THE TAX TREATMENT OF

LOSSES ARISING ON

LOANS ADVANCED

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Submitted by: GD Cochrane

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ABBREVIATIONS

The Act	:	Act 58 of 1962 as amended (The Income Tax Act).
A	:	Appellate Division of the Supreme Court of South Africa
AD	:	Reports of the Appellate Division of the Supreme Court of South Africa (1910 - 1946)
C	:	Cape Provincial Division of the Supreme Court of South Africa
CCR	:	Common Wealth Law Reports
CIR	:	Commissioner for Inland Revenue
COT	:	Commissioner of Taxes
CPD	:	Reports of the Cape Provincial Division of the Supreme Court of South Africa (1910 - 1946)
FC	:	Federal Supreme Court of the Federation of Rhodesia and Nyasaland

ABBREVIATIONS (Continued)

FCOT	:	Federal Commissioner of Taxes (Australia)
Income Tax Act	:	Act 58 of 1962, as amended
KBI	:	Kommissaris van Binnelandse Inkomste
SBI	:	Sekretaris van Binnelandse Inkomste
TCC	:	Tax Cases of Canada

PART I LEGAL NATURE OF LOANS

LEGAL NATURE OF LOANS

Our law recognises two types of loans, namely a loan for use (*commodatum*) and a loan for consumption (*mutuum*).

In a loan for use something is delivered for use by a borrower without reward, and the borrower is obliged to return the same thing he received on loan. For example, a person may lend another person an asset of his, and when the recipient has finished using that asset the identical asset in the same condition as received, is to be returned to the lender.

In a loan for consumption one or more units of some fungible thing are delivered to the borrower. The borrower may consume what has been received but is bound to return the same number of units of the type of the thing borrowed.

In constrasting a *commodatum* with a *mutuum*, it can be seen that a lender in the first instance retains ownership of the asset loaned, whereas in the second, ownership is passed to the borrower, who undertakes to repay the loan by delivering things of an identical quality and quantity as those borrowed.

Thus, an essential characteristic of a loan of money is that the lender is either the owner of the funds advanced, or is authorised to make the loan by the owner. Once delivery has taken place to the borrower a contract can probably be said to be binding.

Thus, a contract of loan cannot be said to be binding by part performance as, in *mutuum* the only person bound is the person who received a service by the handing over of the money in question.

Thus, the lender must not only transfer possesion, but also title in the things lent so that the borrower is legally entitled to consume them. At this stage, the borrower will become the owner of the things lent, and will thereafter carry the risk for any loss or deterioration of the things lent and similarly be entitled to consume or alienate them. At this stage, ownership of the fungibles passes either because they are consumed, or the identity is lost through *confusio* (that is, the mixing of the moneys received with the borrower's own funds).

Possesion and title can be transferred in a number of ways. This could be effected by actual delivery where the lender either delivers the moneys lent to the borrower, or instruct the borrower to collect the things from him; alternatively, the lender may instruct a third party to hand them over to the borrower where that third party has in its possession the funds to be advanced (a bank for example). Alternatively, the lender may permit the borrower to retain for its own use things which the borrower was otherwise obliged to deliver to the lender, or funds due to the lender as a result of the borrower, pursuant to the lender's instructions, selling something which previously belonged to the lender and thereby retaining the proceeds received as a loan for consumption.

Once the borrower has received the moneys lent, it is under a duty to return to the lender things of the same kind, quantity and quality as those which were lent. He may also return the actual asset advanced but in the case of

moneys lent, this is unlikely to occur. The loan should be repaid in the currency advanced, unless the contract proves otherwise.

If the borrower does not return the things as required, at the required time and place the borrower commits a breach of contract. The lender can therefore institute a claim for due performance of the contract and the court will order the borrower to return the sum lent.

To this end, the contract of loan will probably lay down a fixed or determinable future time for the return of moneys advanced. Where this provision is so vague as to be unintelligible, the term of the loan may be void for vagueness and the agreement should be considered as one without any time clause. Thus, strictly speaking, there is no limitation of the right of the lender to reclaim the loan immediately, but fairness demands that the borrower be given a period of grace and be entitled to a reasonable time before he can be compelled to repay moneys borrowed.

In the event of the borrower commiting a breach of contract, the lender will have a personal right against that borrower to claim damages suffered. The *quantum* of the damages claimed will be based on amounts due to the lender in terms of the contract, together with any interest which is due.

In terms of the common law, a *mutuum* did not generally carry a provision for reward (interest). Thus, the provision that interest be paid needs to be stipulated. Thus, an agreement of loan would be coupled with a *stipulatio* for return and where the contract is so reinforced it will be superceded by the *stipulatio*. Where there is a *stipulatio* that interest be paid, this may be agreed expressly or impliedly and thus the borrower will remunerate the

lender by paying interest on moneys advanced. At common law this interest is usually expressed as a percentage of the money lent and is calculated for a fixed period or from the time of receipt until the loan is repaid.

However, as soon as the debtor falls into *mora* he becomes liable to pay damages for the default in the form of interest, as calculated from the time of default. The rate of interest applicable will depend on the circumstances of the case. In the absence of any agreement concerning the rate at which interest is to be paid, the court will award interest as provided by law.

The above legal principles have been fully accepted and applied by the South African tax courts when considering cases concerning losses by lenders on moneys advanced in return for interest.

The rights of a lender claiming damages, have not, however, necessarily, been considered with strict reference to the legal nature of the rights, but the courts have often considered the commercial reality of such a transaction. However, the underlying rationale of the transaction has always been important to the courts in reaching the conclusions discussed herein.

PART II LOSSES ARISING FROM LOANS ADVANCED

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LOSSES ARISING FROM LOANS ADVANCED

1. GENERAL PRINCIPLES

The deductibility of a loss incurred on a loan or advance made to a third party by a taxpayer, where that third party has failed to repay fully or partially a debt, is, as is the case with most other forms of expenditure, subject to the "*general deduction formula*", being Section 11(a), as read with Section 23(g) (*Port Elizabeth Electric Tramway Company Limited v CIR* [1]).

Section 11(a) provides for the deduction of:

> *"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".*

Section 23(g) provides that:

> *"No deduction shall in any case be made in respect of the following matters, namely:*
>
> *(g) Any monies claimed as a deduction from income derived from trade which are not wholly or exclusively laid out or expended for the purposes of trade".*

The general deduction formula comprising by the above two sub-sections can be broken down into the following parts:

- The expenditure and losses;
- Must be actually incurred;
- In the Republic;
- During the year of assessment;
- In the production of income;
- They must not constitute expenditure and losses of a capital nature; and
- They must constitute monies that are wholly or exclusively laid out or expended for the purposes of trade.

