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Uganda Revenue Authority Directive on Leasehold Land Payments

Will it stand legal scrutiny?

Rent expenses | Premium payments | Non tax deductible | Leasehold land

A strict legal reading obscures the commercial nature of leases. For this reason, financial reporting is on the basis of economic substance rather than legal form and the accounting treatment for leases follows this position. Unless specifically excluded or adapted, Uganda's Income Tax Act ("ITA") recognizes the application of generally accepted accounting principles in the determination of income tax liability. The Institute of Certified Public Accountants of Uganda ("ICPAU"), the body mandated under the Accountants Act 2013 to set accounting standards for both the public and private sector in Uganda, has adopted International Financial Reporting Standards ("IFRS"). Positions taken disregarding pertinent IFRS and economic substance over form principles alluded to by the ITA may not only be questionable but also distort tax accounting principles.

A directive issued recently by the Uganda Revenue Authority ("URA") stated that leasehold land rental and premium payments are without exception non-deductible for income tax purposes and this has unsettled many taxpayers. In a country where foreign enterprises can only acquire land use rights by way of leasehold tenure, there are concerns that the blanket implementation of this directive might affect the competitiveness of Uganda as a destination for foreign direct investment in comparison to its regional peers. Kenya and Tanzania allow the deduction of leasehold land rental and premium payments for income tax purposes and this is the normal approach of tax regimes around the world.

In a Public Notice that was published in Ugandan Newspapers on 17th July 2019, the URA observed that some taxpayers have been treating leasehold land payments as revenue expenses which they also deduct for income tax purposes. URA indicates that in its view such payments are capital expenses that ought to be capitalized as part of the cost base of the leased land and only deductible when the lease is disposed of. It is not clear whether by reference to disposal, URA means sublease arrangements, lease surrender/ termination or the expiration of the lease by effluxion of time. URA has argued in earlier instances that land lease costs reflect capital expenses for the purchase of a tangible asset and therefore not deductible for tax purposes.

URA's directive is most likely based on the recent Tax Appeals Tribunal ("Tribunal") ruling in the case of VIVO Energy Uganda Limited versus URA, which is currently on appeal. The Tribunal decision in this case is that payments of rent and premia in respect of land leases are capital expenses which in accordance with section 22 of the ITA are not tax deductible. There was an earlier 2010 High Court ruling in the case of Mukwano Industries (Uganda) Limited versus URA where Justice Lamech Mukasa upheld the Tribunal's earlier position that leasing land with buildings thereon represents the purchase of a tangible asset which would not qualify for deduction under the ITA by way of amortization as an intangible asset.

This publication examines the URA Public Notice with a discussion of the pertinent lease accounting issues. These principles generally give precedence to economic substance over legal form in recording financial transactions and this position is alluded to by the ITA through its recognition of generally accepted accounting principles in the determination of income tax liability.

1. Accounting classification of leases

Accounting for leases is currently governed by IFRS 16. Prior to 1st January 2019, International Accounting Standard 17 ("IAS 17") was applicable. In both standards, the accounting classification is based on economic substance rather than form. Usually the legal form of a transaction is descriptive of its economic substance but there are also cases where the two differ and give different results. As already emphasized, the ITA adopts generally accepted accounting principles and in some instances provides for explicit provisions that derogate from legal form in certain transactions to reflect economic substance. An example is a typical finance lease where the party to whom an asset is leased ("the lessee") is treated as the owner for accounting and tax purposes even though legal title is retained by the party leasing the asset ("the lessor").

At inception, leases are classified as either operating or finance (capital) leases depending on the allocation of the risks and rewards incidental to the ownership of the leased asset between the lessor and lessee. We discuss this classification below.

a) **Finance or capital leases**

Finance leases imitate a debt incurred to acquire the underlying asset leased. In other words, they are analogous to taking out a loan to purchase an asset. This is the reason why for accounting purposes, the lessee capitalizes the leased asset but also books a corresponding liability for the obligation to make lease payments to the lessor. Payments are made periodically and, at the end of the lease term, legal title to the asset reverts to the lessee with the loan repaid.

Under a finance lease, the risks and rewards of asset ownership are substantially passed to the lessee despite legal title remaining with the lessor. Some of the circumstances that infer the existence of a finance lease include:

- the lease transfers ownership of the asset to the lessee by the end of the lease term;
- the lessee can purchase the asset at a price significantly lower than the fair value at the date this right is exercisable;
- the lease term is for the major part of the economic life of the asset;
- at inception of the lease, the present value of the minimum lease payments amounts to at least substantially all the fair value of the leased asset;
- the leased assets are of such a specialised nature that only the lessee can use them without major modifications;
- if the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee;
- gains or losses from the fluctuation in the fair value of the residual accrue to the lessee;
- the lessee has the right to continue the lease for a secondary period at a rent that is substantially lower than market rent.

