THE REPUBLIC OF UGANDA

IN THE HIGH COURT OF UGANDA

AT KAMPALA

CIVIL APPEAL NO. 78 OF 1999

The New Vision Printing &
Publishing Corporation………………………………………………………………
APPELLANT

VERSUS

Uganda Revenue Authority………………………………………… RESPONDENT

BEFORE: THE HONOURABLE MR. JUSTICE R.O. OKUMU WENGI

JUDGMENT

The appellant has appealed to this Court against the ruling of the Tax Appeals Tribunal (T.A.T) rendered on 17/12/99. The single ground is that the Tribunal erred in Law in holding that the Appellant's lease Rentals were not a deductible expenditure for tax purposes. The facts of the case so far as is significant to this appeal, are briefly that the Appellant installed new printing equipment which it sourced through by a finance lease dated 4th August 1995. Under the said lease the Appellant was required to make certain payments to the lessor of the machinery on a Finance lease. These payments included interest and rentals. It is the appellant's case that rental payments were an allowable deduction since such expenditures were wholly and exclusively incurred in the production of the appellant's income. According to the appellant therefore the rentals did not constitute capital acquisition of an asset even if at the end of the finance lease there was the inevitable option to purchase the equipment from the lessor at nominal cost.

On the other hand it is essentially the argument of the Respondent that the annual rental paid by the Appellant amounting to Shs. 243,315,835 for the 1995/96 season consisted of Shs. 140,347,003 as principal (cost) and Shs. 102,968,832 as interest thereon (gain) - It is also contended on behalf of the Respondent that the Appellant itself submitted its Audited

Accounts from which taxable profits were ascertained at shs. 278,840,655/=. The tax assessed was Shs. 83,652,196/=. This computation according to the Respondent arose after allowing interest (Shs. l02,968,832/=) and wear and tear. The Respondent contended therefore that the Appellant did not demonstrate that it had been denied a deduction of the rental expenditure. On the contrary the rental expenditure was not reflected in the profit and loss account in determining the taxable profit of the Appellant. As such the Respondent contended that the rental expenditures had been correctly treated in the books of Accounts and that no extra tax arose out of the lease rentals. In short the Respondent is of the view that the Appellants Balance Sheet treated the expenditure subject of this appeal as a capital liability while the interest component was debited to the profit and loss account. The latter was allowed as a deduction.

Several authorities were cited by counsel on both sides. Mr. Odere learned counsel for the Appellant urged that this case raised novel legal issues being a case of first instance dealing with the treatment of finance leases for tax purposes. He submitted that for the tax year in question the Appellant remitted by way of rentals a total of Shs. 243,315,8371= the lease rental being Shs. 140,347,007/=. This essentially agrees with the Respondent’s figures. Learned counsel however contended that this rental sum was added back into the Appellant’s taxable profits as a result of which it paid unjustifiable tax on it of Shs. 42,104,100/= the essence of this Appeal. Counsel submitted at length on the content of the Master Finance lease, the interpretation of which according to him, resulted in expenditures not of a capital nature or for creation of enduring assets but to enhance production of the Appellants income. Such expenditure he argued was allowed under S.14 (l) of the Income Tax Decree (1974) as having been incurred wholly and exclusively in the production of income. He cited the case of **Kenya Meat Commission vs Commissioner Income tax C.A** on the interpretation of the equivalent section 14(1) of the Kenya Law. He concluded that the appellant was entitled to a refund of Shs. 42,l04,l00/= which was refused by the Tax Appeals Tribunal.

In its findings the Tribunal made its plain sailing finding in the following words:-

> ‘The Tribunal has evaluated the evidence of Mr. Elford and Ms Aslund as regards treatment of Finance leases Under International Accounting Standard 17 (IAS 17). The Tribunal has taken into consideration the evidence adduced that the Accounts of

> the Applicant as presented ... in so far as they relate to the treatment of lease rentals for corporate taxes under a lease agreement internationally.
>
> Notwithstanding, in the view of the Tribunal whether or not these lease rentals are allowable deductions is a matter of law, that is to say, the law in force in Uganda at the time when the rental payments were effected. . . . the Tribunals finding is that the said rental payments included the principal (cost) component and were properly treated in that they were used to reduce the as set liability. Further, the rental payments also included the interest component, which was properly charged to revenue. In other words rental payments made by the applicant contained both the capital item (cost) and interest item (revenue)
> ………The Tribunal finds that under this legal provision (S.l4(l)b, 2,3,4, & 5 of I.T.D. 1974) the principal (cost) component of the rental payment of the leased property in the instant case is not one of the items of expenditure allowed by **section 15(1) (b) aforesaid** …..”