(*Silke on South African Income Tax* [2])

Although the deduction of losses incurred as a result third parties failing to repay debts due to a taxpayer are subject to the general deduction formula as outlined above, the nature of the loss so incurred is, in many respects, different to that of more accepted forms of expenditure and losses. To this end, the following distinguishing features can be identified:

- Loans are advanced by a taxpayer for periods, both short and long. Thus, the precise time at which a loss is incurred is not always readily ascertainable. On the other hand, where an item of expenditure is incurred, there is clearly a parting of an asset (together with the reciprocal *quid pro quo*); whilst losses incurred as a result of fire, theft and the like are similarly readily identifiable.

o In the case of a loan advanced, the taxpayer does not part with an asset. Although it advances finance to a third party, it simultaneously receives a reciprocal right to receive repayment of an identical amount advanced, plus the reward for so advancing the amount. Thus the nature of the taxpayer's capital merely changes form from cash to a right. In *Lever Brother's case* [3] Watermeyer CJ stated:

> *"In the case of a loan of money the lender gives the money to the borrower, who in return incurs an obligation to repay the same amount of money at some future time and if the loan is one which bears interest, he also incurs an obligation to pay that interest. Though I use the words 'gives the money' this must not be taken literally as the usual way of making a loan. As a rule, the lender either gives credit to the borrower... in return for which the lender pays him interest..."*

Conversely, in the case of expenditure incurred, a taxpayer would clearly have parted with an asset (being the funds expended) when obtaining the right attached to the expenditure, or in the case of loss through fire or theft an asset would have disappeared, rather than a simple decline in the value of a right of recourse.

o A lender looks for a return in the form of interest, or similar payment, which is indistinguishable from the nature of the asset (being his money) advanced. The distinguishing feature between

interest and capital is frequently achieved by agreement, wherein a loan agreement stipulates payments to be made by the borrower, and the form of the payments, being interest and capital.

On the other hand, expenditure incurred in acquiring an asset or a service generally results in a return in another form. For example, expenditure on trading stock results in a taxpayer's money being converted into trading stock, which trading stock is again converted into money. The incremental value earned by the taxpayer is the difference between the cost of the trading stock and the proceeds received on its subsequent sale.

The significance of the above is that there is a clear and distinct break between the application of a taxpayer's capital in acquiring the trading stock, and the return generated by the trading stock. In the case of loans advanced where there is no such break, there is a connection between capital invested and lost which could be viewed as being so directly linked to the capital advanced, that the loan itself retains its capital nature, subject to the specific factors surrounding the transaction;

o It would further appear that losses incurred of the nature envisaged have been discussed within the ambit of the general provisions of the Income Tax Act as no specific provisions apply. Thus, the courts have been required to look at the nature of a transaction which does not, it is considered, fall

directly within the ambit of transactions envisaged by the Act, and apply these principles to the specifics. Such an approach has tended to result in a taxpayer being required to show more clearly, it would appear, a change of intention than would be required for other forms of business, such as the investment in trading stock, for example.

Throughout the course of this analysis, it has been assumed that the consequences of an irrecoverable loan are properly referred to as a "loss". In *Joffe and Company's* case [4] Watermeyer CJ discussed a loss thus:

> *"The word 'loss' has several meanings and its meaning in Section 11(2)(a) (Section 11(a) in the Income Tax Act currently in force) is somewhat obscure. In relation to trading operations the word is sometimes used to signify a deprivation suffered by the loser, usually an involuntarily deprivation, whereas expenditure usually means a voluntary payment of money."*

Thus, an amount advanced to a third party as a loan is clearly advanced on the premise that it will be returned; the resultant failure to honour such a commitment is clearly "*an involuntarily deprivation*" and is thus a loss, as opposed to expenditure. Further, the term "*expenditure*", as discussed above, means a voluntary payment. As previously discussed [3], a loan does not, itself, constitute a payment, but merely an advance with an expectation to see the sum advanced returned.

The above assumption that a "loss" arises would appear to be common to the interpretation placed on an irrecoverable loan by the courts. In *Solaglass'* case [5] the issue was stated thus:

> *"The monies claimed as deductions represent... the capital lost by appellant as a result of the loans becoming irrecoverable."*

In reviewing claims made by taxpayers wherein deductions have been claimed for losses incurred as a result of loans and advances made becoming irrecoverable, the courts have emphasized that the key consideration in assessing such a claim is determining whether or not the loan so made was of a capital or revenue nature. In the event of such a loan being of a capital nature, then the loss so incurred would fail to meet one of the above criteria, and would therefore be disallowed as a deduction. In addition, the courts have also emphasized that the loan so advanced must have been advanced in the course of the taxpayer's trade; thus, where a loan was not advanced during the course of, or as adjunct to, the trade in question, it would similarly fail to meet one of the criteria outlined above and could not therefore rank as a deduction.

On the question of whether or not a loss has been incurred, the courts have tended to look at the commercial reality of such a transaction, rather than its strict legal nature, in assessing the taxpayer's claim that a loss has actually been incurred. (See *ITC 1324 43 SATC 47 at 52*.)

Although not directly addressed in cases reviewed, it would appear

that the courts have generally looked at the manner in which a loan or advance was funded when determining the income tax characteristics of the right (being the loan) actually acquired; on the other hand the nature of the right acquired has, at times, been a relevant factor.

Thus, the emphasis of the courts has been to examine from whence the funds advanced were derived, rather than the use to which they were put. For example, in *ITC 257* [6] the taxpayer made loans by way of promissory notes on which he suffered a loss. Even though the notes were converted to cash and reinvested in a similar manner for similar periods, Dr Manfred Nathan KC stated, at 66:

> *"It is true that the period for which money is invested is four months, but sometimes these monies are irrecoverable by the lender and so far as he is concerned, they are for that time frozen capital; he cannot deal with the capital in anyway; it does not differ from the monies paid out for stock in an ordinary mercantile business."*

Thus, where money was invested in the form of a promissory note, rather than a tangible asset in the form of trading stock being acquired, the courts failed to accept the distinction between the promissory note and trading stock, and looked solely at the method in which this right was funded when concluding that the loss was of a capital nature. Similar approaches were adopted by the courts in *Salisbury Board of Executors Limited v COT, (SR) 12 SATC 1*, where at 10 the courts found that the fact that the company had lent a portion of its capital was an important factor. (See also *Stone vs SIR 36 SATC*

117.)

The critical enquiry into the question of whether a loss incurred as a result of a loan or advance being irrecoverable would therefore appear to require an examination into the nature in which it was funded, and the nature those funds assumed in the taxpayer's hands. Stemming from this enquiry would be an examination into the business of the taxpayer, and whether or not losses so incurred were on a revenue account.

2. CAPITAL NATURE

In both accounting, and legal parlance, the cash resources of a taxpayer are commonly regarded as that taxpayer's capital. In discussing the different categories of capital, Innes CJ in *CIR v George Forest Timber Company Limited 1 SATC 20* at 23 stated:

> *"Capital, it should be remembered might be either fixed or floating. The substantial difference was that floating capital was consumed disappeared in the very process of production, while fixed capital did not; though it produced fresh wealth and it remained intact ... Ordinary merchandise in the hands of a trader would be floating capital. Its use involved its disappearance and the money obtained for it was received as a part of the ordinary revenue of the business. It could never have been intended that the money received by a merchant in the course and as a result of his trading should not form part of his gross income. The proceeds of fixed capital stood in a*

different position. The sale of such capital would generally speaking represent a mere realisation which ought from its nature to be excluded, and which this section intended to exclude from the calculation of income."

