Cristal Advocates

The Tax Treatment of Deferred Interest
A Scrutiny of Ugandan Judicial Decisions

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1. Introduction

Despite decided cases by the Ugandan High Court and the Tax Appeals Tribunal addressing the tax treatment of deferred interest, the issue remains thorny and continues to present complexities. While these legal precedents offer insights into how such matters have been adjudicated in the past, they also raise pertinent questions regarding whether the applicable provisions of the law have been suitably interpreted and applied. As set out in this article, the intersection of tax laws and accounting principles with diverging reporting requirements for the same partly contributes to this challenge.

2. Deferred interest

Deferred interest refers to the accumulation of interest on a financial obligation that has not yet been paid by the borrower. This can occur in various financial arrangements such as loans, bonds, or mortgages, where borrowers opt to postpone interest payments to a later date. One common method of deferring interest is capitalizing it, which involves adding the accrued interest to the principal balance of the loan upon which further interest is computed. Alternatively, borrowers may negotiate agreements with lenders to defer interest payments for a certain period, often to manage short-term cash flow constraints.

In the income statement, the treatment of deferred interest hinges on the accounting method adopted by the borrower. Under accrual accounting principles, the interest expense linked with deferred interest is recognized in each accounting period as it accrues, irrespective of whether it's paid. This means that even though the borrower defers actual payment, the expense is still recognized over time. On the balance sheet, deferred interest is recorded as a liability, classified as either current or long-term depending on the payment timeline.

3. Withholding tax on interest payments

Other than the exceptions set out in the law, the general position under Uganda's Income Tax Act ("ITA") is that withholding tax ("WHT") on qualifying interest payments must be deducted and remitted to the Uganda Revenue Authority ("URA") within 15 days following the month in which the borrower makes the interest payment.

Historically, a contentious issue, now definitively settled through decided cases, pertained to whether the WHT obligation arises at the accrual of the interest expense or upon actual cash or equivalent disbursement of interest. Section 2 of the ITA defines "payment" to include any amount paid or payable in cash, in kind, or by any other means of conferring value or benefit on a person.

As the Tax Appeals Tribunal held in the matter of Cooper Motors versus URA (TAT 67 of 2018), essentially, when interest accrues, WHT becomes payable. This is because at the point of accrual, the obligation to make good the payment has arisen, subject to agreement with the lender.

4. When is WHT due on deferred interest payments?

Section 47(1) of the Income Tax Act (ITA) stipulates that interest, in the form of any discount, premium, or deferred interest, should be recognized as it accrues. Section 47(2) of the ITA however creates an exception providing that when the foregoing interest is subject to WHT, it should be considered derived or incurred when "paid". This, in our view, has implications on the timing of the remittance of WHT on the same to the URA and the deductibility for corporate tax purposes of the interest expense accrued by the borrower.

While the Courts in Uganda have correctly determined that "WHT" on capitalized or deferred interest is due when it is actually "paid," they have grappled with the question of whether the act of capitalizing or deferring interest itself amounts to being "paid" as envisaged by the law. There are two recent cases in Uganda that have addressed this issue.

a) MKOPA Limited versus URA (2019)

In this case, the URA demanded WHT from the Applicant on the interest that had accrued in the income statement as an expense, while also acknowledging it as an outstanding liability to the lenders in the balance sheet. The Applicant contested the assessment, arguing that WHT was not yet due because the interest had not been remitted to the lenders.

URA's opposing stance was that the Applicant's cash flow statement clearly indicated an interest cash outflow. The Applicant countered this by stating that

the inclusion of interest repayment in the cash flow statement was an anomaly, explaining why there was still a liability for interest payable recognized in the balance sheet. To address this, the auditor who prepared the original financial statements was invited to the Tribunal and presented a restated cash flow statement.

However, in a decision rendered in 2020, the Tribunal disregarded the Applicant's position and upheld the original financial statements that showed interest as paid. Based on this determination, the Tribunal concluded that WHT should have been paid. This decision was made in accordance with Section 47(2) of the ITA, which states that deferred interest income subject to WHT is considered derived or incurred when it is paid.

The Tribunal did not accept the taxpayer's explanation regarding the inclusion of interest repayment in the cash flow statement, despite it still being recognized as a liability on the taxpayer's balance sheet.

b) ATC versus URA (2019)

Under the terms of a loan agreement with its parent company, ATC Uganda would accrue interest on the loan. However, this accrued interest would be capitalized and remitted or paid to the parent company at a later stage. The key issue examined by the Tribunal was whether the act of capitalization of interest amounted to interest being paid, thereby triggering the WHT obligation under section 47(2) of the ITA at interest capitalisation.

The URA demanded WHT from the Applicant on this accrued interest, which the lender in the Netherlands had also recognized as income in its financial statements and even paid the attendant Dutch income tax.

The Tribunal in line with the earlier MKOPA case agreed with the Applicant that, in the case of deferred interest under Section 47(2), WHT is only due when the interest is actually "paid." However, the rationale for the Tribunal concluding that capitalising interest equated it to being paid to the lender is contestable.

The Tribunal also amplified its concern on how interest not yet derived for income tax purposes in Uganda could be subject to tax in the Netherlands. Our view would be that financial statements are prepared in accordance with international financial reporting standards. Under these standards, income recognition operates on an accrual basis, meaning income is acknowledged when earned, not necessarily when cash or its equivalent is exchanged to fulfil the obligation. And in Netherlands, income tax on interest is due when accrued and not when necessarily “received or paid”

Interest capitalization in the context of the ATC case is the practice of adding unpaid interest charges to the principal balance of a loan. Instead of paying the interest as it accumulates, this method capitalizes the interest by combining it with the principal amount. Consequently, this increases the principal balance on which future interest calculations are based. By capitalizing interest, the borrower delays or defers the actual payment of the accrued interest.

For accounting purposes, the treatment of deferred interest in the income statement ordinarily involves recognizing the interest expense associated with it in each accounting period, regardless of payment status. This means that even if payment is deferred, the expense is acknowledged over time. On the balance sheet, deferred interest is booked as a liability, categorized as either current or long-term depending on the payment timelines.

While the Tribunal rightly points out that payment is not necessarily restricted to the physical exchange of cash, any mode of payment deployed should result in a final settlement of the underlying obligation for one to contend that indeed the liability has been paid. Capitalizing interest while retaining it on the balance sheet of the borrower as a liability still due does not align with the Tribunal's understanding of "paid." Upon appeal to the High Court in 2022, Justice Wejuli upheld the Tribunal's decision.

5. Corporate tax deduction

Under Section 47(1) of the ITA, interest is recognized by both the lender and borrower as an expense and income respectively on an accrual basis. However, an exception exists under section 47(2) of the ITA for interest subject to WHT. In such cases, interest is recognized as derived or incurred when it's actually paid, following the cash method of accounting.

This rule prevents taxpayers from circumventing WHT by exploiting timing differences that can arise when dealing with interest in debt obligations with deferred

interest, discount, or premium. Without this rule, borrowers could annually claim deductions for accrued deferred interest, even if not paid, while WHT would only be remitted when actual payment occurs. It, therefore, follows that in the circumstances of deferred interest, taxpayers cannot claim such as a deduction for corporation tax purposes until such time that interest is actually "paid".

6. Conclusion

While court decisions set binding positions of law, it may be necessary to take a step back to check if recent rulings match the Ministry of Finance's position on how deferred or capitalized interest should be taxed. This will help to ensure that the law is aligned with Uganda's tax policy.

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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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