

Article

## LEGAL ALERT

**Tax Treatment of proceeds from disposal of mortgaged property under the Income Tax Act: analysis of Luwa luwa Investment Limited VS URA HCCA NO. 43 of 2022.**

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## Introduction.

The Commercial division of the High Court of Uganda, Ocaya J, delivered a decision in High Court Civil Appeal No 43 of 2022, LuwaLuwa Investments vs Uganda Revenue Authority, that will have profound implications on the application of proceeds from disposal of mortgaged property by financial institutions upon foreclosure. The Court was exercising its appellate jurisdiction in an appeal against the decision of the Tax Appeals Tribunal in a tax dispute between Luwa luwa Investment Limited and Uganda Revenue Authority.

The court revisited and reiterated the principle that before one is assessed for a tax liability, the law imposing the liability should be clear and unequivocal. More significantly, the court decided that proceeds from the disposal of mortgage property, in as far as it is applied to repay the principle and interest is exempt from withholding tax under Section 117(2)(b) of the Income Tax Cap 340.

## Background.

Equity Bank Uganda Limited (“the Bank”) advanced a credit facility of over 10 Million Dollars to Simbamanyo Estates limited (“Simbamanyo”) which were secured by a mortgage over five properties comprised in Kyadondo Block 243 Plots 1799 & 1800, 2794, 957 and 958, and 30 Kyadondo Block 237 plot 95 all located at Mutungo, Luzira (otherwise known as “Afrique Suites”). Simbamanyo defaulted on its loan obligations and the properties were advertised for sale by public auction in order to recover the outstanding loan sum and interests. LuwaLuwa Investments Limited (hereinafter called the “the Appellant”) acquired all the five properties comprising Afrique Suites from the Bank.

After exchange of correspondences between the appellant and the Uganda Revenue Authority (herein after called “the Respondent”), the respondent issued an administrative assessment for withholding tax to the tune of UGX 965,700,000 (Uganda Shillings Nine Hundred Sixty-Five Million, Seven Hundred Thousand only) for withholding tax in respect of the mortgaged properties that had been acquired from the bank.



The Appellant formally objected to the assessment and the Respondent made its objection decision wherein it upheld the assessment. The Appellant filed an application for review of the Respondent's objection decision at the Tax Appeals Tribunal.

## Decision of the tax appeals tribunal.

The Tax Appeals Tribunal dismissed the application holding that the appellant was a resident person that had purchased Afrique suits hotel which constitute a business asset and was thus, liable to withhold tax and remit to the Respondent. The Tribunal further held that there was no conflict between 118B (2) of the Income Tax Act which imposes a blanket withholding tax at a rate of 6% on purchase of business asset and section 117(2) of the Income Tax Act which exempts interest paid by a resident person to a bank. The tribunal reasoned that payment of purchase price upon disposal of a business asset under section 118B(2) doesn't amount to payment of interest to a financial institution as used in section 117(2). The tribunal further held that the section 118B(2) deals with withholding tax on disposal of business asset which is property income whereas section 117(2) deals with exemption of interest paid to financial institution which is business income. Finally, the tribunal held that the Appellant wasn't exempted under section 119 (5) of the Income Tax Act because the section deals with exemption from withholding tax on goods and services supplied to designated persons but not immovable property which was the case here.

The Appellant, being dissatisfied with the decision of the Tax Appeals Tribunal, appealed to the High Court mainly complaining about the definition of what amounts to a business asset and interpretation of sections 118B (2) and section 117(2) of the Income Tax Act.



## High Court judgment.

### Are mortgaged properties business assets of financial institutions?

The Court in dealing with the issue of whether the mortgaged properties were business assets of the bank found that a mortgaged property is a property of the bank after foreclosure.

It reasoned that there is no requirement that the asset must be owned or put into use by the entity selling under section 118B (2) of the Income Tax Act cap 340 for it to qualify as a business asset. In addition, that the property to be sold need only be a business asset to qualify for withholding tax under section 118B (2) of the Income Tax Act cap 340 regardless of whether or not it belongs to the seller. This is so, according to court, because selling of property is not only done by the proprietors but may also be through third parties (such as agents, donees of powers of attorney, auctioneers among others). Court concluded that the issue of ownership is irrelevant in determination of whether a given asset is a business asset.

