**THE REPUBLIC OF UGANDA,**

**IN THE HIGH COURT OF UGANDA AT KAMPALA**

**(COMMERCIAL DIVISION)**

**CIVIL SUIT NO 810 OF 2015**

**STANDARD CHARTERED BANK UGANDA LTD}...................................PLAINTIFF**

**VERSUS**

**THE COMMISSIONER GENERAL**

**UGANDA REVENUE AUTHORITY}......................................................DEFENDANT**

**BEFORE HON. MR. JUSTICE CHRISTOPHER MADRAMA IZAMA**

**JUDGMENT**

**Introduction and Background**:

By way of introduction and background, the Plaintiff filed this action against the Defendant for the following declarations:

* A declaration that the assessed taxes in dispute contained in the Defendant's letter dated 12th and 15th of June, 2015, are unlawful and unenforceable against the Plaintiff.
* A declaration that the Plaintiff is mandated to provision for its bad debt provisions on the basis of the Financial Institutions (Credit Classification and Provisioning) Regulations 2005.
* A declaration that the bad debts provisions calculated in accordance with the Financial Institutions Act and Financial Institutions (Credit Classification and Provisioning) Regulations 2005 are fully deductible expenses in accordance with the Income Tax Act and the URA Practice Note.
* A declaration that the Defendant is bound by its URA Practice Note issued on 2nd November, 2001 (reference you URA/IT/PN 2/01).
* A declaration that the Bank of Uganda Circular (Circular COB/15 dated 19th of February 2007) does not override the provisions of the Financial Institutions Act or The Financial Institutions (Credit Classification and Provisioning) Regulations 2005.
* A permanent injunction prohibiting the Defendant’s servants or agents from directly or indirectly taking steps against the Plaintiff to enforce payment of the taxes assessed as contained in the letter dated 15th of June, 2015.
* General damages; and
* Costs of the suit

The letter dated 15th of June 2015 written by the Manager Manufacturing and Finance/Large Taxpayer's Office of the Defendant relates to tax returns and bad debts provisions for the year 2013. By notice of assessment the Plaintiff was assessed in an assessment dated 12th June, 2015 for Uganda shillings 13,060,998,533/=. The letter of 15th of June 2015 gave the basis of the assessment.

In the written statement of defence, the Defendant denied the claims in the plaint and averred that the Plaintiff is not entitled to any of the reliefs claimed or at all. In general, information regarding bad debts written off, bad debt provisions, and schedules for recovery of debts were requested by the Defendant from the Plaintiff and the Plaintiff availed the same. Meetings were held by the parties at which the parties aired their contentions and minutes of the meetings were taken. The Defendant rejected the Plaintiff's contentions and disallowed Uganda shillings 35,025,030,898/= claimed by the Plaintiff as allowable deductions for the reasons given by the Defendant. An additional tax worth Uganda shillings 13,060,998,533/= was assessed by the Defendant against the Plaintiff, which the Plaintiff objected to. The Defendant made an objection decision, disallowing the objection and upholding the tax assessment. The Defendant thereafter made a demand for the assessed tax and the same remains unpaid. Additionally the Defendant averred that having examined the Plaintiffs income returns and financial statements filed with the Defendant, examination disclosed that whereas the audited accounts show that a provision for bad debts was claimed at Uganda shillings 47,697,811,000/=, the income tax returns show that Uganda shillings 82,722,841,898/= was claimed as bad debts for the year 2013. The Plaintiff had claimed for and made provision for allowable deductions in excess by Uganda shillings 35,025,030,898/= in her tax returns which was erroneous.

The deductions for specific bad debts are allowed in respect of financial institutions to which the Plaintiff belongs if the bad debt is provided for in accordance with the Prudential Norms on Asset Quality for Financial Institutions/ (Bank of Uganda Prudential Regulations). The excess of Uganda shillings 35,025,030,898/= claimed by the Plaintiff ought to have been appropriated as retained earnings and as such the same fell within the reserve, and was not an allowable deduction for income tax purposes. For that reason additional tax of Uganda shillings 13,060,998,533/= was properly assessed by the Defendant. Furthermore, the Defendant avers and contends that the sum of Uganda shillings 35,25,030,898/= claimed by the Plaintiff as bad debt written off was properly disallowed by the Defendant as a deduction in establishing the Plaintiff’s chargeable income and ipso facto the adjusted tax rightly accrued and is enforceable in law.

**Representations:**

The Plaintiff is represented by Counsel Oscar Kambona appearing together with Bruce Musinguzi of Kampala Associated Advocates while the Defendant is represented by Counsel George Okello of the Legal and Board Affairs Department of the Defendant.

**Agreed Facts:**

In the joint scheduling memorandum endorsed by Counsel of the parties some basic facts are agreed. Most of the documentary evidence was also admitted by consent of the parties.

The following are agreed facts:

On 11th May, 2015 the Plaintiff availed to the Defendants its audited accounts showing that a provision for bad debts was claimed at Uganda shillings 47,697,811,000/=, while the income tax returns show that Uganda shillings 82,722,811,000/= was claimed for the bad debts for the year 2013.

The Uganda shillings 82,722,841,898/= represents specific bad debt provisions calculated under the Financial Institutions Act, 2004 and the Bank of Uganda Regulations while Uganda shillings 47,697,811,000/= was calculated in accordance with the International Financial Reporting Standards.

In compliance with the Bank of Uganda Circular dated 19th of February 2007, the Uganda shillings 47,607,811,000/= was transacted through the 2013 income statement while the access was reflected in the regulatory general credit risk reserve as an appropriation from retained earnings.

The Defendant rejected the Plaintiff submission on the mode of preparation for bad debts and disallowed Uganda shillings 35,025,030,898/= (this represents the excess of Uganda shillings 82,722,841 898/= calculated in accordance with the Bank of Uganda Regulation and Uganda shillings 47,697,811,000/= calculated in accordance with the IFRS) claimed by the Plaintiff as allowable deductions. As a result, the tax worth Uganda shillings 12,060,198,533/= was assessed by the Defendant and the Plaintiff objected to the same.

The Plaintiff's objection was disallowed. The Defendant issued an objection decision maintaining the assessment.

On 2nd of November 2001, the Defendant issued the Practice Note stating that for financial institutions, specific reserves for identified losses or potential losses are allowable as a deduction. It further stated that for this purpose in respect of financial institutions, bad debts provided for in accordance with the Bank of Uganda regulations are allowable as a deduction.

**Agreed Issues for trial:**

In the joint scheduling memorandum seven issues were agreed upon for trial of the dispute namely:

1. Whether the Plaintiff is mandated to provision for its bad debts on the basis of the Financial Institutions Act, 2004 and the Financial Institutions (Credit Classification and Provisioning) Regulations 2005 or in accordance with the International Financial Reporting Standards (IFRS), for income tax purposes?
2. Whether the bad debts provisions calculated in accordance with the Financial Institutions Act, 2004 and the Financial Institutions (Credit Classification and Provisioning) Regulations 2005 are fully deductible expenses in accordance with the Income Tax Act.
3. Whether the Bank of Uganda Circular dated 19th of February 2007 regulates the deductibility of bad debts for income tax purposes, and whether the Circular binds the Plaintiff?
4. Whether the Defendant is bound by its Practice Note issued on 2nd of November 2001?
5. Whether the sum of Uganda shillings 35,025,030,898/= was rightly claimed by the Plaintiff as an allowable deduction for income tax purposes?
6. Whether the tax assessment issued by the Defendant is valid?
7. What remedies are available to the parties?

The Plaintiff called one witness and the Defendant called one witness whereupon the court was addressed in written submissions.

**Submissions of Counsel of Parties**

Having set out the agreed facts, the Plaintiff's Counsel submitted on the agreed issues. I will consider issues numbers 1 and 2 together and resolve the rest of the issues thereafter.

1. Whether the Plaintiff is mandated to provision for its bad debts on the basis of the Financial Institutions Act, 2004 and the Financial Institutions (Credit Classification and Provisioning) Regulations 2005 or in accordance with the International Financial Reporting Standards (IFRS), for income tax purposes?
2. Whether the bad debts provisions calculated in accordance with the Financial Institutions Act, 2004 and the Financial Institutions (Credit Classification and Provisioning) Regulations 2005 are fully deductible expenses in accordance with the Income Tax Act?

On issue number 1, the Plaintiff's Counsel submitted that the general rule of thumb is that a financial institution that incurs a bad debt during the year of income is allowed to claim a deduction for the same. The dispute that arises in this case is one that relates to the provisioning for the bad debts. The Plaintiff on the other hand is mandated to present its bad debts in accordance with the Bank of Uganda regulations, while on the other hand it is also required to present its bad debts in accordance with the International Financial Reporting Standards (IFRS). Both forms of provisioning are a creature of law that the Plaintiff is mandated to comply with.

