THE REPUBLIC OF UGANDA

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

CIVIL APPEAL NO. 55 OF 2019
ARISING FROM TAX APPEALS TRIBUNAL APPLICATION NO. 6 OF 2018

UGANDA REVENUE AUTHORITY :: APPELLANT
VERSUS

MUKWANO ENTERPRISES LIMITED :: RESPONDENT

(Before: Hon. Justice Patricia Mutesi)

JUDGMENT

Background

1. This is an appeal from the ruling and orders of the Tax Appeals Tribunal (hereinafter "the Tribunal") in Application No. 6 of 2018. The brief background of the appeal, as can be gathered from the record of the Tribunal, is that the respondent is in the business of property and real estate development. The respondent buys leases on land from various individuals and entities with or without buildings thereon. Thereafter, it constructs or renovates commercial or residential buildings on the leased properties and then rents them out for profit.

2. Sometime in July 2017, the appellant carried out an audit into the respondent's tax affairs for the period 2010 – 2014. The appellant noticed that the respondent had treated premium and rent payments for 20 of its leases as revenue expenditures. The appellant believed that these expenditures were capital in nature and, as such, non-deductible expenses in the tabulation of chargeable income.

3. Accordingly, the appellant disallowed the expenses for the amortisation of the lease premiums and rejected the treatment of the lease rental payments as revenue expenditure. The appellant added back the UGX 2,344,351,788/= which the respondent had deducted from its gross income in respect of the impugned premium and rent payments for the entire period audited while tabulating its corporation tax. The appellant

then issued an additional assessment to the respondent seeking to recover an additional UGX 3,250,011,968/= in corporation tax. The respondent objected to the assessment.

4. The appellant disallowed the objection and the respondent appealed to the Tribunal. After considering the parties' evidence, the Tribunal found that the premium and rent payments were revenue expenditures since the respondent is in the business of real estate development and the said expenses had been incurred in the acquisition of leases for the respondent's business. The Tribunal, therefore, found that the respondent was entitled to a deduction of the premium and rent payments in the tabulation of its chargeable income.

The Appeal

5. The appellant was aggrieved by the ruling and orders of the Tribunal and appealed to this Court on the following 2 grounds:

> *"1. That the Honourable Tribunal erred in law when they held that the rent and premium paid by the respondent was revenue expenditure and that the respondent is entitled to have them deducted as allowable expenses.*
>
> *2. That the Honourable Tribunal erred in law when it remitted the matter to the appellant for reconsideration of the expenses incurred by the respondent as deductible allowances."*

Duty of the High Court in tax matters

6. Section 27(2) of the Tax Appeals Tribunal Act Cap 345 provides that an appeal may be made to the High Court from a decision of the Tribunal on questions of law only. In **High Court Civil Appeal No. 9 of 2006; Uganda Revenue Authority V Tembo Steels Ltd**, this Court explained that the intention of the legislature in enacting that provision was to leave questions of fact, such as the accuracy of tax assessments, to tax professionals at the appellant and at the Tribunal, and to reserve to this Court only points of law for determination.

7. Therefore, in appeals from the Tribunal, this Court entertains and decides questions of law only. Nevertheless, since the failure to exhaustively and

objectively appraise evidence constitutes an error of law, this Court may, after finding that the Tribunal is guilty of such an error, reappraise the evidence adduced in the Tribunal and draw its own inferences of fact (See **Court of Appeal Civil Appeal No. 172 of 2019; SWT Tanners Ltd & 14 Ors V Commissioner General URA**).

Representation

8. At the hearing of the appeal, the appellant was represented by Mr. Aliddeki Ssali and Mr. Kwerit Sam from its Legal Services and Board Affairs Department. The respondent was represented by Ms. Namungoma Lydia who held brief for Ms. Nakiganda Belinda from M/S Birungyi, Barata & Associates.

