THE REPUBLIC OF UGANDA
IN THE HIGH COURT OF UGANDA AT KAMPALA
(COMMERCIAL COURT DIVISION)

CIVIL APPEAL NO. 32 OF 2020

ATC UGANDA LIMITED……..……APPELLANT

VERSUS

UGANDA REVENUE AUTHORITY……..…….RESPONDENT

BEFORE HON. MR. JUSTICE RICHARD WEJULI WABWIRE

JUDGMENT

This Judgment arises from an appeal from the ruling of the Tax Appeals Tribunal in TAT No. 17 of 2019 delivered at Kampala on 26th May 2020.

I will not restate the detailed background to the Appeal as that is exhaustively reflected in the Record of Appeal. Briefly however, the Appellants/Applicants filed an objection to the Respondents assessment of withholding tax on interest due from the Applicants to their non-resident lender, on grounds that whereas interest had been accrued and was capitalized, it was never paid within the meaning of s.2 (xx) and s. 47 of the Income Tax Act (ITA).

The learned Tax Appeals Tribunal (TAT) upheld the Respondents assessment and the Appellants, being dissatisfied with the Tribunal's decisions, lodged this appeal on grounds, that;

1. The Tax Appeals Tribunal erred in law when it ruled that by converting interest and adding it to the principal loan (PLA) under clause 3.3 and 3.4 of the Shareholder Loan Agreement, the Appellant was paying the interest under the Shareholder Loan Agreement, and thereby erroneously held that:

    a. The conversion of interest and adding it to the principal loan (PLA) was a payment of the interest on the loan within the meaning of sections 2(xx) and 47(2) of the Income Tax Act, Cap 340, and;

    b. The Appellant had the obligation to pay withholding tax at the time of compounding or capitalizing the interest under the loan agreement.

2. The Tax Appeals Tribunal erred in law when it held that the Appellant was liable to pay the assessed Withholding Tax, including the penalty.
3. The Tax Appeals Tribunal erred in law when it relied on Uganda Tower Interco B.V's (UTI) audited books of accounts to hold that the Appellant had paid the interest to UTI.

At the hearing, the Appellant was represented by Kampala Associated Advocates and ABMAK Associates, Advocates & Legal Consultants while the Respondent was represented by their own Legal Department. In addition to the Record of Appeal, the parties filed written submissions and authorities upon which they relied in their respective arguments.

Submissions by Counsel.

Counsel for the Appellant submitted that the Appellant borrowed money from its parent company with interest which was formalized in a shareholder loan agreement. The agreement provided that any unpaid accrued interest would be added to the outstanding principal at the end of

every interest period and the Principal Amount together with all interest accrued would be repaid in full within 84 months (7 years) from the effective date of the loan, the effective date being the date the Agreement was executed on the 29th January, 2012.

That at the time the assessment for Withholding Tax was issued, for the period 2012- 2017, the 84-month period had not lapsed nor had the Appellant paid any interest to its parent Company. That on account of the non-payment of interest, the Appellant did not withhold tax.

Counsel further submitted that in its Ruling, the Tribunal correctly found that Withholding tax on interest is only due when the interest is paid as provided in Section 47(2) ITA. That the Tax Appeals Tribunal rightly interpreted Section 47(2) ITA but later, contrary to the evidence on record, misdirected itself by characterizing a capitalization of interest as payment of interest for purposes of Section 47(2) ITA whereas not.

The Appellant contends that clause 3 cannot exist without clause 4 of the same agreement which provides for repayment. That payment of interest was postponed and not actually paid, it remained outstanding and payable at the end of the loan period. That since, no evidence of an actual payment was adduced by the Respondent nor could it be shown that the repayment date had reached, it follows that there was no liability to withhold tax. That the Tribunal misconstrued the agreement between the parties by holding that interest was converted into the loan and was therefore paid.

That the penal tax is only payable when a tax payer fails to pay tax that is due and it must be shown that the tax payer failed to pay a due tax.