b) **Operating leases**

Any lease arrangement not qualifying as a finance lease is an operating lease under IFRS and the provisions of the ITA. The economic substance of an operating lease is that a lessee rents an asset from a lessor in return for periodic rental payments. The lessee never owns the asset and at the end of the lease term, the asset possession reverts to the lessor. The rewards and risks of ownership of the asset remain with the lessor.

c) **Classification of leasehold land**

For accounting purposes, leasehold land is held under either an operating or finance lease. Commonly, leasehold land is classified as an operating lease which is akin to a rental transaction. The one off premium paid for leasing land denotes prepayment. Leasehold land can also be treated as a finance lease especially if at the end of the lease term, the freehold perpetual ownership in the land is to pass to the lessee among other considerations.

The justification for the above classification is anchored in economic substance rather than legal form. This derives from the fundamental differences between freehold and leasehold tenures. Freehold property is owned in perpetuity by the landlord and not subject to any superior interest. On the other hand, leasehold land is held by a lessee for a fixed period on specified terms, after which it returns to the landlord or lessor. A lease therefore only confers the right of use of the land in question to the lessee under specified terms for a limited period and not the transfer of the absolute perpetual ownership which is retained by the landlord.

Uganda's land law recognises leasehold tenure as a means of land rights acquisition in Uganda and under the provisions of the Registration of Titles Act Cap 230, leases are registrable as a legal interest. This legal position notwithstanding, the economic substance of leases is that the landlord retains the absolute perpetual ownership of the land. For tax and accounting purposes, this is treated as an operating lease subject to other lease classification considerations.

d) **Accounting treatment for leases**

As already mentioned above, IAS 17 regulated the accounting for leases until 1st January 2019 when IFRS 16 came in force. IFRS 16 retains the distinction between operating and finance lease for lessor accounting. In the past, lessees would not book as an asset or liability transactions relating to operating leases on their balance sheet.. Under IFRS 16, lessees must record on their balance sheet all lease transactions regardless of whether they are operating or capital leases.

Accounting Standard	IAS 17		IFRS 16	
Issue	**Lessee**	**Lessor**	**Lessee**	**Lessor**
Finance Lease	• Capitalises the leased asset and corresponding liability to make lease payments • Depreciate the leased asset • Book asset maintenance costs	• Derecognise the asset with an arising gain or loss • Book expected lease payments as receivable	• Recognise a liability for the lease payment and right of use asset representing the right to use the underlying asset • Unwind over the term of the lease the liability and right-of-use asset crystallizing interest and depreciation charges respectively	• Derecognise the asset with an arising gain or loss • Record a finance lease as a receivable, at an amount equal to the net investment in the lease
Operating Lease	• Expense rental payment when due. • If rental payments are paid in advance, a prepayment recognized in the balance sheet	• Book the rental payment as revenue • Depreciate the leased asset • Book asset maintenance costs	• Capitalise leases of more than 12 months as a right-of-use asset and liability. • Unwind over the term of the lease the liability and right-of-use asset crystallizing interest and depreciation charges respectively	• Book the rental payment as revenue • Depreciate the leased asset • Book asset maintenance costs

2. Tax treatment of leases

Lessors' tax treatment hinges on whether the lease is finance or operating. Recent accounting changes to the lessee treatment of operating leases which were previously off-balance sheet items usher some uncertainty on the tax treatment as discussed below.

a) Finance lease

The ITA provides that where a lessor leases property to a lessee under a finance lease, the lessee is treated as the owner of the property and the lessor is treated as having made a loan to the lessee, in respect of which payments of interest and principal are made to the lessor equal in amount to the rental payable by the lessee. The interest component of each payment under the loan is treated as an interest expense incurred by the lessee and interest income derived by the lessor.

A lease of property is a finance lease under the ITA if the lease term exceeds 75% of the effective life of the leased property; the lessee has the option to purchase the property for a fixed or determinable price at the expiration of the lease or the estimated residual value of the property to the lessor at the expiration of the lease market is less than 20% of its fair market value at the commencement of the lease.

- The lessee or person taking out the lease capitalizes the leased asset and takes a deduction of the applicable tax depreciation. The lessor should not claim the tax depreciation on the leased asset despite still retaining legal title to the asset.
- Interest payments subject to exemptions attract withholding tax ("WHT") the rate of which is dependent on whether the payment is made to a resident or non-resident tax person (and in the latter case may be impacted by an applicable double tax treaty)

b) Operating lease

Any lease arrangement not qualifying as a finance lease is an operating lease under the provisions of the ITA and is taxed accordingly.