In applying the above principle, it is apparent that an important enquiry into whether losses made on loan transactions are of a capital nature, is to ascertain whether or not the loss was a loss of fixed or floating capital. In *Stone v SIR 36 SATC 117*, where the taxpayer had advanced monies to an individual in order to earn a profit thereon, the court found that subsequent losses incurred as a result of the borrower failing to honour his commitments, even though there had been a series of transactions, were of a capital nature and not, therefore, deductible. In addressing the nature of the loss (that is, was it a loss of fixed or floating capital) Corbett AJA stated, at 129:

"The central issue remains: was this loss of a capital or not capital nature? One way of dealing with this issue - and one that to me has a logical appeal - is to ask what was it that was lost? The answer, I think, is clear: the appellant lost the capital which he had advanced... The next enquiry follows as a natural collolary: was the capital lost fixed or floating (circulating capital)?...

Applying the distinction, thus described, to the ordinary case of a loan of money, there is no doubt, in my opinion, that the capital lent constitutes fixed capital... It is true that the lender does not retain ownership in the actual money which

passes but, in an economic and accounting sense, it remains his capital and upon the termination of the loan (all being well) it returns to him intact."

In *Stone's* case *supra* it was evident from the facts outlined, that the taxpayer had either invested his capital base in the transaction, or had used it as security to raise further amounts by way of an overdraft. In this regard, Corbett AJA stated, at 132:

"It was not argued that the fact that the appellant used borrowed monies to make loans was, in itself, of any real significance. This could well have been a relevant factor had there been any question of a money lending business being carried on..."

Thus, in interpreting the principles determined by *Stone's* case *supra*, it would appear that the fact that a taxpayer enters into a money lending related transaction wherein a gain in excess of the amount advanced is anticipated, even though such a gain may be in a form other than interest and may be related to the profits of the underlying venture, is only circumstantial; the true enquiry is directed to the nature of the investment made, and the source from which it arose. To this end, the implication appears to be that loans advanced by a taxpayer will be advanced from his fixed capital unless there is evidence to the contrary.

The question of when income earned by a taxpayer changes its nature from being floating or circulating capital into fixed capital would

appear to be determined with reference to either the date a trade debtor pays the amount, or the taxpayer and the debtor agree that the amount due be converted to a loan owing to the taxpayer, rather than a trade debt due. In *ITC 808 20 SATC 343*, which case concerned the remittance of receipts to South Africa from the United Kingdom wherein gains were made through favourable exchange rates, the court was asked to consider whether or not such a gain was of a revenue or capital nature. In finding that the gain was of a revenue nature, Price J stated at 346:

> *"Until the debt was paid it represented a claim for services rendered - as such it was impressed with an income or revenue character. It remained a revenue claim and would keep this character until it was altered by some transaction of which it formed the subject."*

The above aspect was further clarified in *CIR v Brown Brothers Limited 20 SATC 55*, which case concerned a taxpayer who agreed to leave certain commissions due to it in the hands of a foreign company in order to enable that company to bolster its reserves. As with *ITC 808*, a gain was made as a result of exchange rate variances, which gain the Commissioner sought to tax. In discussing the nature of this gain, Blackwell J stated at 59:

> *"What imprint did this money bear throughout this period (being the period retained by the foreign company). It seems to us that the Special Court was right in holding that this was a loan or something in the nature of the loan... What was formally*

money owing, now, by the mere fact of in the new agreement, becomes money lent."

Regarding the deductibility of amounts due to the taxpayer as a result of services rendered, or merchandise sold, Section 11(i) to the Income Tax Act permits a taxpayer to deduct from "Income" as defined in Section 1 to the said Act debts proved to be bad, where such amounts were included in the income of the taxpayer.

Thus, the question of whether or not trade debts themselves constitute a capital or revenue asset has not been directly addressed by the courts, other than in respect of the cases mentioned. However, the *Income Tax Reporter* [1] indicates that debts due to a taxpayer are of a capital nature when they are sold. No direct authority was quoted for this supposition, but the inference to be derived from this article is that Section 11(i) is necessary to permit a taxpayer to deduct bad debts as they are of a capital nature; thus, but for Section 11(i) bad debts would, therefore, be excluded from the general deduction formula by virtue of their capital nature. However, *Meyerowitz and Spiro on Income Tax* [2] make the statement that Section 11(i) is necessary as bad debts do not represent accrued income, and their subsequent non-recovery does not represent a loss or expenditure in the production of income deductible under Section 11(a). It could therefore be stated that the capital or revenue nature of a trade debt was not a factor affecting the decision of Parliament to introduce Section 11(i), but rather such a debt's non-accrual; thus, the premise that a debt due retains the nature of income until it is converted to capital by a formal act (either its payment or its conversion to a loan) is

reasonable.

Further, it is, it is considered, difficult to envisage trade debts being of a capital nature as their non-recovery must be with in the reasonable contemplation of everyday business. Thus, any non-recovery must be viewed as a "*necessary concomitant*" [3] of the business, and therefore a foreseeable or anticipated business cost (loss).

2.1 GENERAL TESTS

The question of whether an item of expenditure (and income) is of a capital or revenue nature has been considered in detail by our courts, with case law on the subject being prolific. The criteria to be applied in determining whether an item of income (or expenditure) is of a capital nature were summarised in *ITC 1185* [1] at 123. The tests to be extracted from *ITC 1185 supra* are as follows:

- The fundamental enquiry is whether, in buying and selling the property and thus earning the profit ... the taxpayer was engaged in carrying on a trade or business or profit making scheme. If that is what he was doing, the profits are income and taxable in his hands. If, however, he held the property as an investment of capital the realisation of the asset would simply be a conversion of the capital asset to cash, which he would receive and hold as capital, the receipt is capital and not revenue.

- Perhaps the most important test in considering whether it is one or the other of these, is the intention with which or the object for which the property was acquired.

- It is clear that the application of the test will not in all cases produce the true answer to the fundamental question; a taxpayer might have bought property with the intention of holding it as an investment of capital... but have changed his mind at a later stage and resolved to merge that asset with his ordinary stock in trade.

- Where the taxpayer had not one clear purpose or intention in acquiring the property but was alive to more than one use to which he might have put it, the enquiry will be to determine, if possible, whether one particular purpose was dominant in his mind. If the court is able to find there was a dominant purpose, which operated decisively or very substantially in the process which lead to the decision to acquire the property, the court will give effect to that dominant purpose or intention.

- The difficulty in these cases lies not so much in the formulation of approach but in the application of the principles which must necessarily guide the court.

Although *ITC 1185* dealt with the question of whether a gain derived from the sale of property arose from the appellant being engaged in a business or profit making scheme, it is considered

that the tests laid down in determining the capital or revenue nature of income are equally applicable in determining the capital or revenue nature of expenditure [2].

2.2 BUSINESS ACTIVITIES

As identified in *ITC 1185* quoted above, the fundamental enquiry is whether the taxpayer was engaged in the carrying on of a trade or business or profit making scheme. In the case of losses incurred on irrecoverable loans or advances, great emphasis has been placed on the nature of a taxpayer's activities when considering whether such losses were of a capital or revenue nature. In this regard, it would appear that the courts have been reluctant to consider occasional money lending transactions as being a profit making scheme when the other business activities of a taxpayer are not complimentary or supportive to such an activity, or the money lending transactions were not an adjunct to the taxpayer's other business activities.

