

Understanding Tanzania's 2014/2015 National Budget

PwC insight and analysis

Finance Act 2014 Update

Financial Services Commentary

Bad debt relief

Background

The Finance Act 2014 has introduced an amendment to the provisions dealing with relief for bad debts of financial institutions to introduce an additional condition for claiming such relief. The question of relief for bad debts has been an area of dispute between the financial sector and the Tanzania Revenue Authority, and the matter is currently the subject of a pending tax appeal. We set out below details of the technical issues in dispute, as well as the effect of the Finance Act 2014 amendment.

Bank of Tanzania regulatory requirement – provisions

Under the Banking and Financial Institutions (Management of Risk Assets) Regulations 2008 (“BoT regulations”), the Bank of Tanzania (“BoT”) requires every bank or financial institution to review and classify its outstanding loans and other risk assets at least once every quarter.

A minimum provision level is prescribed, which is calculated as a percentage of the relevant “credit accommodation and other risk assets” with different percentages depending on classification as follows:

- “Especially mentioned” 5%
- “Substandard” 10%
- “Doubtful” 50%
- “Loss” 100%

This classification is a function of both qualitative and quantitative criteria including age of overdue payments as well as security held by the lender.

Accounting standards

The generally accepted accounting standards in Tanzania are International Financial Reporting Standards (“IFRS”).

Where provisions calculated in accordance with IFRS are less than provisions required under the BoT regulations, a financial institution is required to create a special non-distributable reserve which represents appropriation of distributable reserves

from retained earnings so as to cater for the shortfall.

ITA 2004 – accounting basis

The starting point for the calculation of taxable income is section 21(1) Income Tax Act (“ITA”) 2004, which provides that *“subject to this Act, a person shall account for his income according to generally accepted accounting principles”*. So the accounting treatment applies unless specifically overridden by provisions in the ITA 2004. In considering the question of relief for bad debts of the financial sector, the relevant ITA 2004 provisions to consider are those relating to (i) bad debts and (ii) trading stock.

ITA 2004 – bad debts

- In calculating taxable business income, account is taken of any loss from the realisation of a business asset of a person (section 18 ITA 2004);
- An asset that is a debt claim owned by a financial institution is treated as realised *“when the debt claim becomes a bad debt as determined in accordance with the relevant standards established by the Bank of Tanzania and the institution writes the debt off as bad”* (section 39(d) ITA 2004);
- Where there is a realisation in terms of section 39(d), there is a deemed disposal and immediate reacquisition of the asset at market value (section 42 ITA 2004);
- In the case of a debt claim of a financial institution, *“a person may disclaim the entitlement to receive an amount or write off as bad a debt claimonly after the debt claim has become a bad debt as determined in accordance with the relevant standards*

established by the Bank of Tanzania” (section 25(5)(a) ITA 2004);

ITA 2004 – trading stock

- The definition of *“trading stock”* includes *“in the case of a person carrying on a banking business, loans made in the ordinary course of that business”*(section 3 ITA 2004), and closing trading stock is to be valued at the lower of cost and market value (section 13 ITA 2004);

IMF model Income Tax Act

The ITA 2004 provisions are drawn from the IMF model *“Commonwealth of Symmetrica”* Income Tax Act, and guidance to the meaning of the provisions in the model Act is set out in a separate Commentary on the Act.

The relevant equivalent provisions in the model Act are the following:

- Section 49(2) *“a person may only disclaim the entitlement to a payment or write off as bad a debt claim of the person – (a) in the case of a debt claim of a financial institution, after the debt claim has become a bad debt as determined in accordance with the relevant standards established by the Commonwealth of Symmetrica Bank”*
- Section 82(1)(d)(i) *“A person who owns an asset is treated as realising the asset -(d) in the case of an asset that is a debt claim, when - (i) where the debt claim is owned by a financial institution, the debt claim becomes a bad debt as determined in accordance with the relevant standards established by the Commonwealth of Symmetrica Bank and the institution writes the debt off as bad”*.

The Commentary to the Model Act includes the following pertinent commentary: *“The manner in which financial institutions write off bad debts is frequently governed by prudential regulation. Section 49(2)(a) adopts this procedure so as to provide consistency”*. In other words the object of these provisions is to have consistency between the tax treatment and the regulatory provisioning requirement.

Regional comparison

The Uganda Income Tax Act 1997 in its section dealing with bad debts also makes reference to loss reserves of financial institutions. In the 2001 **Bank of Baroda** case, the Uganda Tax Appeals Tribunal ruled in favour of the bank’s claim for deduction of provisions made in accordance with the relevant Bank of Uganda guidelines.

TRA interpretation

The TRA position is that a provision made in accordance with BoT guidelines is not a sufficient basis for such a claim. Instead, TRA’s position is that a deduction can only be granted when the relevant debts have been physically written off from the books of accounts of the financial institution.

