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Tax Appeals Tribunal rules in favor of URA with respect to a tax dispute with NSSF involving over Ushs 42 billion on whether interest paid to members is a tax allowable expense



TAX LAW



The recent decision in the case of ***National Social Security Fund-V- Commissioner General Uganda Revenue Authority (TAT Application No.3 of 2019)*** determined the tax treatment of the interest payments made to the members of the NSSF.

In this case, an audit conducted by URA into the affairs of NSSF in 2013 for the years 2005 to 2012, revealed that NSSF claimed as an allowable deduction interest paid in respect of contributions made by its members. URA disallowed NSSF's interest deduction issuing an assessment of Ushs. 30,521,703,065 as principal tax and Ushs. 12,196,879,941 as a penalty for late payment of this tax. NSSF objected to this and URA maintained its earlier position hence the appeal to the Tax Appeals Tribunal.

Arguments/Submissions made by the Parties

NSSF contended that;

- i. It provides social security services to its members who make contributions which are invested by it and that its only source of income is its investments.
- ii. As per Section 35 of the NSSF Act, it is mandated to pay interest to its members on the contributions made and hence it incurred interest expenses.
- iii. Section 25 (1) of the Income Tax Act allowed a deduction for interest incurred during the year of income in respect of a debt obligation. NSSF has an obligation under section 19 of the NSSF Act to repay members contributions in form of benefits with interest. Henceforth, NSSF has a debt obligation since the interest payable to members for using their funds is similar to the cost of borrowing the funds.
- iv. The debt obligation (members' contributions) was incurred in production of income included in gross income because NSSF uses members'

contributions to generate income by investing the contributions and this income constitutes gross income of the NSSF.

- v. The decision to deduct the interest expense was based on the advice of the URA in its letter of 23rd August 2001 which indicated that interest to members' accounts was an allowable deduction.
- vi. Since interest paid by the NSSF to its members is a deductible expense, no penal taxes would arise.

URA in its response contended that;

- i. The interest NSSF pays out to its members is a disallowable expense as it fails to satisfy the conditions under Section 25 of the Income Tax Act that is; arising out of a debt obligation incurred by the person in the production of income included in gross income.
- ii. There is no debt obligation but rather a legal compulsion since employers and employees are compulsorily required to contribute to the NSSF.
- iii. Section 25 does not apply to NSSF given the absence of a debtor-creditor relationship but rather presence of trust and fiduciary relationship.
- iv. The interest earned by members at the end of the year is a dividend or a profit.
- v. URA is not bound by its letter of 23rd August 2001 and that its letter of 20th November 2013 disallowing the said interest as an expense took precedence over the letter in 2001.
- vi. Section 136 of the Income Tax Act provided for the imposition of penal interest on unpaid tax and that the law does not permit it to waive interest.

Decision of the Tax Appeals Tribunal

To arrive at its decision, the tribunal framed three sub issues to help it determine the contention between the parties and while citing a wealth of authorities the Tribunal decided as below.

Issue one: Whether the contributions by NSSF's members create a debt obligation within the meaning of Section 25(1) and 2(s) of the Income Tax Act?

The Tribunal found that;

- i. The intention of the legislature under Section 25 and 2(s) was to restrict the meaning of debt obligation to debts payable by a company within a short period of time (current liabilities) which is not the case with the contributions made to NSSF by its members.
- ii. The relationship between NSSF and its members is not that of a debtor-creditor but rather the NSSF has a fiduciary duty to its members and beneficiaries. Consequently, the contributions made to NSSF do not create a debt obligation within the meaning of Section 25 and 2(s) of the Income Tax Act as what is involved is a trust relationship.

Issue two: Whether the amount referred to as interest under Section 35 of the NSSF Act qualifies as interest for the purposes of Section 25(1) and 2(kk) of the Income Tax Act?

The Tribunal observed as follows;

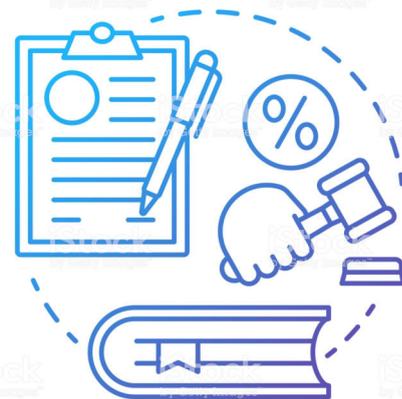
- i. The Tribunal likened the members of the NSSF to shareholders who invest in a company with the aim of obtaining a dividend in this case a return on investment which just like a dividend, is issued after all expenses have been deducted and profits taxed. For that it found that the amount referred to as interest under Section 35 of the NSSF

Act does not qualify as interest for purposes of Section 25 of the Income Tax and is therefore not a deductible expense.

- ii. On the contention that interest was allowable as per letter in 2001, the Tribunal found that in the exercise of its statutory/legal duties of collecting taxes, URA cannot be fettered by its letter of 23rd August 2001 in other words, the letter cannot be relied upon to legalize an illegality.

Issue three: Whether the applicant should pay penal interest?

In the strict sense of the provisions of Section 136 of the Income Tax Act, the Tribunal found that NSSF was liable to pay principal tax of Ushs. 30,521,703,065 and penal interest of Ushs. 12,196,879,941 for the assessed period between 2005 and 2012 totaling up to Ushs. 42,718,583,006.



Tax law

Key issues to note and implications from the decision

The decision sets forth a fundamental principle on the tax treatment of interest expenses paid to members of the NSSF.

Below we summarize the key points notable from the decision.

- ✓ Interest payments made by NSSF to its members is not an allowable expense as per the decision and reasoning of the tribunal indicated above; therefore NSSF is required to factor this in when it's accounting for the taxes due and payable.
- ✓ Exercise of statutory powers and duties cannot be overridden by a letter or by the Principle of legitimate expectation. In this case, NSSF could not rely on the letter in 2001 to restrict the duties of URA of collecting taxes where it is due. In other words, the principle of legitimate expectation fails where it overrides the statutory powers of a public entity such as URA and court is vested with powers to cure this. However, this retroactive change in treatment creates uncertainty on the part of taxpayers as to the extent to which guidance from URA should be relied upon. We note that safeguards to taxpayers may be found in a Private Ruling or Practice Note issued by URA where the law provides that the guidance is bidding on URA as long as the facts of the taxpayer's circumstances are consistent with what is described in the Private Ruling or Practice Note.

It is important to note that interest paid to NSSF members is a significant cost to the NSSF and if it is not tax deductible as decided by the Tribunal, the NSSF will pay

extra tax and therefore less will be appropriated to the members. A case in point is the financial year that ended June 2017 where the interest paid to members was Ushs 681 Billion and this grew to Ushs 1,100 billion in financial year that ended June 2018. With such figures (after adjusting for interest expense attributable to income from government securities which suffers withholding tax as a final tax), NSSF's liability is bound to be far greater than the 42 Billion should URA decide to assess subsequent periods (2013 to-date) given that the assessment in question only covered the years 2005 to 2012.

NSSF has through its lawyers appealed this decision to the High Court and we wait to see whether the High Court overrules or upholds the decision.

For any further insights and/or deeper discussions relating to this case and any other tax related issues, please feel free to reach out to any of our key contacts below;



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