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Legal Brief

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Court of Appeal of Tanzania Rules against NBC in a Significant Tax Appeal

- *Departs from a 'strict interpretation' of a tax statute in favour of a 'purposive approach' in ascertaining the intention of the legislature.*
- *Rules that TRA has the final word on whether any item is deductible.*
- *That section 39s (d) and 25 (4) & (5) of the Income Tax Act, 2004 are not in conflicting positions.*
- *The Taxpayer had failed to discharge the evidential burden.*
- *The decision has serious repercussions for the struggling banking industry.*

The outcome of a long-waited word from the highest court of the land has not been good news to the Banking industry in Tanzania. On the 9th July 2018, the Court of Appeal of Tanzania, sitting in Dodoma rendered its decision dismissing an appeal lodged by the National Bank of Commerce (NBC) that had invited the Court to determine on the tax treatment of 'provisions for impairment of bad and doubtful debts' and 'provisions for reserve'.

Brief Facts of the Dispute

The dispute arose as a result of the Tanzania Revenue Authority (TRA) issuing an assessment against NBC for the years of income 2005, 2006 and 2007 whereby TRA added back impairment provisions and provisions for reserves to NBC's chargeable income. Aggrieved by the assessment, NBC appealed to the Tax Revenue Appeals Board (the Board) where the Bank was not successful. The Board had ruled that, losses arising from debt claims are deductible when they are actually realized and also written off from the books of accounts and that the Bank had not adduced evidence to prove that such debts were written off from the books of accounts in terms of sections 18(b), 39(d) and 25(5) of the Income Tax Act, 2004 (the ITA, 2004).

The Bank's further appeal to the Tax Revenue Appeals Tribunal (the Tribunal) was also unsuccessful. The central issue the Tribunal was called upon to determine, is whether it is necessary for impairment of losses to qualify for deduction, the Bank must write them off. The Tribunal dismissed the appeal on the ground that the Bank had not shown that its debt had been written off from the books of accounts, which is one of the two conditions before the Bank could rely on section 25(5) of the ITA, 2004. Aggrieved by the decision of the Tribunal and determined to challenge the same, the Bank appealed to the Court of Appeal of Tanzania, (the Court).

The Bank's Case

The Bank supported its case by advancing the following key grounds:

- It was wrong for the Tribunal to rely on section 39(d) of the ITA, 2004 to conclude that realization of a debt by a Financial Institution must meet the two conditions: first, that the debt

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must become a bad debt in accordance with the standards set by the Bank of Tanzania (BoT), and second, the debts must have been written off;

- Section 21(1) of the ITA, 2004 requires a taxpayer to account for its income in accordance with the Generally Accepted Accounting Principles (GAAP), amongst them, Regulation 15(4) of the Banking and Financial Institutions (Management of Risk Assets) Regulations, 2001 (the BoT Regulations). A taxpayer had charged off loss arising from 'non-performing loans' which is supported by section 25(4)(a) of the ITA, 2004; and

- That the Tribunal ought to rely on section 25(4)(a) of the ITA, 2004 and not sections 18(b) and 39(d) of the ITA, 2004; consequently, both the Board and the Tribunal were wrong in demanding writing off of the bad debts.

TRA's Case

On the part of TRA, the arguments raised in opposition to the Bank's appeal were that:

- Section 18 was significant as it guides on the calculation of the deduction of loss incurred during the year of income and referred to section 3 of the ITA, 2004 as to what amounts to a debt claim. Section 36 was also relied on how gains or losses are calculated;

- That for a Financial Institution like the Bank, section 39(d) of the ITA, 2004 provides the ultimate guide for deduction of bad debts, in which case section 25(5(a) of the ITA, 2004, was inapplicable; and

- That it was wrong for the Bank to peg a deduction on the BoT Regulations where there existed a clear condition under section 39(d) of the ITA, 2004.

The Court's Determination

- The choice between, which set of the provisions of the ITA, 2004 that are applicable to the deductibility of the Appellant's impairment provisions is much about statute interpretation;

- The Court is enjoined to read the statute as a whole, in context, and, if possible, the Court is to give effect to every word of the statute. The Court is bound to give consistent, harmonious and sensible effect to all of the parts of a statute, to the extent possible;

- Sections 20 to 26, and in particular section 25, are provisions guide in the preparations of tax returns to taxpayers like the Appellant, before presenting them for the assessment by TRA. The impression of section 25(4) and 25(5)(a) of the ITA, 2004, is that the Appellant is given the opportunity to indicate what debt claim has become bad, ripe for deduction and this will include supplying proof supporting the bad debt proposed for deduction;

- In so far as deductions are concerned, the governing provisions are covered under sections 11 to 19 of the ITA, 2004. A plain meaning and harmonious construction shows that the intention of the legislature is that, after receiving the accounting reports or returns, the Respondent (TRA), makes its own assessment, and has a final word on whether any item is deductible;

- Sections 25(4), (5) on one hand and section 18 and 39(d) of the ITA, 2004 on the other hand, are not conflicting positions. They are harmonious in so far as they provide for distinct matters. While section 25(4), (5) provides for preparation of accounts, returns and proposal for deductions, sections 18 and 39(d) give TRA leverage to receive returns and accounts and enjoy the finality of assessment, allowing or disallowing deductions;

- The Court consequently dismissed the appeal in its entirety with costs on the ground that the Bank, much as it relied on section 25(5)(a) of the ITA, 2004, did not discharge its evidential burden to prove that it complied with any one of the two options the appellant had claimed to have complied with under section 25(5)(a) of the ITA, 2004. Equally there was no evidence to justify the appellant's claim that the BoT had approved any loan loss of the appellant to be written off.