In *ITC 1009* [1] JCR Fieldsend QC stated, at 278:

> *"It was common cause that, as laid down in a long series of money lending cases, the issues were twofold: (1) did the appellant carry on a business of money lending, and (2) if so, was the loan in question made as a part of that business?"*

Thus, the above statement which, it is considered succinctly summarises the directions taken by the court to date, looks for the "carrying on of a business" of money lending when conducting an enquiry into the nature of losses made on monies advanced. *Ad hoc*, or occasional money lending transactions, notwithstanding the fact that these transactions were entered into in order to earn profits, have been viewed as capital transactions by the courts. In the case of *Stone v SIR* [2] at 130, Corbett AJA stated:

> *"At no stage was it contended in this case that the appellant was carrying on a money lending business."*

Further, and in quoting from the judgement of the Special Court, Corbett AJA stated at 130:

> *"Each transaction involved a "once and for all" expenditure. The expenditure was not recurring and was not incurred in the course of the conduct of a continuous business as for instance would have been the case where a person lent money in the course of his trade as a money lender."*

In applying the above principles, the courts have indicated that there must, as laid down in the preamble to Section 11, be a "carrying on" of a trade. Thus, a degree of continuity would appear to be essential. Although the definition of "trade", contained in Section 1 to the Act, includes the term "venture"

which term has been defined in *ITC 368* [3] to refer to a "*financial or commercial speculation*", it would appear that the courts have taken a very narrow view on the phrase "carrying on", and where there is no such activity, to find that the taxpayer had failed to discharge the onus on him in terms of Section 84 to the Act, of showing that the capital invested had changed its nature and become floating rather than fixed capital.

The above conclusion differentiates the provisions of the Gross Income Definition, which taxes receipts and accruals, from that of Section 11, wherein expenditure is deducted. In this regard, the Gross Income Definition seeks to bring to account all receipts and accruals which are not of a capital nature, whether or not they are associated with an isolated transaction (See *Stephan v CIR 32 SATC 54* wherein the receipts and accruals of a "one off" salvage operation were brought to account) whilst Section 11(a) only permits the deduction of expenditure and losses incurred in ongoing business activities.

The above approach was, it is considered, summarised by Van Winsen J's following comments [4]:

> "*It is true that in income tax circles single swallows have been known to herald a summer. Thus, in CIR v Stott, 3 SATC 253, it was recognised that in certain circumstances a single undertaking might be of such a nature that it could be correctly described as carrying on of a business. Freely conceding the applicability of this*

principle, each case is nevertheless so dependent upon its own facts that little or no assistance can be derived from the mere recognition of its existence."

In finding against the taxpayer in the above case, Van Winsen concluded that the correct approach was to look at the purported money lending transactions against the totality of a taxpayer's loan transactions, and to consider where, in the light of such dealings, the taxpayer has discharged the onus of proving that the money lent was advanced in the course of a money lending business. Thus, applying the terminology used by the judge, it would appear necessary for there to be more than one swallow for a taxpayer to be considered as having embarked on a money lending business.

The tests laid down in determining whether or not a taxpayer is involved in the business of money lending are, as detailed in *ITC 812* [5], as follows:

- Whether or not the appellant is a money lender or carries on the business of a money lender is a question of fact;

- The principles applicable to profits apply *a fortiori* to the profits of money lenders. It has to be remembered that money is the "stock in trade" of a money lender;

- Investment by an individual of even large sums on mortgages of real estate is not in itself sufficient to

constitute a business;

- The main difference between an investor and a money lender appears to consist in the fact that latter aimed at frequency of turnover of his money and for that purpose usually requires borrowers to make regular repayments on account of principle;

- This has been described as a "system or plan in laying out and getting in his money";

- The obtaining of security is a usual but not an essential feature of every loan made in such a business;

- A person may be a money lender even though he does not advertise or hold himself out as such.

As indicated above, the principle enquiry is the business activities of the taxpayer. That is, determining from a general point of view whether or not the taxpayer is a money lender, as such an issue is a statement of fact. However, the enquiry must go further and establish the function in the taxpayer's hands of the money which came to it.

In the case of *Plate Glass and Shatterprufe Industries v SIR at 112* [6], Margot J stated:

"However, I wish to guard against a conclusion in this

court based solely on the nature of the taxpayer's business, and on whether or not the appellant proved that its business was that of a banker or money lender.

The true enquiry seems to me to be to determine the function in the appellent's hands of the money which came to it from SIE. If that money was held by it on revenue account, as working capital employed by it for the purpose of being turned over at a profit, then any loss in so turning it over would prime facie be deductible.

In this enquiry the nature of the appellant's business provides an important guide, but is not conclusive".

The above case dealt with losses incurred as a result of exchange rate fluctuations on loans due to foreign lenders. The court, in finding against the taxpayer, held that, notwithstanding the fact that the taxpayer was a money lender, the "character" of the finance raised in the taxpayer's hands was "*nothing more or less than capital raised by the PGSI Group for use by companies in that Group, and the taxpayers receipt and administration of the money was for that purpose and not for itself*". (At 112) Further, the fact that the taxpayer was a separate *juristic persona* from the Group did not change the character of these funds.

In pursuing the enquiry as to the nature of the taxpayer's business, due consideration will need to be given to the

activities of the taxpayer in general, and not necessarily to the specific facts in question. By way of an example, *ITC 933* [7], concerned a taxpayer who claimed, as a deduction, loans no longer recoverable where the taxpayer had not lent or advanced new sums during the tax year in question. In commenting on the taxpayer's activities, van Winsen J stated, at 350:

> *"Only a single loan had been made during that year... However, in order to obtain a true picture one must look at all the preceding years from the time when the appellant claimed he had started carrying on a money lending business... in order to ascertain whether there was any continuity and system about the various loan transactions pointing in the direction of a money lending business".*

A further consideration in determining whether or not a taxpayer is a money lender is the attitude the taxpayer may have with regard to funds invested. As indicated above, the money lender aims at frequency of turnover and thus usually requires borrowers to make regular payments on account of principle. This point was emphasized in *Plate Glass and Shatterprufe Industries supra* at 112 where Margot J found that, although the taxpayer showed all the characteristics attributable to a money lender, the funds raised by it were *"nothing more or less than capital raised by the .. Group for use by companies in that Group"*. Thus, the company, although not an investor, was purely

an administrative vehicle to co-ordinate the Group's companies funding requirements. It did not, therefore, view funds raised by it, (and therefore advanced) as being its "stock in trade".

The existence of a "*system or plan in laying out and getting his money*" (*ITC 812* at 472) is also an important, but not decisive feature. *In ITC 1003* [8], the taxpayer who had surplus short term funds agreed to lend amounts to third parties at market related (it would appear) interest rates incurred losses on funds advanced. These losses were claimed for tax purposes by the taxpayer. The courts, in finding against the taxpayer, emphasized that (at 239):

> *"The existence of continuity and system is only an element to be considered with the other facts of the case and the surrounding circumstances. That a business of money lending is being carried on is not the only inference to be drawn from a degree of continuity and system..."*

In the above case, the court found that the appellant was merely finding temporary employment for surplus funds and, as such, losses incurred were on capital account. This consideration was upheld in *Plate Glass's* case *supra*.

