REPUBLIC OF SOUTH AFRICA

IN THE TAX COURT OF SOUTH AFRICA

GAUTENG DIVISION, JOHANNESBURG

CASE NO: IT 14213

(1) REPORTABLE: YES / **NO**

(2) OF INTEREST TO OTHER JUDGES: YES / **NO**

(3) REVISED.

....

SIGNATURE DATE

In the matter of:

TAXPAYER H Appellant

and

THE COMMISSIONER FOR THE SOUTH AFRICAN REVENUE SERVICE Respondent

---

J U D G M E N T

THIS JUDGEMENT HAS BEEN HANDED DOWN REMOTELY AND SHALL BE CIRCULATED TO THE PARTIES BY EMAIL. THE DATE AND TIME OF HAND DOWN SHALL BE DEEMED TO BE 2022/02/09

BAM J:

A. Introduction

[1] In this appeal, the appellant challenges the respondent's decision in allowing a partial deduction of the interest expense it had sought to deduct during the 2011 year of assessment. The appellant contends that the interest is fully deductible, as it was incurred in the course of carrying out its money lending trade,[1] and in the production of income. The respondent argues that on pure application of the requirements of section 24J(2), the appellant fails to meet the requirements. Thus, the interest is not deductible. However, owing to a practice adopted by the respondent, it allowed a partial deduction as aforesaid. The practice is that recorded in Practice Note 31 (PN).

[2] The issues then are:[2] (i) whether the interest sought to be deducted by the appellant was incurred whilst carrying on a trade; and (ii) whether it was incurred in the production of income. Connected to the two issues is the question of whether the respondent has successfully discharged the onus resting on it for its imposition of the understatement penalty against the appellant.[3] The question of interest has since been conceded by the respondent. As such it is no longer an issue between the parties. There is a further issue connected to Practice Note 31 (PN) and whether or not the respondent had correctly limited the interest in terms of the PN. In the course of this judgement, I consider the submissions by the parties regarding the PN.

B. The Parties

[3] The appellant, Taxpayer H, which I propose to refer, is a private company with limited liability. Its registered office is situated at Wynberg, Sandton, Gauteng. The appellant describes itself as an investment holding company[4] with its assets comprising, in the main, unlisted shares in subsidiary entities, loans advanced to the subsidiaries and cash. The respondent is the Commissioner for the South African Revenue Service, with its principal place of business at

---

1 Caselines 002-1: Appellant's response dated 15 February 2015 to the letter of audit findings, para 1; Caselines 009-1: Appellant's notice of appeal 29 October 2015; Appellant's Rule 32 Statement.

2 In terms of Rule 34 of the Tax Administration Act, the issues in an appeal to the tax court will be those contained in the statement of the grounds of assesment and opposing the appeal, (Rule 31 statement) read with the statement of the grounds of appeal (Rule 32 statement) and, if any, the reply to the grounds of appeal.

3 The burden of proving… the facts on which SARS based the imposition of an understatement penalty under Chapter 16, is upon SARS.

4 Director's Report, 2011 Taxpayer H Annual Financial Statements.

299 Bronkhorst, Niew Muckleneuck, Pretoria. The respondent is responsible for administering the Income Tax Act[5] (ITA), and other legislation pertinent to this appeal.

C. Background

[4] The common cause facts may be summarised thus: The appellant, in addition to being an investment holding company, claimed that during the time germane to this appeal (2011 year of assessment), it conducted a trade in money lending with the specific purpose of making a profit from on-lending borrowed funds to its subsidiaries. All money borrowed free of interest, according to the appellant, was used for share investing activities, while interest bearing borrowings were applied towards lending to the subsidiaries.[6] The present dispute can be traced to the respondent's letter of audit findings of 14 December 2014 (the letter) in which the respondent intimated its intention to disallow the interest deduction of R68 133 602, and instead, limit it to the amount of interest received of R34 936 000 and levy an understatement penalty. The letter recorded that the respondent had come to the conclusion that the interest was not incurred whilst carrying on a trade, nor was it incurred in the production of income. In this regard, the respondent identified the following common cause facts as the basis for its conclusion that the interest was not deductible: (i) The appellant borrowed at interest rate of 8.29% per annum, yet it extended loans to its subsidiaries at interest rates ranging between 0%, 5.29%, 6.22% and at times, 8.29% per annum. The interest rates imposed by the appellant, so it was contended, demonstrate no commercial sagacity and exposed the appellant's transactions as nothing more than furthering the group's interests, by enhancing the earning capacity of the subsidiaries. The transactions, according to the respondent were about funding unproductive loans; (ii) the appellant's borrowings were far less than its receivables; and (iii) the appellant's lending transactions extended only to its subsidiaries. Finally, the respondent contended that the appellant had structured its lending transaction so that it could earn neither income nor profit.