Our Assessment of the Judgment

We must point at the outset that both the parties and the Court has somehow missed the point and consequently lost the opportunity to make a determination on the crucial issues in contention. We note the following shortcomings on the parties' presentation and in the Court's judgment:

- The parties and the Court have mixed up the tax treatment of a '*bad debt*' and '*impairment provisions on loans/provisions on doubtful debts*'. In this regard, both the parties and the Court had inadvertently referred to '*impairment provisions on loans/provisions on doubtful debts*' as '*provisions for bad debts*';

- While the issues before the Board were specifically on '*provisions for impairment on loans and provisions for reserves*', subsequent submissions had inadvertently departed from discussing '*impairment provisions on loans/provisions for doubtful debts*' to '*provisions for bad debts*'; and

- Both, the parties and the Court did not clearly discuss and make a determination on provisions for reserves (non-distributable reserves) provisioned due to the requirement of the BoT Regulations.

FK Understands that the bone of contention between the parties centred on '*impairment provisions on loans/provisions on doubtful debts*' and not '*provisions for bad debts*'. A doubtful debt is a debt which is yet to become bad of which IFRS 9 requires entities to provision for such debts. On the other hand, a bad debt is one that is uncollectible, in which case, it is written off from the books of accounts. By mixing up the two concepts, both, the parties and the Court missed an opportunity to deliberate and determine on the treatment of the provisions for impairment on loans by invoking the rules and provisions applicable to bad debts. It is our understanding that, once a debt becomes bad, it has to be written off from the books of accounts and not provisioning for them. As opposed to bad debts, doubtful debts are not written off, rather they are provisioned in accordance with the accounting principles and standards.

Both the parties and the Court failed to appreciate the fact that loans to Financial Institutions, are the institutions'' trading stocks, they are not business assets. This being the case, section 18, 25 and 39 of the ITA, 2004, that were relied upon by the parties and the Court, are not applicable in respect of provisioning for doubtful debts. It is intriguing to note that section 3 of the ITA, 2004 defines 'trading stock' to include, in the case of a person carrying on a banking business, loans made in the ordinary course of that business. And the definition of a business asset under section 3 of the ITA, 2004, expressly excludes a trading stock. Section 18 that deals with losses on realisation of business assets and liabilities cannot be relevant to losses arising from trading stocks. It was expected that the question of deductibility of impairment provisions on loans, would have been deliberated exhaustively and determined by looking at section 13 of the ITA, 2004, that provides for trading stock allowance.

The other aspect that did not receive proper attention of the parties and the Court is on provisions for reserves (non-distributable reserves). We understand that these reserves do arise where the BoT requirements on provisioning for doubtful debts are higher than those under the IFRS. In such a scenario, Banks are required to appropriate from their distributable reserves an amount that will clear the shortfall and provision in a special non-distributable reserve. Such reserves are not available for the use by the Banks until when they are released. It could be argued that, under the principles of income taxation, such reserves ought not to have been taxed until when released. This is based on our firm understanding that income tax, is tax on income that is earned, what is referred to as real income as opposed to hypothetical income. It is noted that the Court did not make a finding on provisions for reserves. Understandably, this might have been attributed to the mix up of what was disputed by raising the impression that parties were disputing on provisions for bad debts, which in essence was not the case.

What the Decision means to Financial Institutions?

The decision will have significant adverse impact on Financial Institutions. It gives TRA a super highway to adding back all specific provisions on impairment on loans and provisions for reserves. Such a treatment, has an enormous consequence on the Banks' liquidity, hence will require Banks to overstretch their financial muscles to meet the Taxman's Tax Bills. We consider this a blow to the Tanzanian Banking sector which has seen a rapid decline of their profits for the past two years. The situation will be more complicated given that the new IFRS 9 mandatory requirements, require Financial Institutions to start providing for loans immediately a financial instrument is created.

While we believe that in an appropriate well-argued case, the Court may make a determination favourable to Banks in respect of impairment provisions on loans/doubtful debts, constructive engagement between the BoT, the Banking Industry and TRA is highly encouraged in order to streamline the tax treatment of various provisions in the Banking sector. It is important the tax rules applicable to the Banking industry are attuned to other laws and regulations governing the Banking sector. The Court should also appreciate that the making of provisions does not mean that automatically tax is not paid on such provisions, rather it is only the time difference, such provisions are taxed as and when they are released.

To the economy, the decision is likely to see Banks developing new strategies to maximize their profits and liquidity in order to be able to survive in the ever increasing competitive financial sector. These strategies may include raising interest rates and borrowing costs.

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