In reply, the Respondent's Counsel submitted that they agreed with the finding and holding of the Tax Appeals Tribunal that the interest was paid at the end of each interest period when it was converted into loan because according to clause 3 of the shareholding agreement, interest accrued during

each interest period on the principal amount and such accrued interest was automatically capitalized and added to the principal amount outstanding at the end of each interest period.

That the Applicant made a payment to the lender (UTI BV) when she added the interest to the principal loan and that by her failing to withhold, the Respondent was justified in imposing the penalty.

That the repayment of the loan was never the issue but rather payment of the interest and clause 3.3 and 3.4 are independent of clause 4.

That the Key condition under Section 47(2) of the Income Tax Act is that withholding tax is due when interest is paid. The Respondents submitted that the foreign lender's books evinced that she received income from the Appellant which was subjected to tax in the foreign lender's jurisdiction. That it is not in dispute that the Appellant expensed the interest payments to the lender in her books and the lender acknowledged the same in her books of account.

In rejoinder the Appellant's Counsel submitted that Clause 4.1 is relevant to the issue of interest because it shows that interest accrued is not paid and is to be repaid at a certain point. That the Tribunal's holding that the conversion of the interest into the loan amounted to the interest being paid was in contravention of Clause 4.1 which clearly held that the interest remained payable and not paid.

That the Repayment of the loan is a key issue for the dispute to be determined. That the Period in issue is 2012-2017 and the Appellant's argument is that the loan and all interest thereon had not been paid for the said period. That the loan could not have been paid without the interest and thus the loan repayment is in issue.

They prayed that the High Court sets aside the decision of the Tribunal.

Resolution by Court.

I have carefully considered the Record of Appeal, the submissions together with the authorities cited and all the grounds of appeal.

Grounds 1, 2 and 3 will be resolved together because they are closely related.

Except for the pertinent parts of the Ruling from which the Appellants derived their grounds for appeal, I find no reason to delve into the detail of the entire Ruling made by the learned TAT. The import of the TAT Ruling is that the accrued interest became part of the principal loan when it was capitalized or converted into loan and that interest was therefore paid at the end of each interest period when the conversion took place.

Ground 1, 2 and 3

Section 47 of the Income Tax Act, provides that;

> *(1) Subject to subsection (2), interest in the form of any discount, premium, or deferred interest shall be taken into account as it accrues.*
>
> *(2) where the interest referred to in subsection (1) is subject to withholding tax, the interest shall be taken to be derived or incurred when paid."*

The import of this provision is that the requirement to withhold tax arises at the time the interest is "paid" and not when it accrues.

In the instant appeal therefore was interest ever paid and if so, when was it paid? The broad question is whether interest is deemed to be paid when capitalized and if so, whether such interest is subject to withholding tax.

It is the Appellant's submission that interest was never paid and on account of the non-payment of interest, the Appellant did not withhold tax.

In their ruling, the tribunal relied on Clause 3.3 and 3.4 Shareholder Loan agreement and found that the interest was paid at the end of each interest

period when it was converted into a loan and that the Appellants were liable to pay the withholding tax including the penalty.

According to clause 3.3 accrued interest was to be added to the principal outstanding on the date when each interest period ended. Clause 3.4 allowed for the accrued interest to be paid in arrears on the last day of each interest period. However, it also stated that where there is insufficient cash flow for such period, the entire accrued interest would be automatically added to the outstanding principal amount.

The tribunal found that capitalizing interest on a loan converts an interest payment into a loan obligation.

In the case of **Paton (As Fenton's Trustee) V Commissioners of Inland Revenue(1)(1935-1938)21 TC 626**, **which, in this appeal, has been misleadingly cited by the Appellants because they sought to rely on the dissenting judgment of Justice Atkin**, the Judges roundly upheld the decision of the special Commissioners and dismissed an appeal in which among others, they determined that the Inland Revenue Commissioners had been right when they found that accruing interest had in fact and in law been paid each half year by means of an advance made by the bank for that purpose, akin to capitalization of interest. Justice Finlay agreed with and relied on the decision of Justice Russell in **In re Jauncey,[1926] Ch.471** and of the House of Lords in **Commissioner of Inland Revenue V Sir H.C. Holser, Bart and J.A Holder 16 T.C 540** and stated that;

> "..it becomes plain that the interest although not in fact paid, must be deemed to have been paid".