[5] The upshot is that the respondent allowed a partial deduction. In allowing the partial deduction, the respondent says it is informed by its long standing practice as set out in its PN read with section 5(1) of the Tax Administration Act (TAA). The letter invited the appellant to provide reasons in the event it disagreed together with any material that may support its case.

---

5 Act 58 of 1962.

6 Taxpayer H's letter of June 2014.

[6] In its letter of response dated February 2015, the appellant disputed the respondent's conclusions. Its main contention was that, notwithstanding that its lending trade was not profitable in 2011, it was profitable in 2012. The respondent finalised its audit on 8 April 2015 and issued the additional assessment on 28 April 2015. The appellant's objection having been disallowed, followed by a notice to appeal, led to the present appeal. I mention for the sake of completeness that in September 2017, the appellant paid the full amount together with interest in the amount of R14 764 642. In addition, SARS withheld an amount of R1.6 million that was due to the appellant as set off against the same disputed debt.

D. Proceedings before this court

[7] The appellant called Ms Y as its only witness. Ms Y, a chartered accountant with a diploma in tax, works for CAP Industrial Holdings, the ultimate shareholder in Taxpayer H. Ms Y, I noted, testified with candour and was not evasive when confronted with information that did not augur well with the appellant's case. She confirmed she was responsible for tax compliance. She wrote the letters sent to SARS and conducted her own investigation into the SARS queries. Ms Y confirmed that Taxpayer H only lent to the group subsidiaries. Testifying with reference to the AFS of 2011 and 2012,[7] she stated that the figures confirm that Taxpayer H had a profit motive. She mentioned that a profit of R50 million was achieved in 2012, if one includes exempt income (dividends) of R20 million. As demonstration of the appellant's profit motive, Ms Y testified that Taxpayer H grew its loan debtors by R339 million during the year in question and reduced its loan creditors by R1,347 million. The ultimate point in support of the Taxpayer H's profit motive was that for approximately five of the six years post 2011, Taxpayer H demonstrably made a profit. In the appellant's view, the interest expense was incurred whilst carrying on a trade and was thus deductible in full. There was no basis for SARS to levy the understatement penalty.

[8] During cross examination, the witness was directed to the tax return filed on behalf of Taxpayer H for 2011, in particular to the declaration section. One of the questions asked was whether the taxpayer entered into any transaction as contemplated in section 24J, and the answer entered was 'No'. This answer is in stark contrast with the whole basis for pursuing the appeal. Ms Y acknowledged the answer. In so far as the loans to the subsidiaries, Ms Y confirmed that there were no written loan agreements. The loans were recorded in a document referred to in the parties' correspondence as Annexure A and they were also recorded in the AFS. The loans were unsecured and carried no terms, including repayment terms. During cross examination, what struck a discord with her testimony in chief was the acknowledgment that from about 2009 to

---

7 Caselines pages 020-123.

2017, the interest incurred in the appellant's money lending transactions consistently exceeded the interest received or accrued to the appellant. After a brief re-examination, the appellant closed its case.

[9] The respondent led the evidence of Ms G, a financial specialist with a Master's degree in Commerce, as its only witness. Ms G confirmed that she obtained the appellant's risk profile from the respondent. This aspect of the risk profile was unclear in terms of how and in what instances it was obtained. Nonetheless, Ms G testified that she went through Holding's AFS for the years 2008 to 2017 and noted that the interest paid was always in excess of interest received, with the exception of 2008 where the interest received equalled that incurred. She confirmed that she did not take into account the interest from the bank in assessing Taxpayer H's profit motive for its lending activities because such interest was a result of cash pooling or cash management activities and had nothing to do with the appellant's lending trade.

[10] In addition to the points set out in paragraph 4 of this judgement, which led the respondent to conclude that the appellant was not carrying on a trade, Ms G referred to the fact that the individual loans carried no security, were not recorded, and had no terms. She further isolated the fact that Taxpayer H did not incur any other expense and had no staff to demonstrate how it managed the loans.