Determination of the appeal

9. I have fully considered the materials on record, the submissions of the parties and the laws and authorities cited. The main question to be decided in this appeal is whether or not the respondent's rent and premium payments are revenue expenditure or capital expenditure. This question is critical because revenue expenditure is a deductible expense in the tabulation of chargeable income while capital expenditure is not a deductible expense in the tabulation of chargeable income. Since the 2 grounds of appeal are related, I will resolve them together.

10. Relying on the Black's Law Dictionary 10th Edition, counsel for the appellant defined "capital expenditure" to mean "an outlay of funds used to acquire or improve a fixed asset". Counsel submitted that land is a fixed asset and that a payment made for the acquisition and / or development of land amounts to capital expenditure which is not an allowable expense in the tabulation of chargeable income under Section 22(2)(b) of the Income Tax Act ("ITA"). Counsel argued that the premium and rent paid by the respondent for the 20 leases constitute capital expenditure because the respondent registered the leases in its own name and developed office and residential holdings on the respective lands for rent. Accordingly, counsel faulted the Tribunal for finding that the respondent's premium and rent payments were revenue expenditure, and hence, deductible expenses under the ITA.

11. On the other hand, counsel for the respondent supported the findings of the Tribunal that the respondent is in the business of real estate and property development and that the impugned leases constitute stock in trade/circulating capital and not fixed assets. Counsel further supported the Tribunal's reasoning that since all the expenses incurred by the respondent in acquiring and maintaining the leases are of a revenue nature, the same were supposed to be treated as allowable expenses in the tabulation of chargeable income under the ITA. Counsel invited this Court to dismiss the appeal and to uphold the Tribunal's decision.

12. Section 22(1) of the ITA allows a tax payer, in the course of tabulating his or her chargeable income, to deduct all expenditures and losses incurred by him or her during a year of income to the extent to which those expenditures or losses were incurred in the production of his or her gross income. However, Section 22(2) of the Income Tax Act provides for exceptions to subsection 1 thereof. Specifically, paragraph (b) of Section 22(2) forbids any deduction to be made to the gross income if it is in respect of an expense or loss of a capital nature.

13. The ITA does not define "capital expenditure" or "revenue expenditure". In **HC Civil Appeal No. 1 of 2019; Vivo Energy Uganda Limited V Commissioner General, Uganda Revenue Authority**, this Court had this to say about the difference between capital and revenue expenditure:

> *"... It has been long agreed that the demarcation line between capital and revenue expenditure is a very thin one and consequently the ultimate conclusion on whether expenditure is capital or revenue expenditure is* ***a question of law and fact which is remarkably dependent on the facts surrounding the circumstances of each case.***
>
> *(....)*
>
> *The case of* ***Atherton v British Insulated and Helsby Cables Ltd (1925)10 T.C. 155****, which was cited by the Appellants, laid down what has been universally accepted as the test for determining what is capital expenditure as distinguished from revenue expenditure. In that case it was held that* ***capital expenditure is a***

thing that is going to be spent once and for all and income expenditure is a thing that is to recur every year. To this is added the rider that identifies a capital expenditure as one that brings on board an asset or advantage for the enduring benefit of the business.

(....)

All the foregoing authorities point to the position that ***typically, capital expenditure is incurred in acquisition, extension or improvement of assets whereas revenue expenditure is a routine business expenditure. Capital expenditure is a non-recurring outlay whereas revenue expenditure is normally a recurring item which is incurred on a regular basis.***

For an expenditure to fall within the purview of Section 22(2) of the ITA, it should be a capital expenditure, ***a once for all payment which is intended to provide a long term benefit to the business and not a recurrent expenditure.*** *The decisions provide useful illustrations; otherwise, the facts of each case are critical in categorising specific expenditure as capital or revenue ..."* Emphasis mine.