The Tribunal then went on to rule that an amendment to the Income Tax Decree brought about by The Finance Statute 1994 [para 31A (1)] did not extend any benefit to a lessee such as the Appellant its purview being only limited to a Lessor who in this case would be Uganda Leasing Company from whom the Appellant leased the item subject of this tax appeal.

From the above it is clear that The Tribunal relied on evidence adduced before it. It also relied on the Accounts presented based on International Accounting standards. Then it put these against the law and arrived at its conclusions. The evidence so far as they are relevant was adduced by two witnesses only. The first witness John Robert Elford testified that he was experienced in finance leases. He then stated:

> “We expected that Uganda Authorities will emulate tax treatment of leasing arrangements elsewhere. A standard Finance lease is different from a loan. In a lease the lessor purchases equipment and allows the lessee to use the equipment during which time rental payments are made. The International practice is that equipment remains the asset of the lessor. We received rental income and regard it as a taxable

income. The lessee entitled to is claim rental expense as a deductible expense."

The witness then contended that by 1995 the laws stipulated that a finance lease with an option to purchase should be regarded as a loan. As such the asset remained an asset of the lessor and income from it was taxable. The second witness Annebritt Aslund made a demonstration to illustrate the different effects on a lessor and lessee of finance leases and the way they are treated in the balance sheet and profit and loss account. She compared the above scenario as practiced in the International Accounting Standard 17 and the scenario legislated in the Income Tax decree 1974 as amended. While she concluded that the assets subject of a finance lease was an asset of lessor with capital allowances accruing to the lessor in cross examination the witness conceded that there was a discrepancy or disparity between the IAS 17 and the provisions of the Income Tax decree in Uganda. In otherwords the witness testified that what was provided for in the law seemed not to correspond with International Accounting Standards as there was a disparity in scenarios. As soon as the witnesses finished testifying counsel for the Respondent asked the Tribunal to find that there was no evidence before it to demonstrate that the tax paid by the applicant was not justified. Learned counsel contended further that beside lack of evidence to back a demand for a deduction to be allowed, there was only a question of law whose interpretation ought to be referred to this court.

Having set out the tribunals finding and the evidence on which it acted as well as the law, the questions that stand to be determined in this appeal are as follows:-

(a) What does the relevant law provide?

(b) Was the evidence sufficiently adduced to enable the tribunal determine the matter before it?

(c) Did the Tribunal correctly evaluate correct conclusion?

First it is necessary to set out the law which then can be applied to the Tribunals findings and the evidence and facts before it. The relevant law is to be found in sections 14 and 15 of the Income Tax Decree 1974 as amended by the Finance Statute 1994 which are set out below. ”S.14(l) For the purpose of ascertaining the total income of any person for any year of income there shall, **subject to section 15 of this Decree,** be deducted all expenditure incurred in such year of income which is expenditure wholly and exclusively incurred by him in production of such income and where under section 26 of this Decree any income of an accounting period ending on some day other than the last day of such year of income is for the purpose of ascertaining total income for any year of income, taken to be income for any year of income then such expenditure incurred during such period shall be treated as having been incurred during such year of income.

(2) Without prejudice to sub-section (1) of this section in computing for any year of income the gains or profits chargeable to tax under paragraph (a) of subsection (2) of section 3 of the Decree, the following amounts shall be deducted.

(a) …………..

(b) …………….

(c) any deductions to be made under schedule 2 of this Decree in respect of such year of income;

(d) ………….

(e) any expenditure of a capital nature incurred in such year of income by any person on legal costs and stamp duties in connection with the acquisition of a lease for a period not in excess of or expressly capable of extension beyond, ninety nine years, of premises used or to be used by him for the purpose of his business;

(f - q) ………….

(3) Without prejudice to subsection (1) of this section in ascertaining the total income of any person for any year of income the following amounts shall be deducted, (a) the amount of interest paid in respect of such year of income by such person upon any money borrowed by him and employed wholly and exclusively in the production of income chargeable under this decree to the extent to which it is not an expense deductible in ascertaining the gains or profits chargeable under paragraph (a) of subsection (2) of section 3 of this Decree.