In his decision, the learned Judge also cited the judgment of Romer , L.J., as he then was, in **Reddie V Williamson (1M.228)**. He held that the decision of the Special Commissioners was sound and dismissed the appeal with costs. An appeal was lodged before the Court of Appeal and judgment was still

given in favor of the Crown, confirming the decision of the trial court (King's Bench).

160 In **Reddie V Williamson, 1M.228**, Lord Cowan said stated as folows;

> *"The true view is that periodical interest at the end of each year is a debt to be then paid and which must be held to have been paid when placed to the debit of the account as an additional advance by the bank ……whether by adding interest to the advance at the end of each half-yearly rest, the interest is in fact*
165 *paid".*

The import of these decisions is that interest is therefore deemed to have been paid when it was capitalized.

In their loan book/ accounts, the Appellants' lender recognizes that interest has been paid. These books are part of the evidence and consideration which
170 the TAT took into account when arriving at their decision. The lenders claim to interest was extinguished when they recognized receipt of interest in their loan book and therefore ATC was no longer under obligation to pay any further interest to the lender, for that particular interest period.

Once capitalized, the interest becomes a part of the principal loan amount.
175 Interest accrues on the "new principal" amount and if this is not paid at the end of the interest period, it is capitalized and in turn earns interest.

The argument that the loan agreement provided for payment of interest at the end of the loan period became untenable in the circumstances. The parties also opted out of this term of their own agreement when they elected
180 to recognize interest as having been paid and received and even paid taxes on the interest as evinced in UTI's books.

S. 47 (1) of the Income Tax Act requires a person to withhold tax from interest paid or payable to a non-resident while s.47 (2) ITA provides that where

interest is subject to withholding tax, the interest shall be taken to be derived or incurred when paid.

Once the interest liability is capitalized when it arises, the interest debt is satisfied and this suffices to invoke the requirements to withhold tax under the Income tax Act. The requirement to withhold tax arises at the time the interest is paid.

In the instant case, interest is deemed to have been paid when the accrued interest was capitalized at the end of each interest period. ATC ought to have withheld tax then and having failed to do so, they would find themselves liable for the tax which they did not withhold together with the attendant penalties as the case is under the income tax law.

I find that the Tribunal rightly held that by converting interest and adding it to the principal loan, the Appellant was paying interest under the shareholder Loan Agreement and that consequently, the appellant had an obligation to withhold tax at the time of capitalizing the interest.

The learned TAT further rightly held that the Appellant was liable to pay the assessed withholding tax and penalties for default.

The Appellants attempt to draw a distinction between "payments" and "paid" as was used by the TAT to determine whether interest had been paid. s.2 (xx) ITA provides that;

> *"Payment" includes any amount paid or payable in cash or kind, and any other means of conferring value or benefit on a person;*

Whereas the Appellants rightly make a distinction between the words as used in s.2 (xx) ITA, I find the attempt to hinge their case on the apparent distinction to be delusive because it would not, with due respect to the Appellants, negate the conclusion arrived at by the learned TAT.

Premised on the foregoing, grounds 1, 2 and 3 fail.

Ground 4

In their fourth ground of appeal, the Appellants contended that the Tax Appeals Tribunal erred in law when it relied on Uganda Tower Interco B.V's (UTI) audited books of accounts to hold that the Appellant had paid the interest to UTI. They challenged the legality of relying on the financial statements made in a foreign country, the Netherlands, to determine tax liability in Uganda.

The Appellants further contended that the learned TAT failed to scrutinize the evidence in the testimony of Dorothy Kabagambe and that of Hassan Mohamood whose import is that UTI had only recognized interest for a period of 2 years and that the first payment had been made in February 2018 and that the appellant therefore never made payment for the period 2012-2017.