Furthermore, the courts held in *ITC 1003* that the fact that there was recurrent expenditure was similarly inconclusive in itself for the reasons identified above. Thus, where a taxpayer merely "*wants to make the money work on a short term basis*", the

inference that the taxpayer has embarked on a money lending business is not automatic and will need to be considered in conjunction with the factors outlined above.

From an investor's point of view, funds invested would be invested with the objective of deriving a long term gain, which gain is analogous to the acquisition of any other business asset. For example, the courts found in *Atlantic Refining Company of Africa's* case [9] that the granting of loans to petrol retailers in order to secure a "tie" with the retailers was a "once and for all" disbursement which resulted in an enduring benefit. A similar decision was reached in the Canadian courts in *Business Art Inc's* [10] case where loans were advanced to establish a supplier in the United Kingdom. As the transaction was intended "*to create an asset of enduring benefit*" (page 2006), subsequent losses on loans advanced were found to be of a capital nature.

Further, in *Salisbury Board of Executors Limited's* case [11], which case concerned the investment by the appellant in mortgage bonds, Blakeway J stated, at 10:

> "*I can see little distinction in principle between the acquiring of an asset like a mortgage bond for the purpose of deriving an income from that asset and the purchase of land in order to make a profit from the produce of such land.*"

Notwithstanding the above, the courts have, in certain instances, permitted the deduction of losses incurred as a result of money lending transactions where taxpayers have been able to show:

- The loan transaction was entered into in order to derive a profit therefrom; and

- Loans and advances were made in the ordinary course of the taxpayer's business.

(This approach is identical to that adopted by the Australian courts, as evidenced in *Fairway Estates (Pty) Limited v COT (Aust) 123 CCR 153 (1970)*.)

In the case of *ITC 1344* [12] the court found that, where a taxpayer formed a private company and advanced funds to that company by way of loans, with the specific intention of selling the shares and loan accounts at a profit, that subsequent losses incurred on the sale of the loan account were deductible. This case did not distinguish between shares on the one hand and loans on the other and, at 24, stated:

> *"It is clear on the agreed facts that the shares and loan accounts were acquired by the appellant for the purpose of resale at a profit"*.

This case is, however, to be contrasted with *Burman vs CIR 53*

SATC 63. The facts of *Burman's* case were, in many respects, similar to those of *ITC 1344 supra*. The court, in finding against the taxpayer commented that (at 71):

> *"However Burman regarded his shares and loans accounts, the fact is that he did indeed hold two different economic entities".*

Further, in commenting on the decision in *ITC 1344*, Goldstone JA emphasized that (at 73):

> *"The decision in that case (ITC 1344) is only explicable upon the agreed facts which recorded, inter alia, that:*
>
> *'It was at all relevant times his intention to sell the said shares and loan account as soon as a development was completed with a view to a profit'."*

Thus, although the principle has been accepted in the Appellant Division that loans can be acquired, or created with the intention to sell together with another asset (being shares in this instance) that intention will only be considered if it is clearly demonstrated. Where this is not, however, the case, the court will look at the underlying legal nature of the loan in the taxpayer's hands, and if it constituted an investment of the taxpayer's capital, it will comprise an investment of a capital nature and will therefore be precluded as a deduction from the taxpayer's income in the event of a loss being incurred.

Where a taxpayer is not a money lender, but carries on a business which necessitates money being lent or the lending of the money is an adjunct to its main business, losses incurred may, subject to the facts, constitute a loss of a revenue nature and therefore be deductible for tax purposes. For example, in *ITC 434* [13], which case concerned losses incurred by shipping and clearing agents on amounts paid or advanced on behalf of their customers, the court found, at 448, that the transactions entered into were of a kind common with clearing agents, and that they are transactions entered into in connection with the earning of the taxpayer's ordinary revenue or income as clearing agents. Further, even where a taxpayer adopts procedures dissimilar to those used by other businesses in the industry in order to enhance his income earning ability by, for example, lending money to suppliers, losses incurred may be of a revenue nature and therefore deductible. The issue is, principally, whether or not the taxpayer adopted as a method of conducting his trade the advancing of money. In *ITC 807* [14] the taxpayer, being a merchant, advanced funds to a manufacturer in order to secure the supply of goods, with the advances to be liquidated by the supply of goods in the ordinary course of business. The taxpayer suffered losses on these advances. The court, in finding for the taxpayer, stated at 340:

> *"There was a double object in making loans to the manufacturing company, vis to keep that concern going so that the appellant could be assured of a supply of goods and to pay in advance for the goods which were to be*

supplied".

Further, in discussing the method in which the taxpayer had elected to conduct his business, against the methods traditionally employed in specific businsses, the court stated, at 341:

> *"It seems to me that it is not essential to find that the making of advances is a customary way of carrying on the kind of business carried on by the appellant, so long as it is being shown to have been the way in which the appellant itself carries on its business... The real question is, how does the appellant carry on its business, not how do other people carry on their businesses".*

Once a conclusion has been reached on the nature of the business activities conducted by a taxpayer, and assuming those activities are the lending of money, the next enquiry is to ascertain whether or not the debt in question was made during the course of those business activities (*ITC 1009 supra*). An enquiry of this nature is common to any item of expenditure claimed by a taxpayer. In this regard, it is considered that Section 11(a) requires that each item of expenditure incurred by a taxpayer be investigated independently and tested against the criteria contained therein. Thus, in *ITC 933 supra*, the court found that a taxpayer who could be regarded as "money lender" could not deduct losses incurred on a particular loan because that loan was not advanced in the course of the taxpayer's money

lending operations. Thus, where it can be shown that a particular amount advanced, which has proved irrecoverable, was not advanced in the course of the taxpayer's ordinary business operations, such amount may be precluded as a deduction from income for the following reasons:

- The loan advanced constituted a part of the taxpayer's capital and not his "stock in trade", and thus the amount so advanced was of a capital nature; or

- The amount was advanced for reasons other than trade, and as such, it was precluded as a deduction in view of the prohibition contained in Section 23(g) of the Act. This aspect is discussed more fully in Part III.

Regarding the capital nature of any particular amount advanced, the courts (see *ITC 933 supra* at 352) have frequently stated that the particular transaction must be looked at against the background of the appellant's loan transactions as a whole. In *ITC 1009 supra*, the taxpayer incurred a loss in respect of a portion of a loan due from a club; the taxpayer's managing director was chairman of the club. The court found that the taxpayer was carrying on a money lending business but as the loan due to the club was initially interest free and unsecured (later attracting favourable interest rates), the loan was nevertheless, more of a "personal accommodation" arranged between the taxpayer's managing director and the club, than a business loan made in the course of the taxpayer's money lending

business. (See also *ITC 44 (1925) 2 SATC 116* where the courts found that the loss arising on a guarantee being called, which guarantee was given by a cartage company to secure work from a building contractor, fell outside the scope of its business activities and, as such, the resultant loss was of a capital nature.)

