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PRIVATE SECTOR POSITION ON THE RENTAL INCOME TAX REGIME

Submitted to the

Minister of Finance, Planning and Economic Development –

Government of the Republic of Uganda

By

Private Sector Foundation Uganda

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PROUDLY UGANDAN

Introduction and the law

Income Tax Amendment Clause 5 (1a) effective 1st July 2022 mandates that ***companies earning rental income will claim expenditures and losses capped up to 50%*** **of their** ***gross rental income and without carrying forward any excess expenditures and losses***, for the financial year 2022/23 and onwards.

Much as we acknowledge the Government's intention of increasing the productivity of tax among non-individual rental taxpayers, the move undermines the professional real estate developers who use banks to construct quality real estate. It is also affecting Foreign Direct Investment (FDI) by venture capitalists into Uganda's real estate industry. The private sector's position is that interest should be fully tax deductible over and above the 50% cap. More so, since it will have already paid tax in the bank and thus it becomes double taxation.

Importance of Real Estate Industry:

The quality of Uganda's real estate has been steadily improving as nicer buildings coming in Kampala's skyline. Choking it now is counterproductive in the medium to long term even from a tax collection perspective. In broadening a better real estate offering, increases the reach of Uganda's trade, the higher the standard of real estate on offer, the higher the influx of international high tax-paying companies.

It is an industry that brings immense value to any country and needs to be treated as a strategic sector in the grand scheme of things and professional investors usually play a lead role in innovation and opening new frontiers.

The real estate is an integral part of the nation's infrastructure quality. It is the catalytic backbone for which a country's economic development is built, for it remains invariably relevant to all industries. A case in point is Dubai where quality real estate has played a catalytic role in the grand strategy of being a top global brand and wonderful lifestyle offering to complement the Emirates airline. Most importantly, the industry acts as a catalyst for the tourism sector development. High-spenders prefer well-developed real estate countries as their tour destinations.

More so, the real estate has strong forward and backward linkages in an economy where its vibrant. Furthermore, the industry is a pathway for other developments as a builder of a capital base. The industry is also essential in the safekeeping of valuable goods and banks require as security to get access to financing for other activities.

The real estate industry gives confidence and a reputation for the country that is doing well, many company headquarters are in cities with better property offerings like Johannesburg, Nairobi, Dubai, Hongkong etc. This also paves the way for further job opportunities present in the construction industry and much more.

Effect and implications of the 2022 tax regime to business and revenue in short, medium and long run.

1) **Revenue.** To appreciate the effect of capping allowable expenses is to project cost and revenue as an average of the investment cost. On average real estate makes an average yield of 8% (6-11%) of the cost of the total investment. Anything above that is often unsustainable and below that the business won't be viable. This will eventually scare away venture capitalists hence low FDI in the sector and poor real estate development in the country.

2) **Expenses**

   a) **High cost of capital**

   Sub-Saharan Africa pays the highest premium on the cost of capital and is often double-digit. Yet, professional and massive real estate projects are usually funded by debt that is facilitated by financial institutions. The commonest ratio being 50:50 debt to equity ratio.

   On average, weighed cost of capital is about 12%, (foreign and local). This translates to about 6% annually is allocated to servicing debt annually (interest portion only). This cost of interest makes up a significant portion of expenses that at times completely encapsulates turnover by more than 60% in the first 5 years of the project life.

   It is therefore imperative that this tax amendment be revised to at least provide for interest expense as a fully deductible outside the 50% cap.

b) Depreciation and startup costs:

The tax regime has an immense effect on the profitability and survival of businesses because allowable deductions i.e., depreciation and startup costs are part of the expense line and these alone attribute to about 40% of the annual revenue in the early years of the property life. This translates to 3 to 4 % of the cost of the total investment annually.

c) Repair and maintenance cost: -

The international average benchmark of 2% of the cost of capital is allocated to the maintenance of the property annually to keep it in a tenantable condition. Most recommend a keeping of 4% reserve fund for this cost but at least more than 2% will be spent of maintenance and life cycle costing.

We know, that in Uganda we don't have a maintenance culture, and this often leads to destruction of value in a property, or it becomes very costly to rejuvenate them when that are completely run down leading to a very high cost per sq meter per unit time compared to other jurisdictions. Therefore, the cap will have a negative effect on keeping the properties in good condition in the medium to long run. Maintenance usually translates to about 20 to 25% of annual gross revenue.

d) Admin Expenses

Other Admin expenses like Salaries and wages, insurance, security, letting, utilities, office expenses amount to about 1.5% of the cost of the investment annually. This translates to 12 to 15% of the annual revenue n average. In a nutshell, because of the above 4 broad categories properties will make loss in the initial 3 to 5 years largely because of interest expense, depreciation and start-up costs.

Properties become profitable when debt has been paid, whose burden decreases with time of the property. The 2022 amendment is discouraging professional investor who are likely to leverage on debt to build innovative structures.

Implication for capping expenses at 50%;

1) **Capital accumulation: -** Capital accumulation is vital, especially for the domestic investor. If not supported, it will inevitably become a domain that only generational savings and possibly foreign stakeholders are able to operate without debt or access very cheap debt that is not impactful on the revenues of the property.

2) **Increase in the cost of housing in Uganda: -**

   The changes came at a time when landlords are already having to pay many new taxes like property tax, rates service tax the local government authorities such as KCCA and which will result to increase the cost of housing in Uganda because of the likelihood to increase rent.

3) **Continuous losses by companies.**

Companies that have already invested will not be able to turn a profit if this regime is not reversed. Furthermore, the regime is making it difficult to attain financing from financial institutions; eroding the accumulated capital; creating a decline in the growth of internationally recognized Grade A buildings and increasing in small structures.

Conclusion

While the Government is keen on mobilizing adequate domestic revenue to cover the budget gap, it is important to consider various attributes that make a good tax regime. This includes stability and predictability. Businesses and individuals value certainty when they are making investment decisions, especially long-term commitments. In contrast, frequent and unexpected changes to the business tax regime does not inspire confidence and can deter long-term investment.

The Appeal

Hon. Minister, the private sector thus wishes to;

1) Kindly inform you that this tax order places the companies in the real estate sector in a debilitating position where they are unable to meet their

finance costs, repairs and the construction of further real estate that provides employment & service to many.

2) Request that you reconsider this 2022 amended percentage for the survival of the industry as a whole, but particularly for the local companies.

3) In the alternative, if 1 and 2 above fails, at least consider Interest expense outside the 50% cap for the reasons expressed above.

We thank you for your consideration and look forward to further engagements on the matter.