[11] On the penalty levied by SARS, Ms G referred to the incorrect deduction which, in the respondent's view, was not permissible in terms of section 24J(2) and, as a consequence, was prejudicial to SARS and the fiscus. She further added that all the information uncovered during the audit was always with Taxpayer H's knowledge. SARS considered that there was a substantial understatement and levied a 10% understatement penalty. She concluded that the respondent had appropriately levied the penalty. During cross examination, she confirmed that the respondent had not taken into account the interest earned from the bank in weighing the case for Taxpayer H's profit motive. It was put to the witness that it was not for the respondent to dictate to a taxpayer how to run its business. This, the witness accepted. This marked the end of the respondent's case.

E. The Law

[12] It is wise to first revisit the point about the nature of the proceedings in this court as set out in *Commissioner South African Revenue Services v Pretoria East Motors (Pty) Ltd*:[8]

> "It is important at the outset to emphasise, as Curlewis JA did in *Bailey v Commissioner for Inland Revenue* 1933 AD 204 at 220, that the Tax Court is not a court of appeal in the ordinary sense; it is a court of revision. That means, as Centlivres JA observed in *Rand Ropes (Pty) Ltd v Commissioner for Inland Revenue* 1944 AD 142 (at 150):
>
> ". . . that the Legislature intended that there should be a re-hearing of the whole matter by the Special Court and that that Court could substitute its own decision for that of the Commissioner."

[13] The section at the heart of the appellant's appeal is section 24J(2) of the ITA. It reads:

> "(2) Where any person is the issuer in relation to an instrument during any year of assessment, such person shall for the purposes of this Act be deemed to have incurred an amount of interest during such year of assessment, which is equal to—
>
> (*a*) the sum of all accrual amounts in relation to all accrual periods falling, whether in whole or in part, within such year of assessment in respect of such instrument; or
>
> (*b*) an amount determined in accordance with an alternative…,
>
> which must be deducted from the income of that person derived from carrying on any trade, if that amount is incurred in the production of the income." [own underlining]

[14] One should make reference to section 24J(3), which deals with an income instrument. It reads:

> "Where any person is the holder of an income instrument ……."

An income instrument is described in section 24J as:

> "(*a*) in the case of any person other than a company, any instrument—
>
> (i) the term of which will, or is reasonably likely to, exceed one year; and…"

[15] In terms of section 102 of the TAA

> "A taxpayer bears the burden of proving:
>
> (*a*) …
>
> (*b*) that an amount or item is deductible or may be set off."

---

[8] (291/12) [2014] ZASCA 9, paragraph 2.

F. Analysis

[16] I consider it appropriate to first deal with the contentions raised by the parties in relation to the PN. In the first instance, in its heads of argument, the appellant raises the point that it is incorrect for SARS to elevate the question of its practice, as set out in its PN, to the status of an issue between the parties. It points out that this was never an issue between the parties. In a further point titled, "Reliance by SARS on its Practice Note" the appellant states that it is common cause that in disallowing the interest deduction, SARS relied on its PN. The appellant goes on to state that it does not deny that PN 31, in the present case, operates in its favour. However, it submits that this court should be reminded of the remarks of the Constitutional Court in *Marshall and Others* v *Commissioner, South African Revenue Service.*[9] Elsewhere in its heads, the appellant revisits PN 31 in a different context. It finally concludes that PN 31 is outdated.

[17] It is not common cause, and it is not correct that the respondent relied on PN 31 in disallowing the interest deduction. The undisputed facts are that the interest expense, in respondent's view, based on the requirements of sections 24J(2), is not deductible. On the contrary, in allowing the partial deduction, the respondent relied on the PN as its common practice. Whether the respondent was correct in its assertions in disallowing the interest deduction is the subject matter of this appeal, and this is plain from a cursory reading of the parties' rule 31 and 32 statements. This then makes the PN a non-issue in this appeal. After all, I do not understand the appellant's contentions to mean that it rejects the partial allowance of the interest. As for SARS' submissions in its heads of argument regarding the PN, the appellant is correct in stating that this was never an issue. Respectfully, there is no need to take the issue of the PN any further. I record that both parties in their heads of argument identify the issues as those set out in paragraph 1 of this judgement. In the succeeding paragraphs, I consider the issues in turn.

