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Recharacterization of a loan as income and the doctrine of limitation of time to keep records for tax purposes

The Tax Appeals Tribunal on 31 October 2024 issued a ruling on recharacterization of shareholder loans by the Uganda Revenue Authority into income.

Additionally, the Tax Appeals Tribunal made a ruling on limitation of time within which URA is to ask for supporting documentation during Audits or any compliance checks.

This communication highlights the key issues resulting from this ruling and related potential implications to taxpayers.

Recategorization of shareholder loans as income and limitation of time to keep records

Case

EXPLORER LIMITED VERSUS UGANDA REVENUE AUTHROITY TAT APP N0.87 OF 2023

Principles in the case

- An interest free loan does not have an effect on the taxpayer's income tax liability and therefore should not be recategorized as income by the tax authority.
- It is unreasonable for the tax authority to request a taxpayer for information that relates to periods after five years.

Brief facts

The applicant, Explorer Limited, is engaged in rental business in which it generates income.

Shareholders extended a loan to the company in 2004 of UGX 513,904,648 that was repayable in 10 years ending in 2014 but was later extended for another 10 years to 2024.

The loan was disclosed in the audited financial statements and income tax returns since 2004.

In 2018, URA recategorized the company's loan declaration as income and raised an additional assessment of UGX 154,171,395.

The company objected to the assessment on grounds that the assessment was based on non-existent income as the company only had rental income as a source of income, therefore had no other source of income. The rental income was declared in the income tax returns.

The company submitted that the standard of proof in tax matters is on a balance of probabilities. Where there is doubt, the taxpayer takes the benefit. The applicant received the loan, disclosed it to URA and that the obligation to pay the loan still exists.

The Company further submitted that the assessment was time barred because the loan was running from 2004 and URA could not query it 14 years later in 2018.

Also, the company indicated that there is no evidence leading to any additional income other than rental income from the building as reported in their income tax return.

The objections team disallowed the objection, and the company applied to the Tax Appeals Tribunal (TAT) for review of the objection decision.

Grounds of Appeal for determination by TAT.

1. Whether URA was justified in recharacterizing the Company's related party loan into income?
2. Whether the URA assessment was out of time?
3. What is the standard of proof in tax maters?

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Decision of the Court

Ground 1: Whether URA was justified in recharacterizing the Company's related party loan into income?

In determination of this ground, the court found that;-

- URA issued additional assessments in January 2023 on grounds that the company had unsupported shareholder loans of UGX 513,904,648 as at 2018 .
- That URA requested documentation such as a loan agreement, board resolutions, bank statements to support the loan as claimed by the company, which information according to URA was not provided hence recategorizing the loan as income leading to the additional assessment.
- URA contended that the company had additional sources of income other than rental income. The company provided URA with a loan agreement, financial statements and a letter from its shareholder extending the loan term.
- TAT held that the loan is not interest bearing and therefore, it had no effect on the company's tax liability. Had it been interest bearing and the company had been claiming a deduction for the interest payments in their income tax returns, then URA would be justified to request for information in support of the interest deduction. This is so because the interest deduction would have had an effect by reducing the income tax liability of the company. Something that was not the case for Explorer Limited as the loan was interest free.
- The court further noted that there should be some basis for recategorization from a legal and accounting perspective. For example, why did URA opt to recategorize the loan as income/ revenue and not as equity since the funds originated from the shareholders. URA did not provide any evidence to demonstrate how that alleged income they recategorized arose.
- The connection between the loan and income was not found and therefore TAT ruled that the Company (Explorer Limited) succeeds on this ground.

Ground 2: Whether the URA assessment was out of time?

In determination of this ground, the court found that;-

- The Tribunal noted that the company provided URA with financial statements, loan agreement and a letter from the shareholders extending the loan repayment period. URA considered the information insufficient and requested for bank statements and board resolutions dating back in 2004.
- That the information requested for by URA are transactional documents for the loan obtained in 2004, which is almost 20 years ago. In as much as the loan is still subsisting, it would be unreasonable to expect any person to maintain records for such a period.
- URA requested for receipts of purchases made, receipts of wages paid to show that the funds were received. The tribunal noted that this was not only onerous but also not practical and not consistent with sound business management principles.
- Section 15(1) of the Tax Procedure Code Act (TPCA) requires taxpayers to maintain records for a period of five years after the end of the tax period to which it relates.
- URA argued that the assessment relates to the 2018 year of income and therefore the company should have kept those records. The Tribunal noted that the kind of information URA requested for is not information that came into existence in 2018. Therefore, the information request was unreasonable.

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Ground 3: What is the standard of proof in tax maters?

In determination of this ground, the court found that;-

- The standard of proof in tax matters is on a balance of probabilities. The Company was able to demonstrate by way of a loan agreement how the loan came into force. The loan was disclosed in the company's financial statements since 2004. The company also provided a letter from the shareholders extending the loan period by another ten years.
- The Tribunal held that this information was enough to believe on a balance of probabilities that the company obtained a loan. And that URA was holding the company to a very high standard, given the passage of time.

Our view

- There has been a lot of controversy around recategorization of related party loans into income by the tax authority. This has been finally settled by the Tax Appeals tribunal stating that recategorization of loans by the tax authority should be guided by the economic substance of the transaction as opposed to its legal form. If the loan does not affect the tax liability of the taxpayer and the tax authority can not prove in any way the connection between the loan and the income or revenue of the company, then the recategorization is an abuse of the powers of the commissioner to recategorize items declared by the taxpayer in the income tax return.
- This judgment sets the parameters regarding the period in which information requests should stretch too. URA should look at the history of the item to determine when it originated before requesting for information that dates back beyond the statutory period of five years. Not all declarations made in the income tax return or audited books of accounts have originated in the year of income being audited.



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