The Plaintiff's Counsel submitted that based on the law, in determining whether a person is entitled to a bad debt deduction, one has to fulfil the test in section 24 of the Income Tax Act (sometimes referred to as the ITA). According to section 24 (1) of the Income Tax Act, it is provided that subject to subsection (2), "a person, is allowed a deduction for the amount of the bad debt written off in the person’s accounts during the year of income." The Income Tax Act further defines what amounts to a bad debt. This is under section 24 (a) (ii) which provides that a bad debt means: "in relation to a financial institutions, a debt in respect of which a loss reserve held against presently identified losses or potential losses, and which is therefore not available to meet losses which subsequently materialised, has been made;"

The Plaintiff's Counsel submitted that save for defining what amounts to bad debt, the ITA further sets conditions for grant of a bad debt deduction. Section 24 (2) (b) of the ITA provides that a taxpayer, and specifically a financial institution, is entitled to a bad debt deduction. It provides that "if the amount of the debt claim was in respect of money lent in the ordinary course of a business carried on by a financial institution in the production of income included in gross income; or…"

The Plaintiff's Counsel submitted that it is not in doubt that the Defendant’s witness DW1 confirmed that the Plaintiff is a financial institution and that in fact it incurred a bad debt provision as a result of lending money to its clients during the ordinary course of business. According to the Plaintiffs witness PW1, the provisions in contention fall within the meaning of section 24 (a) (ii) of the ITA because the debt it provisioned for was a loss reserve held against presently identified losses or potential losses made against specifically identified non-performing debts. She contended that on this basis alone, the Plaintiff is entitled to claim a bad debt deduction.

In an effort to offer guidance, on 2nd November, 2001, the Defendant issued a Practice Note to all financial institutions providing for circumstances under which they could be allowed to make a claim for bad debt deductions. Specifically, under paragraph 2 (b) of the Practice Note it is provided that:

"For financial institutions, specific results for identified losses or potential losses are allowable as a deduction. For this purpose is in respect of financial institutions, bad debts provided for in accordance with the Bank of Uganda Regulations are allowable as a deduction." [Referred to Prudential Norms on Asset Quality for Financial Institutions – paragraph 12 (1) to (6)].”

The Plaintiff's Counsel submitted that in the above Practice Note, the Defendant clearly stated that the Plaintiff was entitled to claim a deduction for bad debts provided for in accordance with the Bank of Uganda Regulations. There are two Bank of Uganda Regulations that are crucial in the determination of how bad debts should be treated. These are the Financial Institutions Act 2004 and the Financial Institutions (Credit Classification and Provisioning) Regulations, 2005. The Financial Institutions Act is the law that regulates how financial institutions conduct their business. It also regulates the presentation of financial records of financial institutions. It empowers the Bank of Uganda to make regulations governing bad debt provisions. In particular according to section 131 (a) of the Financial Institutions Act, it is provided that: the Central Bank may in consultation with the Minister make regulations prescribing Prudential Norms on Asset Quality, including bad debt provisions and write offs. In accordance with its powers, the Bank of Uganda formulated the financial institutions (Credit Classification and Provisioning) Regulations, 2005. Regulations 10 and 11 prescribe specific subjective and objective criteria for identifying and classifying non-performing credit facilities and the basis for calculating specific bad debt provisions. This requires a financial institution to classify and calculate specific bad debt provisions according to 3 categories namely substandard, doubtful and loss. Regulation 11 (1) provides that financial institutions shall maintain specific provisions for all non-performing credit facilities, and under regulation 11 (8) this is required to be carried out and reported to the Bank of Uganda on a quarterly basis. It imposes a statutory requirement which the Plaintiff must comply with.

The Plaintiff's Counsel submitted that in the year 2013, the Plaintiff prepared its books of accounts in accordance with the above Bank of Uganda Regulations. As a result, the Plaintiff had bad debts totalling to Uganda shillings 97,167,728,952/= for 2013. Out of these the Plaintiff claimed Uganda shillings 82,722,841,898/= as a bad debt deduction. This was calculated in accordance with the regulations issued by the Bank of Uganda and the Plaintiff is entitled to claim them as a deduction.

The Plaintiff's Counsel submitted that the assessments arose from the fact that the Plaintiff calculated its bad debt provision on the basis of the Bank of Uganda Regulations which resulted in a specific bad debt provisioning amounting to Uganda shillings 82,722,841,898/=. However the Defendant insisted on calculating the bad debt provisions in accordance with the IFSR which result in a bad debt provision worth Uganda shillings 47,697,811,000/=. The Defendant insisted that the difference between the IFSR and the FIA is Uganda shillings 32,025,030,898/= which is taxable.

The Plaintiff's Counsel submitted that as far as financial institutions are concerned, the Bank of Uganda Regulations takes precedence and therefore should be used as the yardstick for determining bad debts. Under section 133 of the FIA, it is provided that: "for the purposes of any matter concerning financial institutions, this Act shall take precedence over any enactment and in the case of conflict, this Act shall prevail."

The Bank of Uganda Regulations take precedence and it is even more specific when it comes to preparation of annual accounts. The Plaintiff is mandated to prepare its annual accounts in conformity with the Bank of Uganda Regulations and regulation 75 of the FIA provides as follows:

"The Central Bank shall, before annual accounts of the financial institution are finalised, dividends paid, and the capital requirements in sections 26 and 27 at night, required to be satisfied by the financial institution in respect of-

(a) sufficiency of provisions for bad debts;

(b) the existence and enforcement of a proper policy of non-accrual of interest on non-performing loans;

(c) amortisation of preliminary expenses, goodwill and similar expenses."

The Plaintiff's Counsel submitted that for the Plaintiff’s financial statements to be approved by the Bank of Uganda, it had to present them in accordance with the Bank of Uganda Regulations. The Plaintiff had to make provision in its books in accordance with the regulations for bad debt. The Plaintiff in the meeting the requirements of the Bank of Uganda Regulations, established a bad debt provision of Uganda shillings 82,722,841,898/=. He submitted that the bad debt provision amount of Uganda shillings 82,722,831,898/= represents the amount of bad debt that should be allowed. This would be consistent with section 24 (2) of the ITA.

**Issue number 2**

**Whether the bad debts provisions calculated in accordance with the Financial Institutions Act, 2004 and the Financial Institutions (Credit Classification and Provisioning) Regulations 2005 are fully deductible expenses in accordance with the Income Tax Act**.

The Plaintiff's Counsel reiterated submissions on issue one that the Plaintiff is mandated to prepare its financial statements in accordance with the Bank of Uganda Regulations. The Defendant issued a binding Practice Note in which it categorically mentioned that by the debts prepared in accordance with the Bank of Uganda Regulations are deductible. Paragraph 2 (b) of the Practice Note provided that:

"For financial institutions, specific results for identified losses or potential losses are liable as a deduction. For this purpose in respect of financial institutions, bad debts provided for in accordance with the Bank of Uganda Regulations are allowable as a deduction." [Refer to put the insurance norms on asset quality for Financial Institutions – paragraph 12 (1) to (6)]

Counsel reiterated submissions that Bank of Uganda has power to make regulations regarding the provisioning of bad debts. Specifically, under section 131 (a) of the FIA, it is provided that the central bank, in consultation with the Minister, may make regulations prescribing Prudential norms on asset quality, including bad debt provisions and write-offs.

A similar case had been decided previously by the tribunal in the case of **Bank of Baroda (U) Ltd vs. URA Application No. TAT 1 of 2001**, in which the tribunal found that bad debts calculated in accordance with the Bank of Uganda probation norms were fully deductible under section 25 (now section 24). The Prudential norms in question issued as regulations under section 51 of the Financial Institutions Act 1993 were a predecessor to the current Bank of Uganda Regulations and essentially similar. Based on the decision of the tribunal, the Plaintiff is entitled to claim it's deductions for using the Bank of Uganda Regulations to calculate the provisions for the bad debt. Since the Plaintiff calculated its specific bad debt provisions in accordance with the Bank of Uganda Regulations, this resulted in amounts totalling to Uganda shillings 82,722,841,898/=. The debt was calculated in accordance with the law and is fully deductible.

The Plaintiff's Counsel further relied on the evidence elicited in cross examination of DW1 that bad debts were governed by section 24 of the ITA. Counsel submitted that there is no law that mandates that deductible bad debts should be transacted through the income statement. More so, there is no law that restricts the deduction for bad debts if the provision amount is reflected as an appropriation from retained earnings or in a regulatory reserve. It therefore submitted that the basis for the rejection of the bad dated is not the law and should be discarded.

**REPLY OF THE DEFENDANT ON ISSUES NUMBERS 1 AND 2**

In reply, the Defendant’s Counsel submitted that it was necessary to highlight and emphasise that the Plaintiff’s tax returns lodged for the period 2011 to 2013 with the Defendant showed unprecedented 108% increase in the total impairment on loans, from Uganda shillings 7,012,041,000/=, in 2011 to Uganda shillings 82,722,841,898/= in 2013. This generated the Defendant’s interest because the Plaintiff had never done it before. The increased amount was calculated to benefit the Plaintiff. Had it bypassed the Defendant's eye, giving astronomical tax benefits to the Plaintiff and loss to the Republic of Uganda as the amount would have been deducted as expenditure, without any legal basis.