---

9 [2018] ZACC 11 at paragraph 11: In Marshall, the court questioned the rationale behind allowing a unilateral practice of a government agency, (a litigating party) — based on that government agency's own interpretation— to play a role in determining the reasonable meaning of a statutory provision.

(i) Whether the appellant was carrying on a trade in lending, as a money lender, at the time relevant to this appeal

[18] I now consider the question whether the appellant, on the facts of its case, was indeed carrying on a trade in moneylending.

(a) Lack of evidence to suggest continuity; no system or plan of laying out and collecting money; loans unwritten, with no terms;

[19] The courts have repeatedly cautioned that the question of whether a person is carrying on a lending trade is to be established from the facts of each case.[10] Perhaps, at the outset, it is convenient to refer to *Solaglass Finance Co. (Pty) Ltd* v *Commissioner for Inland Revenue*,[11] a case on which the appellant also places reliance for its submissions. The court in *Solaglass* espoused the following guidelines as means of establishing whether one is carrying on a trade as a moneylender or banker.

There had to be an intention to lend to all and sundry provided they were, from the taxpayer's point of view, eligible.

(i) The lending had to be done on a system or plan which disclosed a degree of continuity in laying out and getting back the capital for further use and which involved a frequent turnover of the capital.

(ii) The obtaining of security was a usual, though not essential, feature of a loan made in the course of a moneylending business.

(iii) The fact that money had on several occasions been lent at remunerative rates of interest was not enough to show that the business was of moneylending was being carried on. There had to be a certain degree of continuity about the transactions [see Income Tax Case 812 20 SATC 469].

(iv) As to the proportion of the income from loans to the total income: the smallness of the proportion could not however be decisive if the other essential elements of a moneylending business existed.

---

10 ITC 812 (20 SATC, 469); Income Tax Case No 1644 61 SATC 23.

11 1991 257 (A).

[20] The principles espoused in *Solaglass* guided the court in ITC 1771[12] where SARS' decision to disallow a deduction for revenue loss was confirmed. The facts, in brief, were: The appellant had lent monies to entities within its group and to some external entities. Over a period of time, it had extended several loans to a company within its group, (the debtor company). There were no written agreements evidencing the loans and no evidence of repayment terms. Having suffered losses during a challenging market, the debtor could no longer repay the appellant. When the appellant sought to claim an amount of R24 million as revenue loss, SARS refused the deduction. After applying the guidelines set out in *Solaglass* and although the court had accepted that the appellant was conducting the business of money lending, it still had to answer whether loss had been suffered in the course of a moneylending trade. In the course of its reasoning, the court remarked:

> "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."

[21] In ITC 812 (20 SATC, 469) the court reasoned thus**:**

> **"**The main difference between an investor and a money lender appears to consist in the fact that the latter aims at the frequency of the turnover of his money and for that purpose usually requires borrowers to make regular payments on account of the principal. This has been described as a system or plan in laying out and getting in his money…"

[22] It is noteworthy to point out that throughout its correspondence with the respondent and in its rule 32 statement, the appellant's case was founded on a claim that the interest expense was deductible in full because it was incurred whilst carrying on a trade in money lending with the purpose of producing income, specifically, from interest generated from its on-lending activities. Faced with the stark conclusions to be drawn from applying the law to the facts of its own case, it is plain from a simple reading of the appellant's heads of argument that the appellant no longer wishes to identify with its claims of carrying on a trade in moneylending. It now relies on the rather vague phrase of "interest earning and interesting incurring activities" to describe its trade. One need not look very far to find reason for this sudden change, because the answers are located in the appellant's own version.

[23] First, the appellant was invited to provide any documents in its possession to substantiate its lending trade. It offered Annexure A. Annexure A contains figures of the appellant's borrowing and lending, the names of the borrowing and lending companies within the group, along with a recordal of the applicable interest rates. In summary, the appellant did not dispute that the

---

[12] (66 SATC 205).

individual loans to its subsidiaries were not memorialised and carried no terms including repayment terms. It could provide no Board minutes or documents evidencing its lending policy. There was no security provided for the loans. The appellant could not provide evidence of a plan of laying out and getting in its money as evidence of continuity. Given these undisputed facts, it must now be pellucid why the appellant no longer wishes to make a case that it was carrying on a trade in money lending because it falls woefully short in meeting the test espoused in cases such as *Solaglass* [relied on by the court in ITC 1771] and ITC 812 (20 SATC, 469) to sustain its claim. Indeed, other than the claim that it was engaged in a trade of money lending with its transactions to the subsidiaries, the appellant has not provided a single piece of evidence in substantiation. When one brings into the equation the declaration recorded in its tax return of 2011 – that the appellant had not concluded any transaction in terms of section 24J – it becomes even more difficult for the appellant to sustain its claims of carrying on a trade in moneylending.