14. I quote the above dictum in ***Vivo Energy*** with approval. I also agree with the submissions of counsel for the appellant that, precisely, the phrase "capital expenditure" refers to an outlay of funds used to acquire or improve a fixed asset. Capital expenditure provides a long term benefit to the business as opposed to revenue expenditure which is recurrent and which provides only a short term benefit to the business. The facts of each individual case are instructive in the determination of whether an expense is a one-off expense which provides a long term benefit or a recurrent expense which provides a short term benefit.

15. Expenditure for the acquisition of land is typically treated as capital expenditure since land is a fixed asset. However, this is not always the case in a situation where the taxpayer deals in real estate. Interests in land are the circulating capital for such a taxpayer because, once acquired, these interests are re-sold for profit. All the money used to acquire such interests is revenue expenditure.

16. This seems to have been the ratio decidendi in the Tribunal's ruling. The Tribunal simply reasoned that since the respondent deals in real estate, all its interests in land are its circulating capital and the premiums and rents it paid for those interests are revenue expenditures. I am convinced that, in reaching that conclusion, the Tribunal seems to have missed a critical aspect of the nature of the respondent's business which necessitated a different conclusion from the one reached.

17. I reiterate that it is generally accepted that the land with which a dealer in real estate carries on his business is part of his circulating capital. However, that is only the general rule. As counsel for the appellant correctly submitted, that general rule anticipates a simple situation in which a taxpayer buys and sells interests in different parcels of land. In that situation, there can be no doubt that the taxpayer's interests in land are its circulating capital. The situation in this case is significantly more complicated. The respondent is not merely a dealer in land or a trader of interests in land. At the scheduling conference in the Tribunal, it was an agreed fact that the respondent carries on the business of "property development and real estate". At the hearing, both the respondent's witnesses confirmed that fact. Therefore, the respondent does not simply buy and sell leases. It buys leases and puts them to use for the remainder of their respective durations.

18. The 20 contested leases were acquired from government authorities. The respondent developed the respective lands with office/residential holdings and then rented them out to the public for a profit. It is anticipated that the respondent will remain the registered proprietor of the 20 leases for the remainder of their respective durations which vary from 49 - 99 years and will continue to derive rent therefrom until the leases lapse. The respondent did not simply buy and sell leases and, if that had been the case, that land would merely have been its circulating capital because it would have been acquired for the sole purpose of resale at a profit. The respondent bought 20 leases, developed them and will continue to derive rent from them until they lapse. The leases cannot, in my considered opinion, amount to mere stock in trade or circulating

capital. They are fixed assets of the respondent's business and the money paid to acquire them constitutes capital expenditure.

19. I am also fortified in the above findings by the contents of the respondent's statements of financial position for the entire period audited by the appellant (2010 - 2014). As pointed out by the counsel for the appellant, the respondent declared the "prepaid operating lease rentals" as "non-current assets" in all those statements. The respondent did not specifically address the effect of this declaration before this Court yet the appellant had raised it in its submissions. The Court's opinion is that the categorisation of the prepaid operating lease rentals as non-current assets in the respondent's financials irresistibly infers that, from the onset, the respondent understood the leases and the buildings thereon to be fixed assets, and knew that any money it used to acquire those fixed assets constitutes capital expenditure.

20. For the foregoing reasons, I am inclined to find that the respondent cited the decision of **Gali India Limited V The Joint Commissioner of Income ITA 956/2011 and 957/2011** out of context. The findings in that case, to the effect that costs incurred for land by a taxpayer who deals in real estate are always treated as revenue expenditure, are only applicable to a taxpayer whose only business is to deal in real estate by buying and selling interests in land for profit. Where a taxpayer buys leases in leases, develops real estate holdings thereon and puts those holdings to use by renting them out for profit, the rule in ***Gali India Limited*** is rendered redundant and inapplicable. In the latter scenario, the leases are not simply stock in trade for that tax payer. They are fixed assets of that taxpayer and he or she is expected to derive rent from them for the remainder of their respective durations.