Thus, in order for a taxpayer to be successful in contending that the loan being claimed as a deduction was a part of the taxpayer's money lending business, the taxpayer must be able to show that the particular loan was, on the balance of probabilities, advance in the course of its money lending business. (See *ITC 933 supra*.)

2.3 INTENTION

The next enquiry to be made with reference to any irrecoverable loan or advance is to ascertain whether the funds so advanced are held as a part of the taxpayer's fixed capital; if they are the resultant loss will be of a capital nature. If they are not, the funds advanced are, by implication, of a revenue nature and thus the loss is similarly a loss of floating or circulating capital [1].

It has frequently been stated that the most important test in considering whether the asset was of a revenue or capital nature is the intention with which, or the object for which, the property was acquired [1].

In *CIR v Stott* [2] at 262 Wessels JA stated:

> *"It was sufficient to say that intention was an important factor and unless some other factor intervened to show that when the article was sold it was sold in pursuance of a scheme of profit making, it was conclusive in determining whether it was capital or gross income".*

Although *Stott's* case *supra* dealt with the question of whether land disposed of by the taxpayer was on a capital or revenue account, it is considered that the above principle is equally applicable in cases where outgoings are concerned. To this end, the above phrase was quoted, with approval, in *Salisbury Board of Executors Limited's* case [3].

In analysing the role finance plays in funding a business's operations, Russel CJ in *Salisbury Board of Executors Limited* [4] commented as follows:

- Circulating capital is a portion of the subscribed capital of the company intended to be used by being temporarily parted with and circulated in business in the form of money, goods or other assets, and which or the proceeds of which are intended to be returned to the company with increment and are intended to be used again and again;

- The terms "fixed" and "circulating" are merely terms convenient for describing the purpose to which the capital

> is for the time being devoted in considering its position in respect to the profits available for dividends. Thus when circulating capital is expended in buying goods which are sold at a profit... the amount so expended must be charged against, or deducted from, receipts before the amount of any profits can be arrived at.

In concluding, Russel CJ at 7, stated:

> *"It appears from the (above) that the determining factor is to be looked for in the intention of the company and the distinction, so far as money is concerned, seems to me to be a difference of degree rather than a difference of kind"*.

Although the above analogy with a merchant who invests in materials, and charges this cost against revenues earned does not apply directly to money lenders, the conclusion that the question is a matter degree provides the focus for any such investigation. In the case of an ordinary merchant costs incurred in generating receipts, such as the acquisition of materials, are indeed expensed against the receipts so earned; on the other hand, it would appear that a money lender or investor does not have such an expense, as amounts advanced have not, in the true legal sense, been parted with and do not thus constitute a cost. The only similar "cost" which could be incurred by the person lending money would be costs unwittingly incurred as a result of a borrower defaulting. From this point

of view, it is considered unlikely that the money lender or investor would make any such loan or advance with the intention of losing the amount so advanced. It would appear, therefore, that the key consideration is not the intention of a taxpayer in making any such advance, but the way it views its financial resources, namely whether or not they constitute its "stock in trade".

Thus, the taxpayer's intention in advancing capital is to be looked at in general, rather than the intention with which a specific loss was occasioned. In the event of a particular transaction proving bad, and assuming the taxpayer is a money lender, then the resultant loss would be expensed against income for tax purposes not by reason of the expense being "the cost of acquiring trading stock", but by reason of the loss being a "*necessary concomittant*" [5]. In *Port Elizabeth Electric Tramway Limited's* case [6] at 18, Watermeyer AJP stated, at 17:

> "*All expenses attached to the performance of a business operation bona fide performed for the purpose of earning income are deductible whether such expenses are necessary for its performance or attached to it by chance*".

Port Elizabeth Electric Tramways case *supra* concerned the deductibility of a loss occasioned as a result of an accident involving one of its drivers. In commenting on the deductibility of the resultant expenditure, Watermeyer AJP at 18 went on to state:

"In this case the potential liability is there all the time and is inseparable from the employment of drivers - that is to say inseparable from the carrying on of the business".

Although the above extracts from *Port Elizabeth Electric Tramway Company Limited's* case concerned whether or not the expenditure was incurred "in the production of income", it is considered that they give valuable insight as to the nature of losses occasioned by loans being irrecoverable, and provide an objective approach to evaluating the nature of the funds invested by a taxpayer. Thus, where it can be ascertained that a loss resulting from an irrecoverable loan or advance, although unwanted, was attached to the normal business operations of the taxpayer, then it would be fair to conclude that the funds so advanced formed a part of the taxpayer's floating capital. Thus, it could be stated that the taxpayer advanced the funds in the full knowledge that they may prove irrecoverable and accepted this risk as a part of its normal business risk; the taxpayer's intention was, therefore, to assume this risk in the expectation of a gain. Compared to an investor, there would be a contrary intention, namely, to avoid such a risk as the capital (being the investment) is to be preserved.

Following a review of relevant cases put before the courts relating to losses on loans and advances, it would appear that the courts have placed great emphasis on the nature of the funds in the taxpayer's hands and, it is considered, made it difficult

for taxpayers other than those directly involved in a money lending business to claim resultant losses. This burden on the taxpayer is, it is considered, largely attributable to the inherent nature of a taxpayer's earning ability as that is, by definition, of a capital nature; in the case of finance, this evidences the taxpayer's capital structure and therefore abilities. Thus, and even though, occassional transactions entered into by a taxpayer may *prima facie* appear to be speculative by nature (see *Stone's* case [7]) the courts will look behind the transaction to ascertain the underlying nature of the asset invested. Further, if the taxpayer is unable to show that he has changed his intention with regard to that portion of his capital, then any losses incurred will be of a capital nature. In this regard, it is considered that a taxpayer would have a less onerous burden in proving a change of intention when transacting with any other form of asset.

This distinction arises, it is considered, because of the very nature of a taxpayer's capital. Capital is measured in monetary terms, irrespective of the nature it takes. Thus, money becomes the effective medium of exchange (even where an exchange is in the form of barter). When money itself is risked that portion so risked would appear to be indistinguishable from the entirity of the taxpayer's capital. In the case of another form of asset, separation is more readily achieveable.

For the above reasons, and as previously discussed, the courts appear to have placed great emphasis on a taxpayer's affairs in

general and looked at the nature of the taxpayer's business operations in order to ascertain whether or not they are money lending and where money lending transactions are not performed, whether the transaction was an adjunct to, or an integral part of, the taxpayer's business.

For example, in *Burman's* case [8] the taxpayer was able to show clearly that he had entered into a transaction with the intention of earning a profit, but the courts found that this intention related to his investment in shares, and not loans advanced to companies formed, the shares of which were to be sold. Goldstone JA at 71 stated:

> *"In short, Burman's intention that he would be repaid the loans together with the sale of his shares in the property companies was in no way inconsistent with the loans being genuine and they having the legal consequences which usually flow from contracts of loan".*

Thus, it can be seen from the above quote, that although the courts accepted there was clearly an intention to sell the shares at a profit, the granting of a loan to this same company was a separate and distinct transaction and at best *Burman* could have anticipated a repayment of the loan. Thus, the fact that a taxpayer had elected to fund a business transaction in a two fold manner, namely by "expending" his capital on the acquisition of shares, and secondly by investing a portion of the same capital in loan accounts, the court found that the loss

on the expenditure was different from the loss on capital advanced; whereas the one would be deductible the other would not. This aspect reinforced the finding in *ITC 1322 42 SATC 269*, where at 272 the court stated "*it is however, not possible to ignore the existence of the company*". (This case concerned facts similar in many respects to that of *Burman's* case *supra*.)