(b) Lack of profit motive

[24] The respondent testified that the appellant's lending transactions demonstrate no profit-making motive. It made reference to the rates of interest charged when on-lending and the fact that the loans carried no terms. Expatiating on this point in its heads, the respondent submits that if one examines the nature of the transactions between Taxpayer H and its subsidiaries, it is plain that Taxpayer H could never earn any interest income, let alone profit. It borrowed money at high rates and on-lent at either zero, substantially less interest or at exactly the same interest rate that it was charged. This, according to the respondent, is what led to Taxpayer H making losses from its lending activities in nine of the ten years beginning from 2008 to 2017, with the exception of 2008. According to SARS, Taxpayer H was not pursuing self interest but the group's interests. The substance of these transactions, argues SARS, is that the fiscus is financing the transactions between Taxpayer H and its subsidiaries because Taxpayer H incurs the full interest on borrowing and then claims the interest incurred as a deduction. The subsidiaries benefit without incurring any costs. Taxpayer H, according to the respondent, had subjugated its profit earning opportunity to advancing the profit interests of its subsidiaries.

[25] In making its case, the appellant places reliance on a number of other cases. I touch on these cases with reference to the common cause facts to demonstrate that none of these cases assist it. In the first instance, the appellant says that borrowing at high rates and on-lending at nil interest, low and at times the same interest it had incurred was based on commercial expediency and on facilitation of its own trade. It places reliance on the reasoning of the court in *De Beers Holdings (Pty) Ltd v Commissioner for Inland Revenue* 1986.[13] The appellant explains the commercial expediency in these paragraphs:[14]

> "Sound commercial sense suggests that a company in the position of [Taxpayer H] would only make advantageous loans to its wholly owned subsidiaries if it made sense to do so, i.e. the wholly owned subsidiaries would themselves become profitable, which in turn would benefit [Taxpayer H]. Why else would it do so? [111] [Taxpayer H] does not dispute that it is an investment and holding company and in the course of conducting such business, it advanced borrowed money to its subsidiaries on terms affordable to them so as to enhance profitability and it derived interest and dividends from the same subsidiaries."

[26] The appellant is correct in its reasoning that, boosting the earning capacity of the subsidiaries makes commercial sense for it as an investor and sole shareholder, as it is placed in a position to reap lofty dividends. This court however, is not concerned with what makes commercial sense for the appellant as an investor but it is interested in commercial expediency and the indirect facilitation of the appellant's trade as a money lender. It is common cause that the appellant, at the time relevant to this appeal, was an investment holding company with no staff. It had not incurred a single expense other than the interest expense in question. It also could not demonstrate how it managed the loans. Money lenders demonstrate their profit making purpose by charging remunerative interest rates and fixing terms when lending. In addition, they use a plan or system of laying out and getting back their capital to demonstrate continuity. For this reason, they usually require the borrower to make periodic repayments on account of their capital. Money lenders do not borrow at high interest rates and lend at either nil or substantially low interest rates or at the very same interest they incurred, and look to the fiscus to finance the growth of the borrower and enhance its profitability, in the comfort that they will reap lofty dividends. I find the respondent's argument, that the appellant's lending transactions were about funding unproductive loans for the appellant to reap exempt income, compelling. The appellant's explanation in paragraph 111 of its heads of argument supports this conclusion. In the

---

13 (1) SA 8 (A).

14 Caslines 029:85, paragraph 107 of appellant's heads of argument.

explanation, there is nothing suggestive of commercial expediency or of indirect facilitation of the appellant's trade as a money lender.