Counsel prayed that the Assessment for the period 2012-2017 be vacated and the Respondent refunds taxes collected by the Respondent with interest at a rate of 2% per month from the date of collection till payment in full and the Respondent be ordered to pay full costs in the Tax Appeals Tribunal and the High Court.

Resolution by Court

I will start by addressing the issue of the legality of relying on the audited books of a non-resident foreign based company to determine tax liability.

The shareholder loan agreement shows that UTI (the lender) is a company incorporated in Netherlands and that it holds 99% of issued shares in the Appellant. The Appellant is a company incorporated in Uganda.

In assessing the Appellant, the Respondent relied on the financial statements of the lender which show the interest income from the Appellants and that the same was duly taxed in Netherlands.

Article 11 of the Netherlands- Uganda Tax Treaty on double taxation provides as follows;

> *"1. Interest arising in a Contracting State and beneficially owned by a resident of the other Contracting State may be taxed in that other State.*
>
> *2. However, such interest may also be taxed in the Contracting State in which it arises and according to the laws of that State, but if the beneficial owner of the interest is a resident of the other Contracting State, the tax so charged shall not exceed 10 per cent of the gross amount of the interest.*

Contrary to the submission made by Appellants Counsel, there is no legal bar to recognition of lenders books of account. Article 11(1) of the Netherlands –Uganda Tax Treaty on double taxation legitimizes taxation of interest arising in a contracting state and beneficially owned by a resident of the other contracting state.

Article 3(a) of the Treaty also defines the terms 'a Contracting State' and 'the other Contracting State' to mean the Netherlands or Uganda, as the context requires. To put this into context, article 11(1) means that Interest arising from the Appellant Company (ATC) in Uganda which is beneficially owned by UTI, a resident of Netherlands may be taxed in Netherlands. However, Clause 2 states that such interest may also be taxed in Uganda according to the laws of Uganda.

The above provisions show that much as interest had been taxed in the Netherlands, it could still be taxed in Uganda in accordance with Ugandan laws.

The Parties being bound by the fundamental legal principle of *pacta sunt servanda*, the TAT was perfectly in order when they took into account the audited books of account of UTI, the Tribunal rightly applied the law in the context of the facts of the case before them.

I will now address the issue of the evidence of the two witnesses. I have, in exercise of this courts appellate mandate, carefully reviewed the testimonies of the two witnesses, Dorothy Kabagambe and Hassan Mohamood when they appeared at the Tribunal.

Whereas indeed the learned TAT took note of the testimony of Kabagambe , it did also take into account the testimony of Mahmood that the audit carried out during 2017 - 2018 had revealed default by the Appellants on withholding tax for the period January 2012 – December 2017 and that the accounts showed that the income from ATC had been recognized and that tax had been paid in the Netherlands.

In his testimony, at page 101 of the Record of Appeal, Hassan Mahmood testifies that; *"Around **2017-2018** financial year, ATC was selected for return examination…"* He further state that; "*We discovered that UTI had acknowledged income from Uganda by including it under the income from the audited statements form January 2012 to December 2017".*

Whereas therefore the return examination was conducted during 2017-2018 financial year, the period of default established from the audited statements of UTI was 2012-2017.

From the foregoing, it is evident that the learned TAT rightly addressed and properly guided themselves in arriving at the decision as they did, based on the testimonies of Kabagambe and of Mahmood.

The contention raised by the Appellants that the lenders right to demand for the interest still subsist, was dealt with when resolving grounds 1, 2 and 3 above.

Ground 4 of the appeal fails.

Final Orders

The Appeal fails on all the 4 grounds.

The decision of the Tax Appeals Tribunal and all the orders that were made arising therefrom are upheld.

The Appellants shall pay the costs of this appeal.

Delivered at Kampala this 18th day of February 2022.

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RICHARD WEJULI WABWIRE

JUDGE