The Defendant’s Counsel contended that the Plaintiff was in effect claiming huge bad debt provisions, determined in accordance with the provisions of the Financial Institutions Act, and not the International Financial Reporting Standards (IFRS), as the Defendant had hoped and which is supported by the Plaintiff's past conduct as well as the conduct of other local banks within Uganda. The Plaintiff re-engineered a way of arriving at provisions for bad debts and claimed in excess by Uganda shillings 35,025,030,898/= as provisions for bad debts. The Defendant did not succumb easily but found strength under the Income Tax Act and the Bank of Uganda Laws and Regulations and came to the conclusion that the excess amount cannot pass through as an allowable deduction for tax purposes. The sum total of the Defendant's rejection of the Plaintiff’s claim is that the Corporation tax assessment imposed on Uganda shillings 35,025,030,898/= plus penalties and interest coming to a tax of Uganda shillings 13,060,998,532/= is now overdue for payment.

As far as the first issue is concerned, it does not require court to determine whether the Plaintiff is entitled to claim for bad debts. The Defendant’s Counsel emphasised that it is not the dispute and the dispute is about the process to be applied in arriving at the bad debt amount. The answer to the question has a final effect on the amount of bad debts deductible. The question as designed helps the parties to know how to arrive at the bad debt amount for purposes of income tax deductions. However the Plaintiff's submission ignores this and mixes up the aspect for "provisioning" for bad debt with "entitlement to bad debt". The application of section 24 of the Income Tax Act is with respect erroneously made by the Plaintiff. The section guides on the conditions for entitlement to, and how to prepare/make bad debts. A cautious approach ought to be taken in resolution of the controversy.

The parties are not saying that bad debts have not been recognised by the Defendant but ask the question of how much? The how much is dictated by the method either party took in calculating the bad debt. Should it be done under the FIA or the IFRS or both? The Plaintiff's case is that it prepares the bad debts in accordance with the Bank of Uganda Regulations and the IFRS. PW1 testified that the amount of bad debt provisions calculated in accordance with the Bank of Uganda Regulations exceeded that under the IFRS. The dispute is therefore about the difference between what is prepared in accordance with the two methods. Is it deductible also? In the present case the Defendant only allowed Uganda shillings 47,697,811,000/= but the Plaintiff wanted the claim of Uganda shillings 82,722,841,898/=. This is the difference of Uganda shillings 35,025,030,898/= which the Plaintiff wants to be allowed as part of a further deduction over and above the Uganda shillings 47.6 billion. That amount was recorded in the reserve and rightly so as retained earnings. The Defendant argued that in accordance with the Bank of Uganda Circular exhibit PE 8 paragraphs 4 and paragraph 8 the difference is appropriated as retained earnings and is therefore not deductible. The Circular has not been challenged by either party. The contention of the Defendant is that for the difference to be deducted, it is not a loss and that is not in the profit and loss account but is in the reserves (as retained earnings). The Plaintiff on the other hand the wants the amount taken to the reserves as retained earnings to be allowed as a further deduction. What then would be the retained earnings?

The Defendant’s Counsel relied on www.businessdictionary.com for the definition of 'retained earnings' as "profits generated by a company that are not distributed to stockholders (shareholders) as dividends but are either reinvested in the business or kept as a reserve for specific objectives (such as to pay off a debt or to purchase the capital asset". The dictionary further expounded that retained earnings are reduced by losses. Consequently in balance sheet figure under the retained earnings would be the sum of all profits retained since the company's inception. The question was whether if the difference is retained earnings, it is still a bad debt and deductible? The answer is no because using the IFRS as explained by the witness, the IFRS method determines the recoverable amount raised on the present value of cash flows, taking into account the value of the security provided. The IFRS method now (GAAP) approach is in consonance with section 40 (1) of the ITA which stipulates that a taxpayers method of accounting shall conform to generally acceptable accounting principles.

The treatment of the difference arrived at using the two methods should be in line with section 40 of the ITA which in effect means that the deference should be treated as retained earnings, as buttressed by the Bank of Uganda Circular . If the Circular had placed it in the profit and loss account, perhaps the Plaintiff's contention could have attracted some lenience. The Plaintiff was not justified why it thinks that what should be in the reserves should be treated differently. She has to strictly prove this and failed to do so. As held in **Crane Bank Ltd vs. Uganda Revenue Authority Civil Appeal Number 96 of 2002**, tax exemptions must be construed *strictissimi juris* against the entity claiming the same. The law does not look with favour on tax exemptions and that he who would seek to be this privileged must justify it by words to claim to be mistaken and so categorical to be misinterpreted (see **Uganda Revenue Authority vs. Siraje Hassan Kajura Court of Appeal Civil Appeal Number 26 of 2013**).

The Defendant’s Counsel further submitted that section 24 of the ITA is largely irrelevant to the dispute because the court is not dealing with deductibility of bad debt per se for income tax purposes, but whether what goes to the reserves as retained earnings is equally deductible as bad debts. The only bit of the section that is opposite is the definition of bad debts. Bad debts is defined to mean a debt claim in respect of which the person has taken all reasonable steps to pursue payment and which the person believes will not be satisfied. In relation to a financial institution, a debt in respect of which a loss reserve held against presently identified losses or potential losses and which is not available to meet losses which subsequently materialise, has been made. (Section 24 (3) of the ITA refers). The bad debt must appear in the profit and loss account asset or loss account according to the definition.

The Defendant’s Counsel submitted that in light of the above, there is a need to answer the following is pertinent questions. Was a loss reserve created in the present case? If so, could the 35 billion (among other amounts) be said to have been envisaged by the creation of the loss reserve, even when the amount is retained earnings? The answer is no. The Defendant gave the Plaintiff the due bad debt allowable but the Plaintiff wanted the whole bad debts written off. The existence of the collateral meant that the Plaintiff would still recover the debt and that is why the same is viewed as profits.

The Plaintiff cited the Financial Institutions Act (FIA) 2004 and the Financial Institutions (Credit Classification and Provisioning) Regulations which also provide for treatment of bad debts. In reply the above regulations are for the purpose of monitoring of financial institutions and not guide on the treatment of difference arrived at as a result of the application of two tax methods for tax purposes. This is buttressed by, for instance, regulation 4 of the Financial Institutions (Credit Classification and Provisioning) Regulations, which provides for the objectives of the regulations. Under the said regulations, the objectives of the regulations are:

* To ensure that financial institutions are in proper compliance with the capital adequacy requirements by recognising possible impairment arising from provisions of bad debt and doubtful accounts.
* To ensure that financial institutions promptly identify their non-performing credit facilities and undertake adequate collection efforts.
* To ensure that financial institutions present balance sheet and income statements that properly reflect the financial impact of non-performing credit facilities.

The rest of the provisions of the laws are inapplicable to the issue at hand. In conclusion the Defendant’s Counsel submitted that the Plaintiff is mandated provision for how bad debts in accordance with the FIA, Bank of Uganda Regulations, IFRS (ITA), and where there is a difference in the use of the two methods, the same should be treated for tax purposes as retained earnings in line with the IFRS (GAAP) and therefore the ITA.

**In reply to issue number 2**

Whether the bad debts provisions calculated in accordance with the Financial Institutions Act, 2004 and the Financial Institutions (Credit Classification and Provisioning) Regulations 2005 are fully deductible expenses in accordance with the Income Tax Act?

The Defendants Counsel submitted that in light of the analysis of the first issue, the bad debt calculated in accordance with the FIA and the Financial Institutions (Credit Classification and Provisioning) Regulations 2005 are not fully but are partially deductible expenses for income tax purposes.

In light of the nature of the current dispute, the issue is not that Uganda shillings 35,025,030,898/= contested was calculated in accordance with the FIA and the 2005 regulation, but rather, that the amount is the result of the application of the FIA and the 2005 Regulations on the one hand, and the ITA (IFRS) on the other hand. The question is whether the difference created as a result of the two methods is deductible under the Income Tax Act (section 24 thereof). The clarification makes the second issue as framed superfluous, because from the pleadings, the dispute is not that the Uganda shillings 35 billion rejected by URA as a deduction was calculated in accordance with the FIA and the 2005 Regulations (not warranting the issue as framed above). This calls for amendment of the second issue under Order 15 rule 5 of the Civil Procedure Rules, which allows the court to amend the issues on such terms as it thinks fit, as may be necessary for determining the matters in controversy between the parties.

With reference to the case of **Bank of Baroda (U) Ltd vs. URA** (supra) the case did not deal with the kind of issue as in this suit. The treatment of the amount arrived at as a result of the use of the two rival methods was not canvassed. In the foregoing case, URA had disallowed provision for bad debts because the applicant had not carried out reasonable recovery measures before writing off the bad debts, which is not the case here.

In conclusion the Defendants Counsel submitted that with the modification and clarification of the issue, the court should answer that the amount credited as a result of the difference in the two methods is not deductible as a bad debt under the ITA, because the same is profit.