[27] One may add that the appeal by De Beers was dismissed with costs in that De Beers failed to establish that the loss-making transactions associated with the Engelhard Hanovia of Southern Africa (Pty) Ltd (EHSA) shares were connected to its overall trade as a sharedealer that trades shares for profit, as can be seen from this extract:

> "It is true, as I have already indicated, that the absence of a profit does not necessarily exclude a transaction from being part of the taxpayer's trade; and correspondingly moneys laid out in a nonprofitable transaction may nevertheless be wholly or exclusively expended for the purposes of trade within the terms of s 23(*g*). Such moneys may well be disbursed on grounds of commercial expediency or in order indirectly to facilitate the carrying on of the taxpayer's trade… Where, however, a trader normally carries on business by buying goods and selling them at a profit, then as a general rule a transaction entered into with the purpose of not making a profit, or in fact registering a loss, must, in order to satisfy s 23(*g*), be shown to have been so connected with the pursuit of the taxpayer's trade, eg on ground of commercial expediency or indirect facilitation of the trade, as to justify the conclusion that, despite the lack of profit motive, the moneys paid out under the transaction were wholly and exclusively expended for the purposes of trade … Generally, unless the facts speak for themselves, this will call for an explanation from the taxpayer. In the present case there was, as I have indicated, no satisfactory explanation of the EHSA share transaction from Debhold. It was not a normal sharedealing transaction…"

[28] The appellant misconstrues the commercial expediency and indirect facilitation of the taxpayer's trade referred to in De Beers. The two concepts must relate to the taxpayer's own trade. If one goes back to the common cause facts and isolates only two but compelling points from the appellant's loans, namely, borrowing at high rates and consistently lending at either nil, at low or at same rate of borrowing, and, secondly, the lack of terms, two conclusions may be drawn. Firstly, there is no way of working out what is due to the appellant and by when. It was suggested to Ms Y during cross examination that the lack of terms suggested that the loans were open ended. Ms Y tried to counter the assertion by stating that the Board could always insist that the loans be paid. Precisely what aspect of the loans (the interest or the principal), in what instances, and on what terms the Board would place reliance on in insisting on those payments, remained unclear. Plainly, it appears that it did not matter to the appellant what was paid, when it was paid and whether the capital would eventually be paid at all. Simply, there is no objectively ascertainable system for the appellant to recover its capital nor the interest. When one factors in the fact that a rand paid today is worth more than one paid a year or two later (what is often referred to as the time value of money), it means that even on those loans where the appellant may have broken even by way of interest rate, it would still make a loss as, firstly, the interest

charged is not sufficient to counter the effects of inflation, and secondly, there is no way to found breach where a borrower does not pay. It must now be plain that the appellant's transactions demonstrate no profit motive.

[29] The appellant further places reliance on the reasoning of the court in Income Tax Case No 1404 (1985) 48 SATC 1 (N) where the court, in the circumstances of that case, found it sufficient that the appellant's trading would yield a profit in the medium term, notwithstanding the losses he had incurred in letting out residential units. The appellant states that its own interest incurring and interest accruing transactions did make a profit in five of the ten years from 2008 to 2017. I say more on how the appellant demonstrates its profits later in this judgement. The facts in ITC 1404 are markedly different from the present case in that the taxpayer in that case was limited by the then rent control laws in terms of the rent he could charge. That notwithstanding, he charged every single one of his tenants, including his parents, the maximum rent permissible in terms of the law. His evidence, that he had set his sights on charging higher rentals and pursuing a lucrative letting enterprise when the rent control was phased out by the authorities, was accepted by the court. It was on this basis that the court accepted his explanation of a profit making purpose in medium term. The taxpayer in ITC 1404 had offered no financial favours to anyone.

[30] I now touch briefly on the remainder of the appellant's submissions on this issue of profit making purpose. The appellant places reliance on section 24J(3) and underscores the words **"all accrual amounts"** in that section and argues that the respondent, in assessing the appellant's profit making purpose, ought to have taken into account the interest from the bank. In an effort to demonstrate that it had made a profit in five of the six years post 2011, the appellant extracted some numbers from the AFS including interest received from the bank and the subsidiaries. It then asserts that it made a profit. Section 24J(3) has no relevance to the appellant's case as it deals with an income instrument. It was never the appellant's case that it had either issued or was the holder of an income instrument. One of the defining terms of an income instrument is a term that exceeds or is reasonably likely to exceed one year. It is common cause that the appellant lent only to its subsidiaries, without terms. There is no basis to add interest from the bank when evaluating the appellant's profit making purpose on its money lending. After all, the interest from the bank came from cash pooling activities, according to Ms G's evidence, which was not denied by the appellant.