Although the courts have proved reluctant to allow losses incurred on loans advanced where there was either an absence of intention, or the intention with regard to the capital so advanced was not clearly stated, they have accepted that losses on loan capital are deductible where there is a clear intention on behalf of the taxpayer to trade with those loans. In *ITC 1344 44 SATC 19* the taxpayer was able to show that it was at all relevant times his intention to sell the said shares and loan accounts as soon as the (property) development was completed with a view to making a profit (at 20). In finding for the taxpayer, Grosskopf J stated, at 25:

> "*The benefit which the lender hoped to derive from his loan was not the return of his capital with interest, but a profit on the sale and cession of the loan. The ratio for holding that, in loans of the form and type, the capital lent constitutes fixed capital does not, in our view, apply to loans of the latter type.*"

Coming to the above conclusion, great emphasis was placed on the fact that the taxpayer intended to sell his loan whereas, in

Stone's case *supra* and *Crane's* case [9] the taxpayers advanced funds on which a return was expected in the form of interest or some other consideration, together with a repayment of the capital borrowed. (It should be noted that this principle was accepted in *Burman's* case, at 73; Golstone JA noted, in distinguishing *Burman's* case from *ITC 1344 supra* that there were no facts in evidence in *Burman's* case which established a clear intention to sell the shares and loan accounts at a profit).

Thus, it may be stated in the case of losses occassioned as a result of money lending transactions by persons other than money lenders, the role of "intention" is not as critical as it is in other transactions as there is an automatic presumption that amounts advanced are of a capital nature. Intention nevertheless, plays an important role in evaluating the deductibility of such losses.

2.3.1 Definition of Intention

As discussed, intention is an important, and often conclusive factor. Although the term "intention" is frequently used in income tax cases (as evidenced by the cases referred to) the courts do not appear to have defined it and appear to have used accepted legal definitions. However, references to a taxpayer's intention appear to use, interchargeably, a taxpayer's motive or purpose. It is considered that this distinction is unjustified and a fusing the two concepts could lead to

different conclusions.

The Oxford English Dictionary refers to intention as "*one's purpose of doing*". Purpose is defined as "*the object to be obtained; the thing intended*". Motive is defined as "*that what induces a person to act*".

Thus, a taxpayer's purpose in making an advance could be different from its motive. For example, a taxpayer may advance funds interest-free to a recreational club of which he is a member, with the purpose of providing that club with short term funding in order to enable it to meet its short term needs, whilst the taxpayer's motive could have been to demonstrate its funding abilities to club members, and thereby attract additional business. In the event of the advance proving bad, and becoming irrecoverable, the court could reach different conclusions, depending on its analysis of the term "intention".

Were the court to look at the motive of the taxpayer, it could be argued that the taxpayer's motive was to use the opportunity made available to demonstrate its business abilities, and thereby generate income. As such, a subsequent loss could have been classified as being a loss incurred "in the production of income". On the other hand, the taxpayer's purpose was clearly to provide short term funding to the club. As the purpose did not have

overt income tax consequences, the resultant loss would clearly be disallowed for tax purposes. In the case of *CIR v Pick 'n Pay* [1] the courts looked predominently at the chairman's purpose in making a donation. In his dissenting judgement, Nestadt JA noted, at 152:

> *"The difficulty in the present type of case is that there is unavoidably and inevitably present the intention to benefit the donee; it is inherent in the activity in question. But that does not per se disqualify or preclude the expenditure from having been incurred with the sole object of promoting trade. For as (the learned judge) observes 'otherwise it would follow that all entertaining expenses, or charitable donations would be necessarily included'.*
>
> *This is not so. There will in these circumstances only be a dual purpose where there exists a deliberate and independent or distinct secondary motive which inspired the expenditure; as it has been called a private purpose".*

In concluding, the judge stated at 155:

> *"To sum up on this issue. What ever the subordinate and private or personal objective of Mr Ackermann may have been, from the respondents (Pick 'n Pay's)*

point of view it discharged the onus of proving that the donation was actuated purely by commercial motives; its purpose in benefitting the Urban Foundation was not an independent or distinct one".

Notwithstanding the above distinction, the majority found that *Pick 'n Pay* had a dual purpose, which was to benefit the Urban Foundation; it appears to have ignored the taxpayer's motive which appeared predominent. Thus, the courts tended to view the "cause and effect" of the transaction as one. In *Pick 'n Pay's* case *supra*, the motive, being the quest for publicity, induced *Pick 'n Pay* to consider donating amounts to a philanthropic organisation; the purpose was, the courts found, twofold, namely the desire to obtain publicity, and the desire to benefit a charitable organisation. In this case, the motive did not appear to be a factor in the court's judgement.

On the other hand, in *Atlantic Refining's* case [2] the courts looked at the "paramount motive" of advancing funds. In discussing the capital or revenue nature of an amount of money advanced by the company to secure a "tie", which tie secured an enduring benefit for the business, Malan JA stated at 210:

"An essential requisite of the test (of the capital nature of an investment) to be applied is the

paramount motive which operated upon the mind of the lender in entering into the agreement".

In a further case [3] which concerned the acquisition by a taxpayer of two pieces of land, one to establish a cattle ranch and another to establish a home, neither objective being obtained, the courts found that on the subsequent disposal of the properties that the taxpayer's (dominant) motive was, in the first instance, to acquire the property for a capital purpose. In this regard, JCR Fieldsend QC looked at the taxpayer's "dominant motive" in order to ascertain his "dominant" intention.

Based on the above, it would appear that in matters regarding a taxpayer's intention, greater emphasis is given to a taxpayer's motive than its purpose in entering into a transaction. This rule is not, however, clear and a distinction of the two terms would, at best, be inconclusive in examining a taxpayer's claim for the deduction of a loss incurred as a result of loans proving irrecoverable.

It should also be noted that *Pick 'n Pay's* case concerned the application of Section 23(g), and in particular, whether an amount was "exclusively" expended for the purposes of trade, and not the capital or revenue nature of the expenditure. The enquiry was, nevertheless, an enquiry into the state of the taxpayer's mind at the time

the donation was made and, as such, provides a useful insight into the methodology applied by the courts in making such an enquiry. Notwithstanding this factor, the difference between "exclusively" in Section 23(g) and intention in the determination of capital expenditure or losses lies in degree; "exclusively" refers to the sole purpose of the expenditure whereas "intention" refers to the dominant factor motivating the action of the taxpayer. Thus, in concluding on the role of "purpose" in Section 23(g) Botha JA stated [4]:

> *"The concept of a 'dominant purpose' has no role to play here"*.

2.3.2 Dominant Intention

In determining the intention with which a taxpayer entered into a transaction, the taxpayer's dominant intention must be sought. Where a transaction was entered into with a dual purpose, it is the function of the court to seek, and give effect to the dominant factor operating to induce a taxpayer to effect the transaction. Unless one were to hold, which the Legislature could not have intended, that the taxpayer had to exclude the slightest contempletion of a profitable resale of the property, it seemed to the court that the only test to apply was that of a main or dominant purpose [1].