**In rejoinder the Plaintiff's Counsel submitted as follows:**

Counsel for the Defendant made certain critical admissions which ought to be mentioned. The first one is that the question is not whether the Plaintiff is entitled to claim for bad debts. That is not in dispute. In other words bad debts are deductible. The Plaintiff's Counsel submitted that his admission is critical because the total amount of Uganda shillings 82,722,841,898/= contained in the Plaintiffs tax returns for 2013 were in fact bad debts and the Defendant admits that they are deductible, it follows that the tax of Uganda shillings 13,060,998,533/= is not due and payable.

Furthermore the Defendant admitted that the Plaintiff has the mandate to make provision for bad debts in accordance with the FIA and the Bank of Uganda Regulations. This was a critical admissions because it has been the Plaintiffs contention all along that the total debt provision of Uganda shillings 82,722,841,898/= was written off in accordance with the FIA and Bank of Uganda Regulations. The amount of bad debt provisions calculated in accordance with the Bank of Uganda Regulations exceeded that under the IFRS. The Plaintiff contends that in accordance with section 24 of the ITA, a person is entitled to deduction for any bad debt written off during the persons accounting year.

Thirdly, the Practice Note issued by the Defendant on 2nd November, 2001, is binding upon the Defendant. The Plaintiff's Counsel contended that this was a critical admission and helps to resolve the matter in contention. The crux of the matter is that under section 24 (1) of the ITA, a person is allowed a deduction from the amount of the bad debt written off in the person’s accounts during the year of income. The Plaintiff's Counsel relied on section 24 (2) (b) of the ITA which he contended clearly applied to the Plaintiff and the debt claims question. The Practice Note issued by the Defendant is still valid and binding specifically it provides as follows:

"For financial institutions, specific reserves for identified losses or potential losses are allowable as a deduction. For this purpose in respect of financial institutions, bad debts provided for in accordance with the Bank of Uganda Regulations are allowable as a deduction."

The Plaintiff's Counsel contended that this resolves the dispute because the Plaintiff (as submitted by the Defendant) provided for the bad debts totalling Uganda shillings 82,722,841,898/= in accordance with the Bank of Uganda Regulations and therefore the full amount is deductible. Therefore the total amount falls squarely within the wording of section 24 and the Practice Note and is an allowable deduction in full.

With specific reference to other submissions of the Defendant, the Plaintiff's Counsel contended that the Defendant submitted that in accordance with the Bank of Uganda Circular , the difference between the figure calculated in accordance with the Bank of Uganda Regulations and IFRS amounting to Uganda shillings 35,025,030,898/= is appropriated as retained earnings and is not deductible. He contended that this is not correct because the Plaintiff’s witness correctly testified and explained that the Bank of Uganda Circular was issued to commercial banks in February 2007 to resolve a practical accounting issue arising from the difference between bad debts provisions calculated under the Bank of Uganda Regulations and those calculated under the IFRS. Paragraph 4.0 of the Circular outlined the specific issue in relation to impairment losses (i.e. bad debt provisions) and concludes as follows:

"4.6 Financial Institutions should continue assessing the impairment losses of their financial assets on a quarterly basis as this has been the practice under the Bank of Uganda Regulations".

This made it clear that the banks are still required to calculate their specific bad debt provisions in accordance with the rules prescribed in the Bank of Uganda Regulations and particularly regulation 11 thereof. Paragraph 4.7 of the Bank of Uganda Circular merely deals with the accounting presentation of the excess in the annual financial statements. It does not affect the basis of which the Bank of Uganda specific bad debt provisions are calculated nor does it permit a financial institution to calculate such provision on a low IFRS basis. Furthermore, it does not address the deductibility of bad debt provisions for income tax purposes. This further explains the misunderstanding which is apparent from the Defendant's submission. The Defendant seemed to imply that once the excess between IFRS and Bank of Uganda Regulations is taken to the retained earnings, it ceases to become a bad debt. The Plaintiff's Counsel contended that this was not correct because it remains a bad debt and this is merely dealing with the accounting presentation of the excess. Furthermore, regardless of whether the specific bad debt provisions are reflected in the income statement or in the regulatory reserve, the economic impact on the financial institution is the same. Firstly, the bank suffers an equivalent reduction in its distributable profits. In other words, the amount of retained earnings is reduced in the same way as if the entire amount had gone directly through the income statement. Lastly, the bank suffers an effective reduction in the value of its loan portfolio via the offset of the regulatory reserve.

Accordingly the Plaintiff's Counsel maintained that there is no statutory support for a specific bad debt provision falling within section 24 of the ITA to be treated as non deductible solely on the basis that for accounting purposes, it has been reflected in the regulatory reserve rather than in the income statement.

The Defendant relied on the case of **Crane Bank Ltd vs. Uganda Revenue Authority** (supra) to expound the notion that the law does not look with favour on tax exemptions. The court however is not dealing with a tax exemption nor is the Plaintiff seeking any privilege. The issue before the court is the provision of section 24 of the ITA and its applicability to the facts in issue. Tax exemptions are dealt with by section 21 of the ITA which is inapplicable and therefore the case of **Crane Bank Ltd vs. Uganda Revenue Authority** (supra) is irrelevant.

On the question of whether issue number two should be amended under the provisions of Order 15 rule 5 of the Civil Procedure Rules, this was unnecessary. Both parties agreed on the issues at the scheduling conference without raising any complaint. The issue as framed is irrelevant because it seeks to ascertain whether the bad debts provisions calculated in accordance with the Financial Institutions Act 2004 (FIA) and the regulations are fully deductible expenses in accordance with the ITA. In the premises, the issue should be maintained and are resolved in the affirmative.

In conclusion the Plaintiff’s Counsel submitted in rejoinder that the court should enter judgment for the Plaintiff because the basis for the bad debt reduction is fully supported by the specific provisions of section 24 of the ITA, the Practice Note and the case law. There is no provision in the tax legislation, the Practice Note or case law that either imposes a condition that the bad debt provision must be transacted through the income statement in order to be deductible or restricts the deduction in the provisions reflected as an appropriation from retained earnings or in a regulatory reserve. What is clear and undisputed is that bad debts are deductible under section 24 of the ITA and the total amount of Uganda shillings 82,722, 841,898/= which falls squarely within the wording of section 24 and the Practice Note and therefore the tax of Uganda shillings 13,060,998,533/= is not due and payable. In the premises this court should be pleased to vacate the assessment for the said amount with costs to the Plaintiff.

**Judgment**

**Resolution of issues number 1 and 2.**

1. **Whether the Plaintiff is mandated to provision for its bad debts on the basis of the Financial Institutions Act, 2004 and the Financial Institutions (Credit Classification and Provisioning) Regulations 2005 or in accordance with the International Financial Reporting Standards (IFRS), for income tax purposes?**
2. **Whether the bad debts provisions calculated in accordance with the Financial Institutions Act, 2004 and the Financial Institutions (Credit Classification and Provisioning) Regulations 2005 are fully deductible expenses in accordance with the Income Tax Act.**

I have duly considered the above two issues. The two issues are intertwined because one deals with the method for assessment of tax and the other deals with a point of law which is the crux of the Plaintiff’s appeal to resolve the issue as to whether the assessment, the subject of the appeal, is unlawful.

I have carefully considered the Plaintiff’s suit according to the pleadings which have been set up at the beginning of this judgment as well as the written statement of defence and the controversies arising out of the pleadings of the parties under Order 15 rules 1 and 2 of the Civil Procedure Rules. Order 15 rule 2 of the CPR clearly provides that: *"Where issues both of law and fact arise in the same suit and the court is of the opinion that the case or any part of it may be disposed of on issues of law only, it shall try those issues first, and for that purpose may, if it thinks fit, postpone the settlement of the issue of fact until after the issues of law have been determined*."

The primary complaint of the Plaintiff arises from the Defendant's assessment dated 12th June 2015 and covering letter dated 15th June, 2015. The letter of 12th June, 2015 is an assessment notice assessing the Plaintiff for an amount of **Uganda shillings 13,060,998,533/=** income tax which was to be paid on the due date of 27th of July 2015. This amount comprises of Uganda shillings 10,507,509,270/= which is the total additional income tax payable as well as penalty tax of Uganda shillings 2,553,489,263/=. It is in respect of the tax period 2013. In a letter dated 15th June 2015 Irene Mbabazi Irumba, the Manager Manufacturing and Finance – Large Taxpayers Office of the Defendant wrote to the Chief Finance Officer of the Plaintiff with reference to earlier correspondence and meetings between the parties. The letter reads as follows:

"RE-: TAX RETURNS AND BAD DEBT PROVISION FOR THE YEAR 2013

Reference is made to your letter dated the 11th of May 2015 and the meeting held on 10th of June 2015 in relation to claim the provisions for bad debts for the year ending 31st of December 2013.

Examination of the filed income tax returns and the financial statements show that whereas the audited accounts show claimed provisions for bad debts of shillings 47,697,811,000/=, the income tax return show claimed provisions for bad debts for 2013 shillings 82,722,841,898/= leading to an excess claimed deduction of Uganda shillings 35,025,030,898/=.

In the above-mentioned meeting the excess deduction was explained as being the computed provisions for bad debts arising from different requirements of the Financial Institutions Act and the IFRS.