(ii) Whether the interest expense was incurred in the production of income

[31] In order to determine whether expenditure was incurred in the production of income, the important and sometimes overriding factor is the purpose for which the expenditure was incurred and what it actually effects, [*Commissioner for the South African Revenue Service* v *Mobile Telephone Networks Holdings (Pty) Ltd*[15]]. In this regard, the court must assess the closeness of connection between the expenditure and the income earning operations.[16] In its rule 32 statement, the appellant maintained that the interest was incurred in the production of income on the loans advanced as part of its lending trade, whether such income was earned during 2011 tax year or later. It further submitted that the mere fact that the interest earned on the loans made to the group in 2011 did not exceed the interest incurred does not mean that the interest was not incurred in the production of income. During argument, the appellant submitted that the interest it earned from its subsidiaries constituted income as none of it was exempt. It then concluded that it is undoubted that the "in the production of income" requirement of section 24J(2) has been met. The respondent argues that the purpose of the borrowing was to provide the appellant's subsidiaries with advantageous loans to benefit the group by increasing their earning capacity. It says that there is no evidence that Taxpayer H had an intention of generating income and that Taxpayer H led no evidence to demonstrate that interest was incurred in the production of income nor did it lead any evidence to challenge SARS' conclusion that the expense was not incurred in the production of income. In my analysis earlier in this judgement, I made the finding that however one analyses the appellant's lending transactions, they demonstrate neither a profit making purpose nor the intention to produce income.

[32] In Table 1 below, I set out some relevant figures from Taxpayer H AFS for illustration. A superficial reading of the figures in Table 1 leads to the inelucatable conclusion that the interest expense was not incurred in the production of income but in furthering of group interests in order to increase the profits of the subsidiaries to enable the appellant to reap substantial dividends. It is not a matter of co-incidence or commercial expediency — as the appellant argues — that the interest expense in at least eight years shown in the table, or, if one goes with the undisputed testimony of Ms G, nine years, including 2017, was consistently in excess of that accruing to Taxpayer H. Taxpayer H purpose, as is apparent from the manner it structured the loans to the subsidiaries, evidences no purpose to generate income. I conclude that Taxpayer H has failed to demonstrate that the interest expense was incurred in the production of income.

---

15 (966/12) [2014] ZASCA 4 (7 March 2014) at paragraph 10.

16 See note 17 supra.

Table: 1

ITEM	2008	2009	2010	2011	2012	2013	2014	2015	2016
Dividend	**867 996**	**1 233 770**	**55 027**	**1 182 547**	**20 453**	**32 807**	**119 898**	**450**	**250 819**
Interest from Group C	41 921	17 355	**0**	34 936	87 700	42 480	86 206	90 386	74 182
Interest paid to Group Subs	**-41 921**	**-44 978**	**-33 710**	**-68 134**	**-122 722**	**-102 723**	**-120 330**	**-110 145**	**-91 828**

G. The Understatement Penalty

[33] In dealing with the understatement penalty imposed by SARS, one needs to bear in mind that this court, as a court of review, is called upon to exercise its own original discretion. [See in this regard *Commissioner South African Revenue Services v Pretoria Motors,*[17] with reference to *Commissioner of Inland Revenue* v *Da Costa* 1985 (3) SA 768 (A) at para 774 F-J].

[34] Section 221 of the Tax Administration Act, (TAA) defines a tax position as:

> "4. An assumption underlying one or more aspects of a tax return, including whether or not—
>
> (*a*)
>
> (*b*) an amount or item is deductible or may be set-off;
>
> (*c*) ….
>
> (*d*) an amount qualifies as a reduction of tax payable;"

[17] Note 9 supra.