Our view

Our interpretation is as follows:

- Bad debt provisions made in accordance with Bank of Tanzania (“BoT”) guidelines are deductible on the basis of the explicit reference to BoT provisioning in sections 39(d) and 25(5)(a).
- The references to the write off of bad debts do not require a debt to have been written out of the books. It is simply referring to a write off for tax purposes (i.e. a claim for a tax). This is clear from the wording in section 25 which

states that *“a person may disclaim the entitlement to receive an amount or write off as bad a debt claim”* – the use of the word “may” is deliberate so as to confirm that the taxpayer has the right to make such a claim. Where the taxpayer has made such a claim then he satisfies the conditions of section 39(d) (*writes the debt off as bad*) and so the debt claim is treated as realised. (An alternative view of 39(d) might be that it is referring to accounting write off – however, not in the sense of write off of the debtor out of the books of account, but simply that an accounting provision has been made against the relevant debtor with a resulting expense booked to the profit and loss account.)

- The wording in the equivalent provisions in the model IMF Act is essentially the same as the ITA 2004 wording, and the interpretation of these provisions as set out in the Commentary on the model IMF Act supports the above interpretation.
- An adoption of the TRA interpretation would essentially make meaningless the references to BoT provisioning (in section 25(5)(a) and 39(d) as the physical write off from the books of accounts of the financial institution would only occur at a much later date and only once the institution believes that the debt claim in question will not be satisfied. Such an interpretation would effectively take one back to the general basis for claiming bad debts set out in sections 25(5)(b) and 39(1)(e) (which refer to the requirements that the person *“has taken all reasonable steps in pursuing payment”* and *“reasonably believes that the entitlement or debt claim will not be satisfied”*). Indeed, once a debt is written out of the books there is

nothing to provide against, and so the adoption of such an interpretation would then beg the question as to the purpose of the explicit reference in the tax legislation to bad debts determined in accordance with BoT guidelines.

An alternative ground for a claim for relief for the financial institutions would be on the basis of the ITA 2004 provisions requiring trading stock to be valued at the lower of cost and market value. As noted above loans made in the ordinary course of a banking business fall within the definition of trading stock, and the argument would be that valuation in accordance with the regulatory requirements would be the best approximation to market value.

Tax Appeal Rulings

Two Tax Revenue Appeals Board rulings in 2010 (**Barclays Bank Tanzania Limited v Commissioner General and CRDB Bank Plc v Commissioner General**) supported the interpretation that a tax deduction can be claimed for a provision for bad and doubtful debts made in accordance with the BoT regulations and approved by the BoT, as required under the banking laws.

However, this interpretation was reversed in a 2011 Tax Revenue Appeals Tribunal ruling, which ruled that a deduction can only be granted once the bad debt has been actually written off from the books after failure of recovery measures and disposal of security.

This ruling has been appealed and a hearing is awaited in the Court of Appeal. Even if the Court of Appeal ruling reverses the ruling of the Tribunal, the effect of the Finance Act 2014 amendments will be to limit the relevance of such a ruling to the past.

Finance Act 2014 amendments

The Finance Act 2014 makes the following amendments to sections 25(5)(a) and Section 39(d) (amendments highlighted and underlined):

- Section 25(5)(a): “(a) in the case of a debt claim of a financial institution, after the debt claim has become a bad debt as determined in accordance with the relevant standards established by the Bank of Tanzania **and that such institution has taken all reasonable steps in pursuing payment and the institution reasonably believes that debt claim will not be satisfied;** and;”
- Section 39(d): “(d) in the case of an asset that is a debt claim owned by a financial institution, when the debt claim becomes a bad debt as determined in accordance with the relevant standards established by the Bank of Tanzania and the institution writes the debt off as bad; **after such institution had taken all reasonable steps in pursuing payment and the institution reasonably believes that the debt claim will not be satisfied**”

These amendments make sections 25(5)(a) and 39(d) meaningless as the real effect of the amendment is that bad debt relief for financial institutions is to be on the same basis as for persons other than financial institutions (as already set out in section 25(5)(b) and 39(e)). If this was the intention of the legislature, then it would have been simpler to simply delete sections 25(5)(a) and 39(d) and remove any pretence of a differential treatment for the financial sector.

Concerns

The concerns with the lack of synchronisation with the Bank of Tanzania provisioning are the following:

- **Regulatory:** Tax on the BoT provisions erodes the safety net that the provisions are in place to provide and thereby defeats the regulatory purpose of the provisioning requirement.
- **Cost of finance / financial deepening:** If financial institutions cannot get relief for BoT provisions at the time of provisioning, this will definitely be factored into the financial sector’s interest rate pricing.
- **Administrative burden:** Bad debts are by definition part of the business of lending, and so financial institutions will have very significant numbers of bad debts. Introducing a requirement for the banks to provide to the Tanzania Revenue Authority details of each and every debt written off and reasons as to why such debt is not recoverable will impose a very significant administrative burden.
- **Simplicity:** The change works against one of the main objectives when introducing the ITA 2004, namely greater alignment between accounting and taxation.

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