In view of the above explanation, we wish to draw your attention to URA Practice Note Number URA/IT/PN 2/01 on the deductions of bad debts that indicate that specific bad debts are provided for in accordance with the Bank of Uganda Regulations i.e. Prudential Norms on Asset Quality for Financial Institutions are allowable deductions.

Further to the above, Circular COB/15 issued by Bank of Uganda provides in paragraph 4.7 that **"in circumstances where loans losses arrived at using Bank of Uganda Regulations is higher, the difference would be accounted for as an appropriation of retained earnings"** Bank of Uganda confirmed that the Circular forms part of the Bank of Uganda Regulations and hence the excess provisions are accounted for as an appropriation of retained earnings. The implication of this is that specific provisions that go through the income statement are allowable deductions, while the specific provisions that go through the reserves are not allowable deductions for income tax purposes.

In view of the above, claimed excess provisions for bad debts of shillings 35,025,030,898/= for the year 2013 that did not go through the income statement have been disallowed.

Additional tax arising from the above adjustment is shillings 13,060,998,533/=, as per the attached detailed workings. Please arrange to pay the identified tax to avoid accumulation of interest on outstanding amount.

Yours faithfully…"

In paragraph 4 (v) of the written statement of defence, it is averred that the Defendant made an objection decision, disallowing the objection and upholding the tax assessment. The objection decision is admitted as exhibit PE 11 in the joint scheduling memorandum of the parties. Date of the objection is 23rd of July 2015 while the date of the objection decision is 21st of October 2015. The objection decision notice indicates that the objection was disallowed. The grounds for disallowance of the objection are not included. The suit was filed on 4th of December 2015. Section **100** of the **Income Tax Act Cap 340** laws of Uganda 2000 provides that a taxpayer dissatisfied with an objection decision may at the election of the taxpayer appeal the decision to the High Court or apply for review of the decision to Tax Tribunal established by Parliament by law for purposes of settling tax disputes in accordance with article 152 (3) of the Constitution. Specifically section 100 (4) of the Income Tax Act provides that an appeal to the High Court may be made on questions of law only. It reads as follows:

"(4) An appeal to the High Court under subsection (1) may be made on questions of law only and notice of appeal shall state the question or questions of law that will be raised on appeal."

An appeal to the High Court shall be on questions of law only. Specifically the appeal is from an objection decision and at the election of the taxpayer whether to proceed before the Tax Appeals Tribunal for review of the decision or appeal to the High Court on questions of law. The procedure for commencing an appeal in the High Court is by lodging a notice of appeal with the registrar of the High Court within 45 days after service of the notice of objection decision (see section 100 (2) of the ITA).

While the suit was commenced by way of a plaint contrary to section 100 (2) of the ITA, the Defendant did not object to the procedure adopted and the issue is one of form and not substance (See **Saggu vs. Roadmaster Cycles (U) Ltd [2002] 1 EA 258** in that case the Court of Appeal of Uganda following other precedents in effect holds that irregularities in form which do not go to jurisdiction do not render the suit a nullity). The Defendant filed a written statement of defence answering the questions of law that are disclosed in the plaint. The questions of law are reflected in the declarations sought under paragraph 3 of the plaint. As a matter of legal doctrine, the High Court can only decide points of law on appeal from an objection decision arising from an assessment for income tax under the Income Tax Act and consequential objection decision. For that reason, it is only the points of law which are disclosed that may be handled by this court and not factual controversies relating to the amounts etc except where a question of principle is involved. Points of law cannot however arise out of the blue without reference to the facts. The facts are primarily not in dispute and the relevant material facts are contained in the joint scheduling memorandum of the parties. The relevant facts are also contained in the letter of the Defendant dated 15th of June 2015 and admitted in evidence as exhibit P5. Exhibit P6 is the notice of assessment dated 12th of June 2016 while the notice of objection decision is exhibit P 11.

In the letter dated 15th June, 2015 and which gave rise to this controversy and is admitted in evidence as exhibit P5, issues number 1 and 2 are covered. I have extensively quoted exhibit P5 relating to the tax returns for the year 2013. While it is not in dispute that bad debts are deductible or allowable for income tax purposes as a deduction, the controversy arises out of an excess amount which the Plaintiff claimed as a deduction of Uganda shillings 35,025,030,898/=. The excess deduction was considered as the computed provisions for bad debts arising from different requirements of the Financial Institutions Act and the IFRS. According to the Defendant under the URA Practice Note Number URA/IT/PN 2/01 on deductions of bad debts, specific debts are provided for in accordance with the Bank of Uganda Regulations i.e. Prudential Norms on Asset Quality for Financial Institutions are allowable deductions. The Defendant also noted in the letter of 15th June, 2015 quoted above that further to the Circular COB/15 issued by Bank of Uganda , it is provided in paragraph 4.7 that "in circumstances where loan losses arrived at using Bank of Uganda Regulations is higher, the difference will be accounted for as an appropriation of retained earnings. According to the Defendant the implication is that specific provisions that go through the income statement are allowable deductions while specific provisions that to go through the reserves are not allowable deductions for tax purposes. The conclusion was that the excess provisions for bad debts of Uganda shillings 35,025,030,898/= for the year 2013 that did not go through the income statement were disallowed.

As a matter of fact the alleged excess amount is the difference between using the Bank of Uganda Regulations which gives a higher amount than the IFRS. The Bank of Uganda Regulations is consonant with the Financial Institutions Act. The difference between the two methods gives rise to the amount in controversy. That difference is supposed to be accounted for as an "appropriation of retained earnings". In other words it is not included in the income statement. For the moment there is no controversy about the fact that the assessment relates to the amount of Uganda shillings 35,025,030,898/= which is the difference between 82,722,841,898/= and Uganda shillings 47,697,811,000/=. As far as the amounts are concerned the Defendant's argument is that the amount of Uganda shillings 35,025,030,898/= which was supposed to be an appropriation of retained earnings in the reporting ought not to have been deducted. It is further not in dispute that it is a bad debt. The difference merely arose from the reporting instruction which is to the effect that where the loan losses arrived at using Bank of Uganda Regulations is higher, the difference, would be accounted for as an appropriation of retained earnings. In other words where the loan losses which can be translated as the bad debt arrived at using the Bank of Uganda Regulations is higher than that using the IFRS method, the difference between the two amounts will be accounted for as an appropriation of retained earnings.

For further clarity on the point, the IFRS method leads to a bad debt charge of Uganda shillings 47,697,811,000/= while the Bank of Uganda method leads to a bad debt provision of Uganda shillings 82,722,841,898/=. There is no controversy about the fact that the stated amounts relate to bad debt provisions for the year 2013 or fall in the category of bad debt provisions. The difference in methodology and the different results are not controversial and the court is not required to determine which methodology is more consistent with the Income Tax Act section 24 thereof. There was no attempt to explain the rationales for the two methodologies in calculating bad debt provisions. I must emphasise that the controversy is complex because it determines the basis for calculating loss or a bad debt in a year of income which controversy does not directly answer the question of whether for a particular year of income there was a profit or loss on the basis of the fact and not accounting principles. The accounting principles deal with reporting of the income status and other matters for purposes of the Central Bank while reporting income for purposes of the Income Tax Act can be separate and severable from the purpose of the Financial Institutions Act.

Lastly, I need to emphasise the point that the High Court handles questions of law and does not go into matters of fact. That mere fact generates a complex situation because the two methods used were not interrogated for consistency with the Parent Act and section 24 of the ITA that deals with the Income Tax Matters. Section 18 (4) of the Interpretation Act Cap 3 Laws of Uganda 2000 expressly provides as follows:

"Any provision of a statutory instrument which is inconsistent with any provision of the Act under which the instrument was made shall be void to the extent of the inconsistency."

The matters concerning income tax ought to be handled under the Income Tax Act and regulations made there-under and not a separate enactment. The rationale for accounting methods adopted should not depart from the rationales under the Income Tax Act. A statutory instrument cannot amend or override the provisions of the Parent Act. Secondly there are two enactments which were referred to in the course of submissions on the points of law raised in this appeal. The first enactment is the Financial Institutions Act 2004 which deals with the reporting of income for accounting purposes and for the objectives of that Act of Parliament. The second Parent Act is the Income Tax Act Cap 340 (the ITA). Counsel for the parties and the witnesses used the Financial Institutions Act 2004 for accounting and reporting purposes and the Income Tax Act and particularly section 24 thereof which deals with the bad debts as well as the Practice Note issued under the ITA.

The obvious question is whether reporting income under the Financial Institutions Act 2004 can be considered on the same footing as reporting or assessing income for tax purposes under the Income Tax Act. Furthermore, two authorities are concerned with the issue of classification of bad debts. Under the Financial Institutions Act 2004, reporting is made to the Central Bank/Bank of Uganda while under the Income Tax Act it is made to or income assessed by the Commissioner Uganda Revenue Authority.