[35] Section 222 of the TAA reads:

> "(1) In the event of an 'understatement' by a taxpayer, the taxpayer must pay, in addition to the 'tax' payable for the relevant tax period, the understatement penalty determined under subsection (2) unless the 'understatement' results from a bona fide inadvertent error."
>
> (2) The understatement penalty is the amount resulting from applying the highest applicable understatement penalty percentage in accordance with the table in section 223 to each shortfall determined under subsections (3) and (4) in relation to each 'understatement'.
>
> (3) The shortfall is the sum of—
>
> (*a*) the difference between the amount of 'tax' properly chargeable for the tax period and the amount of 'tax' that would have been chargeable for the tax period if the 'understatement' were accepted;
>
> (*b*) the difference between the amount properly refundable for the tax period and the amount that would have been refundable if the 'understatement' were accepted; and
>
> (*c*) the difference between the amount of an assessed loss or any other benefit to the taxpayer properly carried forward from the tax period to a succeeding tax period and the amount that would have been carried forward if the 'understatement' were accepted, multiplied by the tax rate determined under subsection (5).
>
> (4) …
>
> (5) The tax rate applicable to the shortfall determined under subsections (3) and (4) is the maximum tax rate applicable to the taxpayer, ignoring an assessed loss or any other benefit brought forward from a preceding tax period to the tax period."

[36] In terms of section 102(2) of the TAA:

> "The burden of proving whether an estimate under section 95 is reasonable or the facts on which SARS based the imposition of an understatement penalty under Chapter 16, is upon SARS."

[37] The respondent states that the appellant adopted a tax position that the interest expense is deductible in full. It further states that by claiming the interest deduction, which it was not entitled to, the appellant understated its income. With reference to the testimony of Ms G, the respondent asserts that it established the facts on which the understatement penalty (USP) is based.

[38] It will be recalled that Ms G had testified that, during the audit, the appellant was requested to provide any record to substantiate its claims of carrying out a moneylending trade. The appellant could not provide anything other than Annexure A and its AFS. Ms G further testified about the prejudice to SARS and the fiscus and the fact that all the information uncovered during the audit was always within the appellant's knowledge. In simple terms, the appellant knew that it had no records to substantiate its moneylending trade. The respondent further adds that apart from reciting the information that is contained in the appellant's Grounds of Appeal, the appellant failed to lead evidence to demonstrate that the understatement of its income was as a result of a *bona fide* inadvertent error and also had failed to lead evidence to contradict SARS' findings that the penalty was appropriately levied.

[39] The appellant affirms its position by stating that there was no understatement. In its view, the interest expense was fully deductible. It goes on to state that in the event the court were to disagree with its conclusions that the interest was deductible, and consequently, that here was indeed understatement, such understatement was as a result of a *bona fide* inadvertent error. The appellant places reliance on section 222(1) and underscores the words, **"unless the 'understatement' results from a *bona fide* inadvertent error"**. It then makes the point that it was for SARS to satisfy itself that the understatement did not result in such an error, this being a jurisdictional fact for SARS to overcome prior to imposing any understatement penalty. The respondent, according to the appellant, did not even plead that the understatement was not due to an inadvertent *bona fide* error. Finally, the appellant quotes Van Zyl DJP in the Port Elizabeth case number 24662, stating that if a taxpayer has acted honestly and reasonably, and relied on expert advice, any error will constitute a *bona fide* inadvertent error and no understatement penalty ought to be levied by SARS. The appellant simply concludes that "this is the case on the present facts".

[40] I do not accept the appellant's contention that prior to levying the USP, SARS had a duty to satisfy itself that the understatement did not result from a *bona fide* inadvertent error. The appellant's assertion amounts to turning the burden of proof set out in section 102(2) of the TAA on its head. The burden remains with the appellant to prove that the interest expense is deductible and hence no understatement of its income. In the event the appellant had provided evidence that the understatement was due to an inadvertent bona fide error, in terms of section 221, it would not be competent of the respondent to levy the USP. The appellant led no such evidence.

[41] On the appellant's conclusion that it relied on expert advice and on that basis no USP should be levied, the appellant led no evidence to demonstrate that it relied on expert evidence. The conclusions drawn by the appellant have no basis. On the other hand, SARS led the evidence of Ms G who isolated the appellant's failure to demonstrate that it was conducting a trade. I conclude that the understatement penalty was appropriately levied in the circumstances of this case.

H. Conclusion

[42] In the result, I am satisfied that the appeal lacks merit and falls to be dismissed.

I. Order

1. The appeal is hereby dismissed with costs.

2. The assessment issued by the Commissioner on 28 April 2015 is hereby confirmed.

_____

NN BAM
JUDGE OF THE HIGH COURT
JOHANNESBURG

Mr Sandile Nhleko : Accountant Member
Ms Baneka Xaba : Commercial Member