- The lessor can claim tax depreciation in respect of the asset leased as set out in the ITA;
- The lessee would previously under IAS 17 take a deduction of annual rental payments and amortised premium payments in determining their taxable profits;
- IFRS 16 requires the lessee to recognise the right of use asset and corresponding liability for the lease payments. These are unwound over time crystallizing notional interest and depreciation charges respectively. We see tax authorities rightly disallow for tax purposes this notional interest and depreciation charge.

c) Are leases intangible assets for tax purposes

In 2010, Uganda's High Court ruled that leasing land with buildings thereon is without exception purchase of a tangible asset and therefore not deductible for tax purposes. A criticism of this judgement by seasoned tax experts is that it adopts a strict legal interpretation of leases which muddles the commercial reality espoused by IFRS and the ITA.

IAS 38 outlines the accounting requirements for intangible assets, which are non-monetary assets without physical substance and identifiable (either being separable or arising from contractual or other legal rights). Leasehold tenure gives the tenant (lessee) the right to exclusively possess and use real property for a fixed period of time. Since the lease serves as a contractually provided interest, not the absolute perpetual ownership in the land, it is an intangible asset. The right-of-use asset capitalised for operating leases under IFRS 16 is the lessee's right to use an asset over the life of a lease and our view is that this qualifies as an intangible asset.

Section 31 of the ITA provides that a person who has incurred expenditure in acquiring an intangible asset having an ascertainable useful life is allowed a deduction in each year of income during the useful life of the asset on the straight-line basis.

Conclusion

To the extent leasehold land takes on the character of a finance lease, there is a good case that the underlying rental and premium payments are not tax deductible for income tax purposes because the economic substance of the transaction is analogous to freehold land tenure that confers absolute ownership in perpetuity even though legally structured as a lease. For most of the time, however, leasehold land is treated as an operating lease thereby only conferring the right of use of the land and not the underlying absolute perpetual ownership. Our view is that the right of use qualifies as an intangible asset.

Under IAS 17, lessees would expense annual rental and amortised premium payments under an operating lease and our position is that these would be deductible for tax purposes. If URA were to argue that lease rentals and premium payments expenses under IAS 17 were non-deductible for tax purposes on the basis they are expenses of a capital nature, we consider that these costs would still be tax deductible under section 31 of the ITA as intangible assets. IFRS 16 now requires lessees to capitalise the right of use of an asset for operating leases and unwind over the term of the lease the depreciation charge. Our position is that this right of asset qualifies as an intangible asset and therefore also gives rise to a tax deduction under section 31 of the ITA.

It is our recommendation therefore that URA re-evaluates its position on leasehold land incorporating a broad-based view of lease transactions. A blanket notice requiring all leasehold land lessees to disallow for income tax purposes rental and premium payments irrespective of the applicable circumstances not only heightens taxpayers' anxiety but also escalates the potential for tax disputes. At present, the determination of whether leasehold land payments are deductible for tax purposes has largely focussed on the legal interpretation of the distinction between capital and revenue expenses which in our view does not address the real issue. Attention should be focussed on the economic substance of leases in addressing whether the underlying payments thereof are deductible or not for tax purposes.

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At Deloitte, he lived and worked in Uganda, Kenya, Tanzania and the United Kingdom for over 6 years and subsequently became the firm's chief of staff for the Energy and Resources Industry Group seeing him play a lead advisory role in Uganda, Kenya, Tanzania, Mozambique, South Sudan, Somalia and Ethiopia.

Denis is widely published and a regular commentator in the local, regional and international media and speaker at various forums regarding the taxation and financing of energy projects as well as the protection of large capital projects within the framework of international investment law.

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From 2004 to 2008, he worked in Russia where he led Deloitte's oil and gas industry group and established Deloitte's office in Sakhalin. He moved to East Africa in 2009 leading Deloitte's energy and resources industry group in Uganda, Kenya, Tanzania, Rwanda, Ethiopia and Mozambique. He was initially based in Kampala, Uganda later relocating to Dar es Salaam, Tanzania. Bill returned to the UK in 2014 supporting Deloitte UK teams working on outbound projects investing in Africa and was a key member of Deloitte UK's energy and resource practice until his retirement from the firm in September, 2018.

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Prior to joining Cristal Advocates, he had worked as a Private Secretary to the President of the Republic of Uganda. During this time, he participated in several public and private sector engagements that included advising and coordinating activities relating to oil and gas as well as infrastructural projects of national significance. John had earlier worked with the Post Bank Uganda Limited and Shonubi Musoke and Co. Advocates.

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Dickens was instrumental in UNOC's formation and initial period of operation and also served as its head of Contracts, Negotiations and Advisory until May 2018. Prior to joining UNOC, Dickens was Legal Counsel at the Petroleum Directorate of the Ministry of Energy playing key legal advisory roles on the negotiation and implementation of PSAs, Joint venture and other oil and gas agreements. He was also part of the team that shepherded the process of enacting the current Ugandan oil and gas Legislations and Regulations including the local content requirements.

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