21. Furthermore, the respondent heavily relied on ***Vivo Energy*** to submit that since a lease does not take away the ownership of the land from the lessor, the rent paid for it is revenue expenditure and does not contribute to the cost base of the lease. The respondent invited this Court to rely on, and uphold, ***Vivo Energy***. In its rejoinder submissions, the appellant submitted that ***Vivo Energy*** is materially distinguishable from this case both in facts and principle.

22. The factual distinction between ***Vivo Energy*** and the present case is obvious. In ***Vivo Energy***, leases were acquired by a fuel retailing company for the placement of petrol stations. There was no doubt in that case that fuel and related products were the circulating capital of that company and not the leases impugned therein. In the present case, the respondent's business is acquisition, development and improvement of real estate, by way of construction and, or, renovation of buildings and further letting out of those buildings. In this case, more careful scrutiny has had to be given to the respondent's leases in this case to determine whether the same constitute stock in trade or fixed assets.

23. However the factual distinction between ***Vivo Energy*** and the present case does not significantly undercut the relevance of the findings in that case to the present dispute. In my considered view, ***Vivo Energy*** is relevant and applicable to this dispute. I reiterate that ***Vivo Energy*** correctly restated the law on the difference between capital and revenue expenditure. However, it appears that both parties and the Tribunal misconstrued the ratio decidendi in ***Vivo Energy***. At pages 17 – 18 of the ***Vivo Energy*** judgment, this Court stated that:

> *"... **In the instant case, the Lease Agreements made separate specific provisions for premium and rent.** The Agreement provided for periodic rate of payment of rent. The rent was due to be payable recurrently in advance over the duration of the lease ranging from monthly, quarterly, annually to several years in advance.*
>
> ***In the circumstances therefore, whereas the premium was a once for all capital expenditure, the rent was a recurrent revenue expenditure.***
>
> *I can therefore find no other way to categorise the rent other than as a recurrent expenditure and one which therefore is a deductible expense within the purview of section 22 of the ITA.*
>
> ***Conclusion.***
>
> *I find that the Tribunal erred in law when it held that rent paid in respect of the Appellant's leases is not a deductible expense.*

The Tribunal misdirected itself when it concluded that rent payments be considered in the cost base of the lease under s.52(2) ITA and having done so concluded that it was not tax deductible. The decision by the Tribunal in that respect is reversed.

Except for the aspect of the Appeal in respect of premium, to which the Appellant has conceded as being ineligible for deduction, the Appeal succeeds.

The Rent expenditure incurred by the Appellants shall be accordingly deducted under s22 ITA from their tax obligation to the URA ..." Emphasis mine.

24. Contrary to the findings of the Tribunal and the submissions of both parties in this appeal, the true ratio decidendi and conclusion in ***Vivo Energy*** was that rent for a lease is revenue expenditure because it is recurrent and benefits the business in the short term while premium for the same lease remains a capital expenditure because it is a one-off payment which has an enduring benefit for the business in the long term. In that case, the taxpayer was found to have correctly conceded that premium is ineligible for deduction in the tabulation of chargeable income pursuant to Section 22(2)(b) of the ITA. Indeed, the gist of the Court's final orders in that case was that the rent for the leases was deductible but premium was not deductible.

25. There is no doubt in my mind that the premium paid by the respondent for the 20 leases was a capital expenditure. The mere fact that the respondent amortised premium payments is, in and of itself, the first indictment on the respondent's case. Amortisation, as correctly defined by the Tribunal, means "to gradually extinguish a debt often by means of a sinking fund". For tax purposes, amortisation implies the process of gradually writing off the initial cost of a non-current asset.

26. Amortisation applies only to fixed/non-current assets and, as such, the amortisation of an expense automatically infers that that expense was a one-time capital expense which has to be spread out over the useful life of the fixed asset and written off gradually. The conduct of the respondent in amortising what it calls revenue expenditure is self-defeating. Revenue

expenditure cannot be amortised and allocated or spread to more than one accounting period. Revenue expenditure can only be claimed as a deductible expense within the year it is incurred.