Without first making reference to the method adopted by the Plaintiff in reporting income for tax purposes, it is obligatory for every taxpayer under section 92 of the ITA to furnish a return of income for each year of income of the taxpayer. Thereafter or at any time, the Commissioner based on the taxpayers return of income and any other information available, will make an assessment of the chargeable income of the taxpayer and the tax payable on it for a year of income within five years from the date the return was furnished under section 95 of the ITA. Where the Commissioner is not satisfied with the return of income for a year of income furnished by a taxpayer, the Commissioner may according to the Commissioner's best judgment, make an assessment of the chargeable income of the taxpayer and the tax payable thereon for that year (see section 95 (2) of the ITA). Where an assessment has been made, the taxpayer may object to the assessment as happened in this case. Under section 92 (2) of the ITA a return of income shall be in the form prescribed by the Commissioner and shall state the information required and shall be furnished in the manner prescribed by the Commissioner.

It is not in controversy that there was an assessment of the Plaintiff by the Commissioner and the Plaintiff objected to assessment and this dispute primarily relates to the method used by the Plaintiff which is at variance with the method used by the Defendant in arriving at what is deductible in terms of bad debts.

A bad debt is deductible under section 24 of the ITA. Section 24 of the ITA also defines what a bad debt is. It provides as follows:

24. Bad debts.

(1) Subject to subsection (2), a person is allowed a deduction for the amount of a bad debt written off in the person’s accounts during the year of income.

(2) A deduction for a bad debt is only allowed—

(a) if the amount of the debt claim was included in the person’s income in any year of income; or

(b) if the amount of the debt claim was in respect of money lent in the ordinary course of a business carried on by a financial institution in the production of income included in gross income.

(c) If the amount of the debt claim was in respect of a loan granted to any person by a financial institution for the purpose of farming, forestry, fish farming, bee keeping, animal and poultry husbandry or similar operations.

(3) In this section—

(a) “bad debt” means—

(i) a debt claim in respect of which the person has taken all reasonable steps to pursue payment and which the person reasonably believes will not be satisfied; and (ii) in relation to a financial institution, a debt in respect of which a loss reserve held against presently identified losses or potential losses, and which is therefore not available to meet losses which subsequently materialise, has been made; and

(b) “debt claim” means a right to receive a repayment of money from another person, including deposits with financial institutions, accounts receivable, promissory notes, bills of exchange and bonds.”

The taxpayer is allowed a deduction for the amount of the bad debt written off in the person's account during the year of income as specified in section 24 (2) of the ITA. A deduction can only be allowed if the conditions stipulated under section 24 (2) of the ITA are fulfilled. The first condition is if the amount of the debt claim was included in the taxpayer’s income in any year of income or if the amount of the debt was in respect of money lent in the ordinary course of the business carried on by a financial institution in the production of income included in gross income. The Plaintiffs case falls under section 24 (2) (b) of the ITA quoted above. Similarly section 24 (2) (c) is applicable. The classification of the transaction either in respect of money lent in the ordinary course of the business carried on by financial institution in the production of income included in gross income and in respect of a loan granted to any person by financial institution for the purposes of farming, forestry, fish farming, beekeeping, animal and poultry husbandry or similar operations is not in dispute and does not need to be inquired into. The assumption is that the bad debts involved in the controversy all fall within the provisions of section 24 of the ITA. A bad debt is further defined by section 24 (3) (a) of the ITA in terms of reasonable steps taken to pursue payment and which the person reporting reasonably believes will not be satisfied and in respect of a financial institution, it is a debt in respect of which the loss reserve held against presently identified losses or potential losses, and which therefore is not available to meet losses which subsequently materialise, has been made. A debt claim means a right to receive a repayment of money from another person, including deposits with financial institutions, accounts receivable, promissory notes, bills of exchange and bonds.

Section 24 is the subject of a Practice Note issued by the Commissioner under section 160 of the ITA. Section 160 (1) of the ITA provides that the Commissioner may issue Practice Notes setting out the Commissioner’s interpretation of the ITA. The purpose of the Practice Note is to achieve consistency in the administration of the ITA and to provide guidance to taxpayers and officers of Uganda Revenue Authority. In exhibit P4 the Commissioner on 2nd November, 2001 issued the Practice Note and item 2 thereof deals with deduction of bad debts. It provides as follows:

"2. Deduction of Bad Debts

1. For persons other than financial institutions, a bad debt is allowed as a deduction only if all reasonable steps for recovery have been taken and there is a reasonable ground that the debt will not be recovered.
2. For financial institutions, specific reserves for identified losses or potential losses are allowable as a deduction. For this purpose in respect of financial institutions, bad debts provided for in accordance with the Bank of Uganda Regulations are allowable as a deduction. [Refer to Prudential Norms on Asset Quality for Financial Institutions Paragraph 12 (1) to (6)].
3. Paragraph 12 (7) of the same Bank of Uganda Regulations provides for 1% general provisions of the total outstanding credit facilities. This 1% general provision does not satisfy the requirements of section 25 of the ITA and is therefore not deductible.
4. Any recoveries of previously written off bad debts would be treated as income and taxed in the year in which the recoveries are made."

The simple guidance of the Commissioner in the Practice Note has two faces. On the first ground for financial institutions, specific reserves for identified losses or potential losses are allowable as a deduction. The second aspect is that to determine what is allowable as a deduction, reference is made to the Bank of Uganda Regulations as to what are allowable as deduction and particularly regulation 12 (1) to (6) of the Prudential Norms on Asset Quality for Financial Institutions is applicable.

While an appeal proceeds on a point of law, the Defendants witness DW1 Irene Mbabazi Irumba, a manager in the Domestic Taxes Department in her written testimony made it clear that the controversy arose when there was a 108% increase in what was deductible in 2013 as far as the Plaintiff’s income returns were concerned. Secondly, the deduction was as the result of impairment on loans as allowable deduction for tax purposes. They established that the reason for the 108% increase was that application of the Financial Institutions Act with regard to bad debts provisions which resulted in huge provisions and consequently a huge deduction for tax purposes and therefore less tax payable. On the other hand the application of the **IFRS** which is the **International Financial Reporting Standards** resulted into a less quantum of the amounts deductible and consequently less tax payable. In paragraph 8 she testified that for the year 2013, the varied application of the two distinct methods was that the provision claimed under the FIA was Uganda shillings 82,722,841,898/= while the provision claimed pursuant to the IFRS was Uganda shillings 47,697,811,000/=. Uganda Revenue Authority applied the IFRS treatment which was the past treatment of the Plaintiff and other banks. She testified that this was supported by the Circular issued by the Bank of Uganda on 19th February, 2007 and further clarified and confirmed in a letter dated 19th March, 2009. The clarifications were annexed.

Strangely PW1 Stella Musisi, the Financial Controller of the Plaintiff relied on the Practice Note of the Defendant. In her testimony she indicated that the Practice Note makes reference to the **Prudential Norms on Asset Quality for Financial Institutions** and the relevant paragraphs quoted above. Under section 46 (4) of the FIA, the Plaintiff was supposed to ensure that its financial ledgers and other financial records are kept in accordance with both the International Accounting Standards and such other requirements as the Central Bank could make in writing. Secondly the FIA provided that the Central Bank would make regulations prescribing Prudential Norms on Asset Quality including bad debt provisions and write offs. In 2005, the Bank of Uganda promulgated the **Financial Institutions (Credit Classification and Provisioning) Regulations**. Under those regulations, the Plaintiff was mandated to classify its bad debts according to the three categories namely substandard, doubtful and loss. The regulations mandated that the Plaintiff would maintain a specific provision for all non-performing loans. Finally under section 75 of the FIA, the Plaintiff is mandated to provide its annual financial statements to the Bank of Uganda for the bank to be satisfied on the sufficiency of the Plaintiff’s provision for bad debts.

According to PW1, under the IFRS, a financial asset and impairment loss is incurred if there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset and that the loss event has an impact on the estimated future cash flows or the financial asset that can be reliably estimated. The amount of loss is measured as the difference between the asset carrying amount and the present value of estimated future cash flows discounted at the financial assets original effective interest rate. According to PW1 the difference between the IFRS and the FIA is the result of the method used to determine the impairment losses on the loans and advances. Under the FIA, the Plaintiff uses "days past due" method to make provision to its loans whereas the IFRS determines the recoverable amounts based on present value of cash flows which also puts into consideration the value of the security provided among others. Furthermore she testified that in 2007, the Bank of Uganda issued a Circular to all commercial banks regarding the difference in the accounting treatment between the FIA and the IFRS regarding impairment. It stated that the commercial banks are required to calculate their bad debts in accordance with the Bank of Uganda Regulations. Generally, PW1 testified that the accounting classification of the bad debt does not take away the fact that the bad debts already occurred. In other words it is a question of form rather than the substance.

The basis of the dispute has already been mentioned above and according to PW1 is simply that the amount of bad debts provisions calculated in accordance with the Bank of Uganda Regulations exceeded that under the IFRS. The difference between the two methods arose due to the fact that the regulatory reserve credit risk reserve contained in the excess amount as an appropriation of retained earnings. The Plaintiff’s case is that it claimed Uganda shillings 82,722,841,898/= in accordance with section 24 of the ITA, the Bank of Uganda Regulations and the Bank of Uganda Circular. According to PW1 the Defendant rejected the amount of Uganda shillings 35,025,030,898/= on the basis that the specific provision was not claimed through the profit and loss account and was instead taken through the reserves.