"S.15 (1) Subject to subsection (2) , (3) , (4) and (5) of section 14 of this Decree for the purposes of ascertaining the total income of any person for any year of income, no deduction shall be allowed in respect of

(a) any expenditure or loss <u>which is not wholly and exclusively incurred by him in the production of income.</u>

(b) any Capital expenditure, or any loss, diminution or exhaustion of Capital.

Later amendments to the Income Tax Decree specifically brought about by Finance Statute No.9 of 1994 provided as follows under Part II of Schedule II to the Decree.

"7(1) Subject to this part where during any year of income any machinery owned by any person is used by him for the purposes of his business or let or leased out by him there shall be made in computing his gains or profits for that year of income a deduction (in this part referred to as a wear and tear deduction")

(2) ………….

(i) ………..

(ii) ……….

(iii) all other machinery and office equipment including computers, furniture, tools, security equipment or similar articles 2O for class (iii)

8(1)

(2) Subject to this part where machinery is brought into use for the purpose of a trade without being purchased or ceases permanently to be so used without being sold it shall be deemed to have been purchased or sold as the case may be and the cost or amount realized shall be deemed to be the price which it would have fetched if sold in the open market.

9. Where machinery is let upon such terms that the burden of the wear and tear thereof falls directly upon the lessor this part shall apply in relation to him as if the machinery were, during the period of the letting in use for the purposes of a business carried on by him.

Other paragraphs in this part then deal with installation expenses on existing buildings as part of capital expenditure on the provision of machinery forming part of the machinery. They also relate to balancing deductions, or charges and attempts to avoid certain mischiefs and putative sales of machinery with a clear proviso that excludes an elective option by a non resident party (see Proviso to para 13 thereof).

The above sets out the legal regime in which the Finance lease subject of this appeal was set. While the new Income Tax Act 1997 specifically defines Finance leases it cannot be said that the above provisions did not envisage them. To this extent it is irrelevant that there exists an “international” law of Finance leases which universally prescribes their treatment for tax purposes. The testimony of J.R. Elford in this regard would introduce an element of speculation and import into the Tax law of this country (as it then was) extraneous considerations. The evidence of Aslund highlighting the dichotomous position as practiced in the International Accounting standards and as provided in the Income tax Decree in relation to Finance leases points to the difficulty of applying mooted universal rules in an area governed by a local statute. It can hardly be said that commercial accounting practices even if universally practiced can outride a statute. It can also be hardly said that the treatment of Finance leases in England or in Metropolitan Jurisdictions where they originated must be accorded in Uganda without reference to or in disregard of the local law.

In this regard reference must be made to some of the numerous cases cited to this Court by Counsel on either side. From a reading of **Kenya Meat Commission vs The Commissioner of Income Tax** Civil Appeal No. 56 of 1967 (reported as case No. 127) it is clear that evidence of the nature of the expenditure is important in the determination of the question whether its deduction was permitted. In that case the Court of Appeal for Eastern Africa was faced with the question whether a contribution made by the Commission for research was allowed by sections 14 and 15 of the East African Income Tax (Management) Act 1958. These sections are possibly similar but not exactly worded in the same way. SPRY JA. held:-

> "I do not understand what purpose was intended to be served by the words
>
> "Without Prejudice to." [in S.142]; but after comparing section 14(1), section 14(2) and section 15(1) I think Mr. Hewitts submission [that subsections (1) and (2) of section 14 must be read independently.. . . as without prejudice to cannot mean the same as subject to……..”] must be correct. Section 14(1) allows the deduction of expenditure wholly and exclusively incurred in the production of the income for the year in question. It should be noted that the subsection does not say that only such expenditure is to be deducted. Section 14(2) allows certain other deductions of an entirely different nature. They include bad debts which are not expenditure and which while they result from giving credit presumably in order to obtain business cannot be said to have been incurred in the production of the income for the year in question. They include contributions to persons and provident funds which are long term matters and certainly not related to the production of income in any one year. They include also various kinds of capital expenditure including that for scientific research with which we are concerned. Such expenditure might or might not produce income in the year in which it was incurred but it would be most likely to produce benefits in future years. All these matters dealt with in subsection (2) seem to me entirely different from the expenditure dealt with in subsection (1). Then there is section 15 (1). This is the negative subsection which provides that no deduction is to be allowed which was not incurred in the production of income or which is of a capital nature, but **this subsection is expressly made subject to section 14(2).** It seems to me quite clear from these provisions that the classes of expenditure referred to in section 14(2) are exceptions to the general rules

set out in section 15(1) (emphasis added).