27. Additionally, all the agreements for the 20 leases recognise premium as a one-off payment separate from rent which recurs on a regular basis. This confirms that premium for the leases was understood to be capital expenditure while rent for the leases was taken as revenue expenditure

28. The parties also argued extensively on the nature of the impugned leases. The respondent insisted that the 20 leases were operational leases while the appellant maintained that they were financial leases. It is clear that the 20 leases do not satisfy the criteria for financial leases as prescribed by Section 59(3) of the ITA. This means that the leases are operating leases. Unfortunately, the ITA only provides for financial leases and does not anticipate operational leases. Sections 17(3) and 40(1) of the ITA allow reference to the generally accepted accounting principles, unless the ITA provides otherwise. These provisions render the acclaimed International Accounting Standards ("IAS"), now called the International Financial Reporting Standards ("IFRS") as of January 2019, relevant and applicable to operating leases.

29. I agree with the respondent's reliance on IAS 17 paragraph 14 for the position that "a payment made on entering into or acquiring a leasehold that is accounted for as an operating lease represents prepaid lease payments that are amortised over the lease term in accordance with the pattern of benefits provided". However, contrary to the respondent's interpretation of that provision, my considered view is that it makes a payment made in entering into or acquiring a leasehold to be a capital expense and that this is why it allows such a payment to be amortised over the lease term. Acquisition of a lease is different from maintenance of a lease. While premium is payment made to acquire a lease, rent is payment made regularly to maintain the lease. Accordingly, the true import of IAS 17 paragraph 4 is that premium for an operating lease is money paid to enter into and acquire that lease. It is treated as a prepaid lease payment and the lessee is allowed to amortise it over the lease term. The provision remains inapplicable to lease rent payments which

are made at agreed regular intervals to maintain an already-acquired operating lease over its term.

30. Therefore, in line with the rule in ***Vivo Energy***, this Court concludes that the Tribunal erred when it found that both premium and rent payments for the 20 leases constitute revenue expenditure. The Tribunal ought to have found that while rent payments constitute revenue expenditure which is an allowable deduction, premium payments constitute capital expenditure which is not an allowable deduction. Ground 1 of the appeal, therefore, succeeds partially.

31. With specific regard to ground 2 of the appeal, Section 19(1)(c) of the Tax Appeals Tribunal Act allows the Tribunal to remit matters to the appellant for reconsideration with directions or recommendations. In view of my findings on ground 1 of this appeal, the Tribunal was justified to remit the matter to the appellant for reconsideration. The Tribunal only erred in the nature and scope of the direction which accompanied the remittance of the matter to the appellant. The Tribunal should have directed the appellant to only deduct rent, and not both rent and premium, while tabulating the respondent's chargeable income. Accordingly, ground 2 of the appeal also succeeds partially.

Reliefs

32. Consequently, the appeal succeeds in part. I make the following orders:

i. The Tribunal's ruling is set aside to the extent that it classified premium payments for the 20 leases as revenue expenditure.

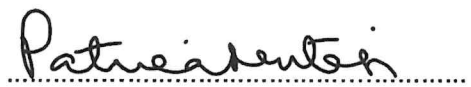
ii. The impugned assessment is remitted back to the appellant for reconsideration with directions that:

(a) The rent payments for the 20 leases shall be deducted from the respondent's gross income for the period audited in the tabulation of the respondent's chargeable income.

(b) All premium payments for the 20 leases shall be treated as capital expenditure.

(c) The appellant shall issue a revised additional assessment to the respondent after the reconsideration.

iii. Each party shall bear its own costs of the appeal and those of the proceedings in the Tribunal.



Patricia Mutesi

JUDGE

(30/ 12/2023)