I have carefully considered the controversy after addressing my mind to the written submissions of Counsel as well as the evidence presented and the pleadings.

Practice Note exhibit P4 and paragraph 2 (b) is quite explicit about deduction of bad debts as far as financial institutions are concerned. It provides that specific reserves for identified losses or potential losses are allowable as a deduction. For this purpose, in respect of financial institutions, bad debts provided for in accordance with the Bank of Uganda Regulations are allowable as a deduction. Under section 160 of the Income Tax Act, the Practice Note is binding on the Commissioner and the officials of Uganda Revenue Authority. The simple question to be asked pursuant to the Practice Note is whether the bad debts are provided for in accordance with the Bank of Uganda Regulations. For this reason the Plaintiff relied on the Financial Institutions (Credit Classification and Provisioning) Regulations, 2005 Statutory Instruments 2005 No. 43 particularly Regulation 11 which deals with provision on classified credit facilities and provides as follows:

"**11. Provision on classified credit facilities**

(1) Financial institutions shall maintain specific provisions for all non performing credit facilities.

(2) All credit facilities classified as Substandard, Doubtful or Loss shall be subject to specific provisions, regardless of whether the subjective or objective criteria were used in determining classification.

(3) Specific provisions for substandard assets shall be maintained at not less than 20% of the outstanding balance of the credit facility.

(4) Specific provisions for doubtful assets shall be maintained at not less than 50% of the outstanding balance of the credit facility.

(5) Specific provisions of loss assets shall be maintained at 100% of the outstanding balance of the credit facility; the loss assets are to be written off against accumulated provisions within ninety days of being identified as loss, unless approval of the Central Bank to defer write-off has been obtained.

(6) The outstanding balance consists of principal, interest which has been capitalized and all other charges, fees and other amounts, which have been capitalized to the outstanding balance; interest in suspense may be deducted from the outstanding balance before determining the provisions.

*General provisions*

(7) In addition to specific provisions, financial institutions are required to maintain a general provision of at least 1% of their total outstanding credit facilities net of specific provisions and interest in suspense.

(8) The provisioning level shall be reviewed at least on a quarterly basis and shall be reported to the Central Bank using the forms specified in regulation 7.”

The above cited regulation 11 deals with the making of provision for non-performing credit facilities in which category falls bad debts. The question of what a bad debt is has not been the subject of controversy at all. The characterisation of a bad debt should be based on section 24 of the Income Tax Act. Secondly and notwithstanding the above, the characterisation of a bad debt also falls under the regulatory authority of the Bank of Uganda /Central Bank. The question still remains as to what a bad debt is for income tax purposes. The Plaintiff bank as a commercial bank has an obligation to keep accurate records and specifically a reference was made to section 46 of the Financial Institutions Act 2004 which provides as follows:

"46. Financial ledgers and other financial records

(1) A financial institution shall at all times keep financial ledgers and other financial records which—

(a) show a complete, true and fair state of its affairs; and

(b) explain its transactions and financial position to enable the Central Bank to determine whether the financial institution has complied and continues to comply with this Act.

(2) The financial year of every financial institution shall be the period of twelve months ending on the 31st December in each calendar year.

(3) Where the financial year of a financial institution is different from that prescribed in subsection (2), the financial institution shall, within twelve months from the commencement of this Act, change its financial year to comply with subsection (2).

(4) The financial ledgers and other financial records to which this section applies shall be kept in Uganda and shall comply with the requirements of—

(a) the Companies Act,

(b) International Accounting Standards, and

(c) such other requirements as the Central Bank may in writing prescribe.

(5) All accounting entries in financial ledgers and all financial records to be kept by a financial institution shall be kept and recorded in the English language using the system of numerals employed in Government accounts.

(6) A financial institution shall preserve the financial ledgers and other financial records referred to in this section for a period of not less than ten years.”

The use of the IFRS is presumably prescribed by section 46 (4) (b) of the Financial Institutions Act cited above because it prescribes that the Plaintiff shall comply with international accounting standards. What are these international accounting standards? However section 46 (4) (b) does not exclude any other requirement that the Bank of Uganda may prescribe for purposes of reporting under the said provision. It is merely a general provision that deals with accounting and reporting to the Bank of Uganda. It deals with general accounting standards and is not definitive on what method should be used in calculating bad debt charges. There is, however, a specific provision in the FIA which deals with bad debts. Where there is a specific provision dealing with bad debts, it is prudent to first consider what it prescribes before resorting to the general provisions of section 46 of the FIA which prescribe the duty to keep accurate accounts by Financial Institutions. In relation to bad debts, the relevant provision in section 75 of the FIA which provides as follows:

“75. Requirements on provisions

The Central Bank shall, before annual accounts of a financial institution are finalized, dividends paid, and the capital requirements in sections 26 and 27 are met, require to be satisfied by the financial institution in respect of—

(a) sufficiency of provisions for bad debts;

(b) existence and enforcement of a proper policy of non-accrual of interest on non- performing loans;

(c) amortization of preliminary expenses, goodwill and similar expenses.”

The cited provision provides that the Central Bank shall be satisfied by the financial institution about the sufficiency of provision for bad debts. Section 75 (a) of the FIA assumes that the bad debts have been disclosed in the accounting. The making of a provision for bad debts assumes that the bad debts are known. The bad debts are deemed to have been disclosed and the satisfaction of the Central Bank should be about the question of whether there was sufficient provision made for the bad debt or bad debts. The phrase "bad debt" is not defined except under section 24 of the Income Tax Act. The Practice Note exhibit P4 refers to specific reserves for identified losses or potential losses and provides that they are deductible or allowable as a deduction. Furthermore, it provides that the bad debts are allowable in accordance with the Bank of Uganda Regulations as a deduction. The conclusion is that the only conclusive definition of a bad debt for income tax purposes is that found under section 24 of the Income Tax Act.

As earlier on written in this judgment, any provision of a statutory instrument which is inconsistent with any provision of the Act under which the instrument was made shall be void to the extent of the inconsistency according to section 18 (4) of the Interpretation Act Cap 3 laws of Uganda 2000. In this particular case, the definition of a bad debt cannot be taken from another statute but should be based on the parent Act which is the ITA. Furthermore, the provisioning for bad debts under the FIA is for purposes of the Central Bank and not for income tax purposes. Secondly it is a methodology for purposes of the Act.

A bad debt is clearly defined under section 24 (3) (a) of the ITA. A bad debt means:

“ ...

1. “bad debt” means—

(ii) in relation to a financial institution, a debt in respect of which a loss reserve held against presently identified losses or potential losses, and which is therefore not available to meet losses which subsequently materialise, has been made”

A bad debt in the context means a debt in respect of which a loss reserve held against presently identified losses or potential losses, and which is therefore not available to meet losses which subsequently materialise, has been made. Contrary to the Defendant's submissions, it includes loss reserves for accounting purposes. For that reason I agree with the interpretation of PW1, the Financial Controller of the Plaintiff that a person is entitled to a deduction for bad debt written off during the persons accounting year. According to exhibit P4 which is the Practice Note issued by the Commissioner, where that debt is recovered in a subsequent year, it would be included as income that is taxable in the year in which the recovery has been made.

Finally I have duly considered the written submissions of the Defendant’s Counsel and the controversy is as follows:

1. Whether a bad debt is fully or partially deductible?
2. The Plaintiff wants the whole bad debt allowed as a deduction for purposes of establishing the taxable income.
3. Whether a bad debt must appear in the profit or loss account for it to be allowed as a deduction?
4. The narrower and overarching issue is whether bad debts which are reported as retained earnings and reported in the reserves for accounting purposes to Bank of Uganda is allowable as a bad debt deduction?

In conclusion on issues 1 and 2, it is established from the Practice Note which has the interpretation of the Commissioner General URA that what is retained as a reserve from bad debts is to be taxed in the year in which recovery of the bad debt is made. What is the implication of this interpretation? It means that the reserve is not taxed but allowed as a deduction from taxable income. If it is not allowed as a deduction from taxable income, it means that it is taxed and the Practice Note to tax what is reserved in the year in which the recovery is made would not be followed. I must point out that this analysis does not consider any security against which the borrowing was made but considers the bad debt as money owing which has not been recovered in due time after reasonable recovery measures have been taken. In other words that failure to recover the specific amount is the bad debt charge. I further agree with the Plaintiffs submission and it is the law under section 160 of the Income Tax Act that a Practice Note is binding on the Commissioner and her Personnel.

As part of the conclusion on issues 1 and 2, I have further considered what a deduction is for clarity on the first conclusion. According to section 7 of the ITA the chargeable income of a company (such as the Plaintiff) for a year of income, is charged to income tax at the rate prescribed in Part II of the Third Schedule to the ITA. Section 15 of the ITA provides that chargeable income is:

“Subject to section 16, the chargeable income of a person for a year of income is the gross income of the person for the year less total deductions allowed under this Act for the year.”