The Court then held that the expenditure was allowed as a deduction. The point to be made here is that while section 15(1) was made subject to S.14 (2) in the East African Act, the position in the Income Tax Decree 1974 was a double reversal. Section 14(1) is clearly made subject to section 15 of the decree. Further section 15(1) is also made subject to section 14(2) 3, 4, and 5. This means that while the **Kenya Meat Commission** case stands for the independent reading of section 14(1) and 14(2) the fact that section 14 (1) is made subject to section 15; deductions which may be allowed must conform to the stipulation in section 15. This would mean that the law sought to restrict even further the categories of allowable deductions and English and Indian Authorities on the matter or regarding similar provisions may not be wholly helpful.

See **Commissioner of Income Tax vs Buhemba Mines Ltd** CA No. 77 of 1955 (per Forbes J.A) . In this case it was clearly stated that the law intended to draw a line between deductible and non deductible expenses. For an expense to be deductible it must have been incurred for the direct purpose of producing profits. Therefore some evidence had to be led on the matter. On the basis of the evidence adduced before the Tribunal it appears it was not easy to find that the expenses were deductible. The accounts as presented complying with Commercial Accounting practices did not specifically seek for deduction of the expenditures subject of this Appeal. The deduction was merely claimed on the basis of an understanding that it was allowed in cases of Finance leases. One witness indicated however a disparity between commercial accounting practice and her reading of the Income Tax Decree. It is the view of this court that for a deduction to be allowed it must either be so allowed by statute and or that it is not prohibited by statute. At the same time for an expenditure to qualify for a deduction some evidence of its character must be adduced. Thus to a certain extent it is a question of fact and law. The evidence must demonstrate that the
expenditure was "wholly and exclusively" incurred by the appellant in the production of the income. If part of such expenditure relates to a capital acquisition, wasting asset or could be deemed to be the capitalised value for an asset then a doubt arises as to whether it was wholly and exclusively incurred in the production of income (and not an asset). In this regard it is a question of fact what the payments of principal component in the Finance lease related to. Was it related to producing income for the year in question wholly and exclusively or was it

applicable to realization of asset value for the future?

In this Courts view even the English Courts have in recent times adopted a restricted view of what constitutes trading income as opposed to income arising out of investment for income tax purposes. In **Nuclear Electric PLC vs Bradley Inspector of Taxes** (1996) 1 WLR 529, the House of Lords held that whether investment income amounted to a trading receipt was a question of fact in each case depending on the nature of the tax payer's business and whether the income arose from a fund employed in the business. In that case the tax payer invested money in a National Fund for storing and reprocessing nuclear fuel for re-use and disposal. It earned profits and the company, an electricity generating facility sought tax benefits. The court held that this was investment and not trading income and it found also that it was not the business of the company to so invest, its business being to generate electricity.

Although this case is not on the same points of fact and law, it points to the need for some evidence of the wholesome and exclusive nature of the expenditure in relation to the production of income. Where as it appears, in this case, that either this evidence is insufficient or if it is taken that payment of principal was in effect payment for machinery in the final analysis then such expenditure is not deductible. Interest on the finance lease is specifically deductible and this is what happened in this case.

From the above I am unable to say that under the Income Tax Decree 1974, rental installments in a Finance lease with an option to purchase, were a deductible expenditure. There may be benefits to the lessor and perhaps this is what should have been anticipated by the gullible tax payer when it was pitted against a dexterous lessor a debt at financial schemes with inbuilt tax avoidance mechanisms. The tax payer's auditors also did not make out a case for deduction in the early stages or in the final accounts although I cannot tell if there would have been any difference. I have thus been unable to point a finger at a provision in the law that permits the deduction of principal repayments in a finance lease. On the other hand the law prohibits such deduction. One question can also arise if indeed taking printing machinery on a finance lease is part of the business of the Appellant in this case; in otherwords whether repayments of such lease rentals can be said to be wholly and exclusively incurred in production of income. Rather the scheme enabled a subtle and onerous sale of equipment to

the Appellant who may not deduct such repayments in computing its taxable income.

The result is that this Court dismisses this appeal with costs and grants leave if needed by the appellant here to prefer a second appeal without further application.

R.O. Okumu Wengi

Judge

21/3/2000