and therefore the interest component of Ushs68.6 billion carried tax liability which is subject to tax. The appellant on the other hand submitted that the debt due from the Appellant was not taken away but was paid when it was converted into equity. And that the debt was due to the Government when it was substituted, hence increasing equity of Appellant.

The Appellants further contention is that it discharged its contractual obligation to pay the principal and interest in respect of its debt to the government by way of accord and satisfaction.

The accounts of National Water and Sewerage Corporation (appellant) for the year ended 30th June 2007 together with the report and opinions of the Auditor General on page 16 states as foot note ***Term debt converted to equity. Based on prior negotiations between the Government of Uganda and National Water Sewerage Corporation, it was resolved that the four major loans obtained by National Water and Sewerage Corporation in prior years through the government of Uganda from the external donors be converted into equity. On 30th May 2007 via minute No. 243 the Cabinet approved the Capitalisation of National Water and Sewerage Corporation through the conversion of National Water Sewerage Corporation long term debt into equity. The Minister of Finance Planning and Economic Development presented a brief to parliament on the proposed capitalization of the Corporation through a conversion of National Water Sewerage Corporation long term debt into equity . A resolution was presented to parliament for approval.**

The above set of facts has not been disputed by the respondent at all. And in such circumstances, where the appellant did not receive cash but the debt was converted to equity then this court is inclined to agree with the submissions of the Appellant that the obligation to pay tax does not arise. Furthermore, from the audited books of Account as per documents on court record, and as correctly submitted by the appellant in my view, the debt converted to equity which the subject matter of the present dispute is reflected under assets and liabilities of the National Water Sewerage Corporation (page 16 of the Accounts for the year ended 30th June 2008).

So the same cannot be deemed to have been recovered otherwise it would have been reflected in accounts as income on the revenue side of the income statement. So where the item is shown on the balance sheet as liability, then is it not income at the same time.

The respondents rely on section 62(2) of the income tax Act to urge that the statute allows even where there is no technical recovery that such recovery is deemed. With respect, I find and hold that section 62 (2) does not give the Respondent a discretion to deem, because it is premised on the condition that; **There has been an occurrence of an event which is inconsistent with the basis for the deduction.**

In the present case, there is not even or (it has not been shown), which is inconsistent with the basis of deduction. The deduction of interest arose because there was a debt. The debt attracted interest. Conversion of interest into capital means that the loan of Ushs84.99 billion and interest thereon of Ushs68.6 billion was paid by way accord and satisfaction and the appellant earned no physical or real income within the meaning of the Income Tax Act. . So there is nothing inconsistent. Many learned scholars have addressed the subject under consideration. **Graham Stedman and Nicole Turmiati, Nabaro** in their article,

Restructuring and insolvency briefing October 2009, define Debt – equity swap: as follows:-

A debt – equity swap or a debt conversion to equity in a transaction in which a lender agrees to covert a loan into shares of equity. There is no cash exchange in a debt equity swap transaction.

In another write up entitled,

Corporate restructuring: lessons form the experience Michael Pormerleon, William Shaw, World Bank Publications, 2005 Business Economics page 314)

The above author suggests that Tax issues play an important role in the dynamics of the negotiation in a number of ways. That tax considerations can be the main factor in the restructuring of a company. Favourable tax treatment on the write off restructuring of a debt can enable creditors to write off more debts or create a structure that is better shifted to a restructuring of a business or to a re-allocation of the risks and wealth.

In debt equity swaps, tax implications could arise where the nominal value of the debt differs from the value of the equity received in exchange for the debt.

Furthermore section 2 (ppp) of the **Income Tax Act** defines “**Swap agreement**” to mean an arrangement between a person who has incurred a debt obligation with a floating interest rate and a person who has incurred a debt obligation with a fixed interest rate under which the persons agree to exercise their interest obligations.

And section 2 (qqq) of the **Income Tax Act** defines “**Swap payment**” to mean payment under a swap agreement.

Section 2 (yyy) of the Income Tax Act defines “**person**” to include an individual fund, a government, a political sub division of a government and a listed institution. The above provisions coupled with the scholarly opinions already given translates a debt to equity arrangements inform of a swap this transferring its tax obligation from the creditor. And in which case, the creditor is merely minimizing loses and not earning any income so as to attract taxation. In their submissions Counsel for the Respondent’s urge about “**interest income, and interest expenditure**” However, from what has been outlined the appellant did not recover “**interest income**” and that is not part of the dispute.

Section 154 (5) of the Companies Act defines “**Equity Share Capital**” to mean in relation to a company, its share capital excluding any part thereof which neither as respects capital, carries any right to participate beyond a specifies amount in distribution.”

A debt or equity does not therefore constitute income. The company will always be indebted to share holders for their contribution of capital (Equity). The company would be wrong to treat a capital contribution as a taxable income (read profit)

In the premises, this court is inclined to agree entirely with the submissions by Counsel for the appellants that the respondent’s erred to decide that conversion of a debt in equity is a taxable income.

In the result, it is the finding and holding of this court that section 62 of the Income Tax Act does not make the conversion of the interest expense of Ushs68.6 billion assessable to tax. The same is not subject to tax after its conversion into equity by the Government of Uganda. Consequently; I do hereby allow the appeal and set aside the objection decision made by Respondent on 12.4.2012 against the Appellant.

Since the case involves Government Institutions, and in the interests of future harmony in whatever other transactions, I exercise this courts discretion to order that each party meets their own costs.

Judge

Mr Habib Arike for the respondent

Mr. Diana Kasibante for the Appellant present

Mr. Ojambo Court Clerk present

Court: Ruling delivered in open court.

Justice W. M. Musene

HIGH COURT JUDGE

5th June 2013