IN THE INCOME TAX SPECIAL COURT

BEFORE

The Honourable Mr Justice P Blieden	President
N Crafford-Lazarus	Accountant Member
I J Moolman	Commercial Member

In the appeal of:

APPELLANT

CASE NO 10969

(Heard at Johannesburg on 7 February 2003)

JUDGMENT

JOHANNESBURG February 12, 2003

BLIEDEN, J:

For the year of assessment ending 28 February 1997 the appellant, a limited liability company registered as such according to the laws of South Africa, conducted the business of an investment and financing company. In its calculation of taxable income

for that year it claimed a loss of R24 064 626,00 being in respect of a loan to "A" which it claimed to have written off as being irrecoverable.

The Commissioner disallowed the appellant's claim of a loss in his assessment of the appellant's taxable income for the year concerned, and it is against this decision that the present appeal is directed.

It is the appellant's case that the irrecoverable loan arose as part of its business as a moneylender and therefore the irrecoverable loss suffered by it justified the claim as a taxable loss for the year concerned in terms of section 11(a) of the Income Tax Act, No 58 of 1962 (as amended) (the Act).

The relevant section of the Act reads:

> "*11. General deductions allowed in determination of taxable income* –
>
> *For the purpose of determining the taxable income derived by any person from carrying on any trade within the Republic, there shall be allowed as deductions from the income of such person so derived –*
>
> *(a) expenditure and losses actually incurred in the Republic in the production of the income, provided such expenditure and losses are not of a capital nature;*"

This section of the Act must be read with its counterpart, section 23(g), which reads:

> "*23. Deductions not allowed in determination of taxable income* –

> *No deductions shall in any case be made in respect of the following matters, namely –*
>
> *(g) any moneys claimed as a deduction from income derived from trade, which are not expended for the purposes of trade;*"

As is demonstrated by the two sections, section 11(a) provides positively for what may, and section 23 negatively for what may not, be deducted in the determination of a taxpayer's taxable income: A deduction claimed must satisfy both sections. CIR v Nemojim 1983 (4) SA 935 (A) at 946-7.

In the present case in order for the appellant's loss to be deductible, the following must be proved by it:

(i) The loss was in fact suffered.

(ii) The loss was incurred in the production of income.

(iii) The loss was not of a capital nature.

(iv) The loss was incurred for the purposes of the trade of the appellant.

One witness gave evidence in this case. He is R who at all relevant times was a director of"B"; a member of the management committee of the appellant and a director

of the "C". Because of his position in the various companies, R was able to describe fully the nature of the relationship between the appellant and "A", the other members of the group as well as the various loans made by the appellant to "A" over a period of some years. This evidence is to the following effect:

1. "A" was a company in which 90% of the shares were owned by the "C". The remaining 10% were owned by an individual.

2. At all times material "A" conducted the business of manufacturing shipping containers for the overseas market.

3. The appellant over a period of many years had conducted the business of an investment and financing business within the "C". It held shares in a number of companies quoted on the Johannesburg Stock Exchange as well as in some companies not so quoted. For the tax year ended February 1997 the market value of its quoted shares was R167 349 505,00, and the valuation by its directors of its unquoted shares was R10 283 663,00. In addition to these investments it had loans to other companies mainly in the "C", and in addition to a company outside the group. The terms and conditions relating to each of these loans differed from debtor to debtor.

4. The situation relating to "A" was that over a period of years various monies were advanced to it as loans by the appellant. A schedule of the amounts

advanced and repaid by "A" to the appellant during the period March 1995 to April 1997, when "A" effectively stopped trading, is set out in pages 92 to 101 of the dossier.

5. At no stage was there any written agreement between the appellant and "A" relating to the monies lent, but the relationship as debtor and creditor was governed by the following considerations:

(a) "A" and the appellant shared common directors.

(b) The appellant would advance monies to "A" from time to time when the latter needed such monies in order to enable it to continue its business activities, and when the appellant had money available to advance. All loans made by the appellant to "A" had to be approved by the appellant's board of directors.

(c) Interest on all loans advanced by the appellant was calculated at an agreed rate which was market-related and was capitalised monthly.

(d) No date for repayment was fixed. "A" was only obliged to make repayments as and when it was in a financial position to do so and in amounts which suited its financial position from time to time. In R's words "*the loan was open ended*".

(e) There was no differentiation of payment for interest or capital.

(f) The appellant at no stage asked for or was given any security for the monies advanced to “A” from time to time.

6. In April 1996 when “A” owed the appellant R24 064 626,00 the board of “A” decided to close down its business as it had been losing money consistently. This was largely due to the fact that Chinese manufacturers of containers similar to those made by “A” were selling them at a price which could not be matched by “A”, and it could no longer competitively participate in the international container market. “A” was effectively closed down on 30 June 1996. It could not repay any portion of the loan to the appellant, who wrote it off as irrecoverable.

7. On 31 December 1996 the appellant in writing ceded its right title and interest in the loans that it had made to “A” to “B” for no value. On 2 April 1997 the appellant’s board of directors confirmed the writing off of the loan to “A” at a board meeting. The reason for the cession to “B” was to ensure that all the debts of “A” to members of the “C” could be consolidated. With the completion of this cession “A”’s indebtedness to “B” amounted to R84 827 040,00. It was decided not to wind-up “A” as it was the policy of the “C” not to liquidate its subsidiaries, which “A” in effect was. The

reason for the Group adopting this attitude was that it did not want to be seen as not supporting its subsidiaries and affiliated companies.