## **Is section 118B (2) of the Income Tax Act ambiguous?**

In relation to the issue of ambiguity of section 118B(2) which imposes a withholding tax at a rate of 6% on purchase of business asset, court found that the section is not ambiguous as it clearly charges tax on the transaction of selling and buying a business asset, notwithstanding the fact that the asset is not a business asset of the transacting parties. It is the status of the asset as a business asset coupled with its purchase that creates the obligation to withhold, the obligation being on the purchaser of the asset.

## **Is there a Conflict between sections 118B(2) and Section 117 (2)(b) of the income tax Act.**

On a very significant note, court found that section 118B(2) conflicts with Section 117 (2)(b) of the income tax Act. The trial judge reasoned that the obligation to withhold tax under Section 118B(2) is a mode of collection of income tax. Where the transaction is not amenable to income tax, there can be no withholding since there is no tax to remit.

The court reasoned that whereas Section 117 (2) (b) of the Act exempts payment of interest to a financial institution by a resident person from withholding tax deduction, Section 118B(2) declares all proceeds from disposal of a business asset by a resident person subject to withholding tax at a rate of 6%. Court departed from the reasoning of the majority members of the Tax Appeals Tribunal that payment of purchase price upon disposal of a business asset under section 118B(2) doesn't amount to payment of interest to a financial institution as used in section 117(2). The court noted that when a mortgaged property is foreclosed, the bank

applies the proceeds to recover its principal and interest on the loan facility. The principal recovered does not form part of the chargeable income of the bank. The interest recovered by disposal of a foreclosed mortgage is business income of the bank. However, the same interest income is exempt from withholding tax under section 117(2) of the Act. That only the surplus of the consideration for the sale of mortgaged property after deduction of the principal sum and interest is properly amenable to withholding tax.

The learned judge concluded on the evidence available, that the bank had lent a principal sum of USD. 10 million but only recovered 4.35 million from the sale of the mortgaged properties. The amount paid by the appellant only partly covered the principal which does not form part of the chargeable income of the bank thus not amenable to withholding tax.



## **Character of income received by a financial institution from disposal of mortgaged property.**

The Court critically looked at section 36 of the Mortgage Act 2009 to determine whether the proceeds from disposal of a mortgaged

property gives rise to business income or property income. Under section 36 of the Mortgage Act 2009, consideration from disposal of mortgaged property is applied towards settlement of the Principal loan amounts, Interest, charges and penalties. In the view of the court, the principal amount recovered by a financial Institution is not subject to tax under sections 15 and 17 of the Income tax Act as they do not constitute chargeable income of the bank. The interest income constitutes business income of the bank as opposed to property income under section 18(1) of the income Tax Act. The word interest in tax law context includes any payment, including a discount or premium, made under a debt obligation which is not a return of capital, fines, penalties. Accordingly, the court concluded that consideration from the disposal of mortgage property, in as far as it includes interest is exempt from withholding tax in accordance with Section 117(2)(b) of the Income Tax Act. Court further concluded that the principal recovered from the foreclosure of a mortgaged property by the bank is obtaining a refund of capital and is not amenable to withholding tax in accordance with the Income Tax Act. However, any surplus arising from the disposal of such properties is subject to withholding tax.

## Implications of the court decision on the financial sector.

Although this decision is likely to be subject to appeal, it has greatly clarified the position of the law with regard to tax treatment of proceeds received by a financial institution from the disposal of mortgaged properties.

The stakeholders in the financial sector are entitled to treat the principal and interest

recouped from the disposal of mortgaged property exempt from withholding tax.

However, in the event of any excess consideration received from the disposal of a mortgaged property, tax should be withheld at 6% by the purchaser in accordance with section 118B (2).

Financial Institutions are expected to draft clear sale agreements detailing the application of the proceeds of a sale to ensure that there is a distinction between the proceeds applied to settle the indebtedness of a mortgagor towards a mortgagee and any of the excess so received such that any tax obligations arising from the transaction can be clearly ascertained.

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