The deductions are allowed under the ITA and for a year of income. Particularly deductions are generally provided for under section 22 of the ITA which provides in section 22 (1) (a) that all expenditures and losses incurred by the person during the year of income to the extent to which the expenses and losses were incurred in the production of income included in gross income are deductible. Section 24 specifically deals with deductions of bad debts and the conditions to be fulfilled for deduction to apply. What is material is that as determined by section 22 (1) (a) the bad debt should fall in the category of losses incurred by the person during the year of income. The question of substance whatever methodology is adopted is whether the tax payer incurred a loss in the year of income. The very fact that a bad debt can be recovered subsequently and factored as taxable income in the year in which the recovery is made proves by logical inference that the bad debt was a loss in the year when the payment should have been made but was not and reasonable steps had been taken in vain to recover the debt. In the context of section 24 (2) (b) the debt must have arisen out of money lent in the ordinary course of the business of a financial institution in the production of income included in gross income. The loss should not be available to meet losses which subsequently materialise, and the loss has been incurred.

I have further considered the logic of retained earnings from assets which may earn income in future but which were written off in the year of income as a bad debt and retained in the reserve as retained income for that year of income. Perhaps the policy makers should address their minds critically to this issue and set out clear guidelines for how retained earnings, being a characterisation of a portion of bad debts using the IFRS accounting method, should be treated for tax purposes.

The Defendant’s Counsel submitted that the amount of Uganda shillings 35,025,030,898/= was recorded in reserve and rightly so as retained earnings. The Defendant’s Counsel argued that it is not a loss but retained earnings. That the practical effect was that it is not deductible and therefore should be taxed. In other words it is not deductible from taxable income and becomes taxable. He argued that it is like ploughing back income as capital which may earn income.

I have further scrutinised the Practice Note which provides that: “Any recoveries of previously written off debts will be treated as income and taxed in the year in which the recovery is made.” In theory it cannot be assumed that a bad debt may be recovered. I agree that where it is secured and a bad debt provision has been made for it, it may still be recovered in future. The interest and penalties, if any, are matters for future accounting for income tax purposes. If it is allowed as a deduction on the footing that it is a loss and inter alia because it is not available for distribution as earnings, the deduction allowance only applies to that year of income. Any recoveries of the bad debt would in future be reflected as taxable income and taxed. If it is reflected as retained earnings and taxed in that year of income, any future recoveries would still be reflected as income. Yet in the previous year it was a loss and not available for distribution. The classification of the bad debt in terms of the difference between the Bank of Uganda Regulation calculations and IFRS calculations become a mere naming of a loss for accounting purposes. Yet there is some substance in the idea that a bad debt can be considered an investment for income if it meets the criteria for potential earning capacity. A bad debt by classification is money which is not available as income and where reasonable steps for recovery of income were taken in vain.

In the premises, I agree with the Plaintiff’s submission that the loss remains a loss until and unless reversed by recoveries in subsequent reporting periods. In any case under the binding Practice Note, the bad debt loss can become a recovered income and be reflected in future assessments as taxable income. The long and short conclusion is that a tax payer is not chargeable for a loss in a year of income and a bad debt which falls under the definition of a “bad debt” in relation to a financial institution under section 24 of the Income Tax Act is per se allowable as a deduction under that section.

In the premises issues numbers 1 and 2 are answered as follows:

On issue number 1 the Plaintiff is obliged to provision for bad debts under the Financial Institutions Act, 2004 and the Financial Institutions (Credit Classification and Provisioning) Regulations 2005 in terms of the statutory instrument and the Financial Institutions Act, 2004. The Plaintiff is also supposed to file accounts with the Bank of Uganda and in addition it has to be up to standard under the IFRS. That notwithstanding for income tax purposes, bad debts must meet the criteria of section 24 of the Income Tax Act and the Practice Note issued by the Commissioner on 2nd November, 2001.

Issue number 2 is answerable in the affirmative.

1. **Whether the Bank of Uganda Circular dated 19th February 2007 regulates deductibility of bad debts for income tax purposes, and whether the Circular binds the Plaintiff?**

With reference to issue number three the Plaintiff’s Counsel submitted that in 2007, the Bank of Uganda issued a Circular in which it tried to address issues surrounding the difference between the IFRS and the FIA accounting presentation is. In paragraph 4.6 of the Circular exhibit PE 8, it stated that: "the existing procedures in The Financial Institutions (Credit Classification and Provisioning) Regulations, 2005 in respect of determining the adequacy of specific and general provisions for loan losses will continue to apply in the transition period." The Plaintiff's Counsel submitted that it was in agreement with the analysis of the Plaintiff on the preceding issues because the Bank of Uganda Circular makes it clear that accountability has to be done in accordance with the Bank of Uganda Regulations. To the extent that the statute entitles the Plaintiff to a bad debt provision on the basis of the Bank of Uganda Regulations, he submitted that the court should find that in fact the Plaintiff is entitled to the said bad debt reduction.

In reply the Defendants Counsel relied on section 131 (1) of The Financial Institutions Act 2004 for the proposition that the provision gives the Central Bank in consultation with the Minister power to make regulations prescribing Prudential Norms on Asset quality, including bad debt provisions and write offs. Subsequently, the Bank of Uganda made a Circular for all commercial banks dated 19th of February 2007 which forms part of the Prudential Norms on Asset Quality for all commercial banks. Paragraph 4.8 of the Circular provides that in circumstances where a loan losses arrived at using Bank of Uganda Regulations is higher, the difference would be accounted for as an appropriation of retained earnings. The Plaintiff has not disowned the Circular or objected to it and in fact relied on paragraph 4.6 thereof. In conclusion the Circular regulates the treatment of the difference in the amount of bad debts arrived at as a result of the two methods. It mandates that the bank treats the difference not as loss of profits or retained earnings with a condition that it should not be distributed as dividends, unless the permission is obtained from the regulator. The Circular is binding on the Plaintiff.

I have carefully considered the issue and both parties are in agreement that the Circular is binding on the Plaintiff. However in issues number one and two, it has been resolved that the Circular or the Regulations regulate reporting to the Central Bank and is not per se relevant for purposes of income tax returns under the Income Tax Act. It may be good evidence for purposes of Income Tax Act but provisions for bad debts for income tax purposes are dealt with under the Income Tax Act. The Circular is not binding on the Defendant for income tax purposes except where it is consistent with the ITA and particularly in relation to whether a bad debt is an allowable deduction or not. The Circular does not answer the question of whether a bad debt is deductible or allowable as a deduction for purposes of calculating income tax.

1. **Whether the Defendant is bound by its Practice Note issued on 2nd November 2001?**

As far as issue number 4 is concerned, the Plaintiff's Counsel relied on section 160 of the Income Tax Act and submitted that the Practice Note immigration has not been repealed or revoked and is in force up-to-date. The Practice Note is binding on the Commissioner until the revoked.

On the other hand, the Defendants Counsel submitted that section 160 of the ITA was repealed and replaced by section 44 of the Tax Procedure Code Act 2014. However section 44 quoted by Counsel indicates that the Practice Note issued by the Commissioner is binding on the Commissioner until revoked by the Commissioner. In the premises both parties are in agreement with the conclusion that the practice note issued on 2nd November, 2001 is binding on the Defendant. I do not need to add anything to that conclusion.

1. **Whether the sum of Uganda shillings 35,025,030,898/= was rightly claimed by the Plaintiff as an allowable deduction for income tax purposes?**

The Plaintiff's Counsel submitted that the assessment of the Plaintiff was erroneous and therefore the sum of Uganda shillings 35,025,030,898 is an allowable deduction.

In reply the Defendants Counsel relied on earlier submissions on issues number one and two.

The court’s conclusion on issue number 5 is derived from the resolution of issues numbers 1 and 2. The sum of Uganda shillings 35, 25,030,898/= is a bad debt which may be recovered in the subsequent years of income and may be treated as income only after recovery or recoveries. In the premises the above sum is a bad debt that is supposed to be an allowable deduction under section 22 and 24 of the Income Tax Act.

1. **Whether the tax assessment issued by the Defendant is valid?**

Issue number 6 has been resolved by issues numbers 1, 2, and 5. The assessment of the Plaintiff for the sum of Uganda shillings 13,060,998,533/= is not valid or due and payable.

1. **What remedies are available to the parties?**

Following the resolution of the above issues, the Plaintiff was correct in providing for bad debt provisions calculated in accordance with the Bank of Uganda Act and Regulations as well as having correctly interpreted section 24 of the Income Tax Act. The assessment of the Plaintiff on the basis of Uganda shillings 35,025,030,898/= was erroneous and the sum of Uganda shillings 13,060,998,533/= assessed for payment of income tax is hereby set aside.

Under section 27 of the Civil Procedure Act, costs follow the event and the appeal succeeds with costs to the Plaintiff.

Judgment delivered in open court on 18th August, 2017

**Christopher Madrama Izama**

**Judge**

Judgment delivered in the presence of:

Oscar Kambona appearing with Bruce Musinguzi for the Plaintiff

Rodney Golooba for the Defendant

Charles Okuni: Court Clerk

Julian T. Nabaasa: Research Officer Legal

**Christopher Madrama Izama**

**Judge**

**18th August, 2017**