8. On 5 September 1997 "B" sold its total claim against "A" to "D" for a total consideration of R6 545 000,00. A written agreement reflecting the sale is at pages 23 to 28 of Exhibit A to the papers.

In our view this matter can be decided on a crisp point and it is not necessary to decide whether the loss claimed by the appellant arose from the loan to "A" becoming irrecoverable and being written off as claimed by the appellant, or whether it was as a consequence of the decision that the cession was worth nothing in the opinion of the appellant as claimed by the Commissioner.

The question for determination is a decision as to the nature of the loan transactions between the appellant and "A". On behalf of the appellant it was submitted that the relationship between the parties was that of a moneylender and a borrower. In this regard we were referred to the case of Stone v SIR 1974 (3) SA 584 (A) at 596A-D per Corbett AJA (as he then was) who stated the position as follows:

> "*It has been accepted in a number of cases, mainly in the Special Court, that where the taxpayer can show that he has been carrying on the business of banking or money-lending, then losses incurred by him as a result of loans, made in the course of his business, becoming irrecoverable are losses of a non-capital nature and deductible. ... The rationale of these decisions appears to be that capital, used by a money-lender to make loans, constitutes his circulating capital and that, consequently losses of such capital are on revenue account. I shall*

accept, for the purposes of this case, that these decisions are correct, provided that the business is purely that of money-lender and the loans are not made in order to acquire an asset or advantage calculated to promote the interests and profits of some other business conducted by the taxpayer. (cf Atlantic Refining Company of Africa (Pty) Ltd v CIR 1957 (2) SA 330 (AD).) There is, however, in my view, no warrant for extending this principle to loans by persons who are not conducting a money-lending business."

In Solaglass Finance Co (Pty) Ltd v CIR 1991 (2) SA 257 (A) at 271B-H Friedman AJA laid down certain guidelines for ascertaining whether a taxpayer is a moneylender in certain circumstances, as follows:

"*Whether or not a taxpayer can be said to be carrying on the business of a money-lender or banker is in each case a question of fact to be decided in the light of the circumstances of the particular case. The following are guidelines which have been laid down for the determination of the question whether a taxpayer can be said to be carrying on such a business:*

1. *There must be an intention to lend to all and sundry provided they are, from his point of view, eligible. See Secretary for Inland Revenue v Crane 1977 (4) SA 761 (T) at 768D-E.*

2. *The lending must be done on a system or plan which discloses a degree of continuity in laying out and getting back the capital for further use and which involves a frequent turnover of the capital.*

3. *The obtaining of security is a usual, though not essential, feature of a loan made in the course of a money-lending business.*

4. *The fact that money has on several occasions been lent at remunerative rates of interest, is not enough to show that the business of money-lending is being carried on; there must be a certain degree of continuity and system about the transactions.*

5. *The proportion of the income from loans to capital income; the smallness of the proportions cannot, however, be decisive if the other essential elements of a money-lending business exist.*"

The Solaglass case dealt with a situation somewhat similar to the one in the present case, namely an investment and loan company in a group of companies lending money to other companies in the same group.

In the present case I shall accept for the purposes of argument that the appellant did in fact lend money to some of its associated companies or third parties from time to time as a moneylender. However, here the issue is not what the appellant's business was, but what the transaction between appellant and "A" was in the present context. In this regard the statements of Van Rheenen J in ITC 10326 (1998) at 396 to 397 is of relevance. The learned judge said:

> "*A long-term loan without any repayment terms, in my view, lacks the essential characteristics of floating capital which, if it becomes irrecoverable, constitutes a loss of a capital nature.*"

I am in respectful agreement with this statement. In the instant case the evidence by R, as well as the various financial statements which form part the dossier, make it plain that whatever the nature of the transaction between the appellant and "A" was, it was not that of a commercially acceptable money-lending transaction as described in the cases to which reference has already been made. The loss suffered by the appellant was of a capital nature. The reasons for this are:

(a) There was no objectively ascertainable system for the appellant to recover the money that it lent from time to time nor the interest payable on such money. One cannot escape the conclusion that if "A" was at no stage in a position in which it could make payment to the appellant, the loan would just not be repayable. This seems to have been the position in 1996 when "A" stopped trading. An agreement of this nature is contrary to the very basis of a money-lending transaction, which requires a "*degree of continuity in laying out and getting back the capital for further use*".

(b) The appellant had no way of recovering the monies lent and advanced except in the event of "A" being able to afford to pay it. This is fundamentally contrary to what one would expect in a relationship of a moneylender and borrower as defined by the various authorities quoted above.

Having reached this conclusion it is not necessary to deal with the various other arguments raised on behalf of the Commissioner to justify his refusal to accept the appellant's loss for tax purposes. This is not to say that there is no merit in these arguments.

The evidence in this case plainly shows that the loss incurred by the appellant was not in the production of the appellant's income as required by section 11(a) of the Act, nor were the monies lent to "A" advanced to it for the purposes of the appellant's trade as required by section 23(g) of the Act. It was for the appellant to prove both of these

requirements in terms of section 82 of the Act. This section of the Act places the burden of proof to show that the Commissioner's decision is wrong squarely on the appellant. The appellant has failed to discharge this burden. The following order is made:

The appeal is dismissed. The Commissioner's assessment is confirmed.

On behalf of Mr Crafford-Lazarus (Accounting Member)

Mr I J Moolman (Commercial Member) and myself.

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P BLIEDEN - PRESIDENT

The judgment should be reported **YES** **NO**

Adv A J Lewis instructed by Weavind and Weavind, Pretoria
appeared on behalf of the appellant

Ms A Collins represented the Commissioner for Inland Revenue