In *COT (SR) v Levy* [2], which case concerned the sale by a taxpayer of shares in a property holding company acquired by him predominantly to earn income, the courts found that, notwithstanding the fact that *Levy* admitted to the hope that the value of the shares would increase and there would be a gain in excess of the amount paid, the dominant factor operating in the mind of the taxpayer was the desire to obtain a good revenue from the property.

Where the courts cannot find a dominant intention, they will find that the taxpayer has failed to discharge the onus of proof on him where he is required, in case of irrecoverable loans, to show that the loans were advanced as a part of his ordinary course of business. In the case of *COT v Glass* [3], which case concerned profits realised on the sale of immovable property, the courts found that the taxpayer could not show a dominant intention at the time the property was acquired. As such, the resultant gain was taxable.

In applying the above to instances concerning irrecoverable loans, the courts have found that the "dominant feature" of the loan advanced is to be sought. In *ITC 933* [4] van Winsen J stated at 352:

> *"It is apparent from the foregoing review of the appellant's loan transactions that the dominant feature of the loan transaction was that of an*

investment and not of money-lending. The greater portion of the loans were made for long periods and in some cases fixed property security was obtained. These loans clearly show an investment intention."

Thus, the court in ascertaining a taxpayer's intention with regard to the employment of its capital looked to objective factors such as the period for which the funds were advanced, and security obtained. The court found the above, notwithstanding the fact that the taxpayer had raised the funds, advanced via a short term loan (overdraft) at a rate of 5,5% interest whilst advancing the funds at rates of interest varying from 7% to 10%.

Further on in the above judgement, at 353, the Judge felt that the correct approach was to look at the specific transactions against the background of the totality of the appellant's loan transactions and to ask whether, in the light of all such dealings, the appellant has discharged the onus of proving that the loan transactions in question were advanced in the course of a money lending business. It would therefore appear that, regarding the question of intention, funds advanced for specific transactions are viewed as coming from a common pool and it is the manner in which the taxpayer regards that pool which will determine the capital or revenue nature of a particular transaction. Thus, if a taxpayer's source of funds are fixed capital, and his use of the funds reflect this

intention, then resultant losses, notwithstanding the fact that they may have resulted from speculative transactions, will constitute capital losses. This concept is further extended to include instances where a taxpayer uses its capital base as security to raise funds to on lend. Thus, in *Stone's* case [5] Corbett AJA commented:

> *"I now turn to the second group of deductions, the losses sustained in respect of the suretyship (and guaranteed) transactions .... In either event, the enquiry is: what was lost ... It seems to me that in entering into these transactions appellant risked his capital in a manner similar to that in which the loans were made (to Kasmai); and that the losses which he ultimately sustained were losses of capital. These guarantees were not undertaken as a part of a business to give such guarantees."*

In discussing the "nature" or "character" of a guarantee, Corbett AJA also commented as follows [5]:

> *"It was submitted by respondent's counsel that what appellant did in these instances was to 'pledge or lend his credit'. Though perhaps lacking in juristic accuracy, this description does indicate broadly, from a commercial point of view, what occurred."*

Further, the courts have, in instances where a taxpayer is regarded as a money lender, looked at the purpose (or intention) with which amounts have been advanced. In *ITC 1327* [6] the court found that the taxpayer was carrying on the business of money lending, but that a certain transaction to a company controlled by him was not made in pursuance of this business. Thus, the court concluded:

> *"The true position is, as the court sees it, that the appellant decided to assist C to take over the company (and not in pursuance of its money lending operations)."*

Thus, the court in referring to the appellant's decision, made reference to its intention. This case reiterated the principle laid down in *Atlantic Refinings's* case wherein the courts sought to ascertain "*the paramount motive*" which operated upon the mind of the lender in entering into the agreement [7]. In *Crane's* case [8], the taxpayer was persuaded by a third party to advance certain monies to a company for a period of three months in return for a market-related interest rate and a raising fee. *Crane* obtained security in the form of an acknowledgement of debt and the personal guarantee of the company's director. The company being unable to repay the debt in full was liquidated and the director sequestrated with the result that a portion of the amount owing became irrecoverable.

The taxpayer had been involved as a financial agent but had not, prior to the above transaction, advanced loans himself. In order to assist him embark on this business, he sold his house and a substantial portion of his furniture to make more money available. Thereafter, with the assistance of a financial agent, *Crane* entered into a number of transactions in addition to the one in question.

In commenting on the respondent's argument that it was his intention to commence a business of money lending, the court stated, at 199:

> *"The fact that three of the transactions were loans for short periods does not in itself turn the respondent into a person conducting a business of money lending... The evidence placed before the (court) does not in the light of the nature of the transactions which the respondent had concluded establish on a preponderance of probability the requisite intent of carrying on the business of money lending."*

Where a money lender enters into a money lending transaction with a twofold intention to, firstly earn interest income and, secondly to secure a capital right, it is considered that the courts will look for the "dominant" motive in entering into the transaction. In

the event of there being losses on such a transaction the deductibilty of such a loss will be determined by the taxpayer's dominant motive.

For example, in *Fairway Estates* case [9] the taxpayer, being a money lender, advanced funds in order to earn interest and at the same time secured a right to acquire 25% of the equity of the borrower. The court, in finding for the taxpayer noted that the transaction was "normal" in the case of money lenders and was not therefore affected by this right.

This case, which is Australian, correctly reflects, it is considered, the direction that will be taken by our courts in similar circumstances.

2.3.3 Change of Intention

As indicated in the case of *Crane* [1] referred to immediately above the mere fact that a taxpayer may have embarked on a series of transactions which have the characteristic of money lending transactions, is insufficient to result in the capital so invested taking on the nature of "floating capital". In commenting on the nature of capital, and its ability to change, Boshoff AJP in *Crane's* case *supra* stated at 197:

"(C)apital is fixed in the sense of being invested in assets intended to be retained, more or less permanently, and used in producing an income. Circulating capital is capital intended to be used by being temporarily parted with and circulated in business in the form of money, goods or other assets and which or the proceeds of which are intended to return with an increment and are intended to be used again and again and so always return with some accretion... It must not, however, be assumed that the division into which capital thus falls is permanent. The language is merely used to describe the purpose to which it is for the time being appropriated. This purpose may be changed as often as considered desirable."

Although Boshoff AJP in the above case used the example of a bank investing a portion of its capital in immovable property, and periodically selling this property to invest the proceeds in its business, it would appear that the change in the nature of the capital envisaged in the above, is not as readily obtainable as may be anticipated from a reading of the above paragraph in cases other than that of a banker.

In the case of *John Bell and Company (Pty) Limited v SIR* [2] Wessels JA stated, at 105 when discussing the concept of a "change of intention" the following:

"The mere change of intention to dispose of an asset hither to held as capital does not per se subject the resultant profit to tax. Something more is required in order to metamorphose the character of the asset and so render its proceed's gross income. For example, the taxpayer must already been trading in the same or similar kinds of assets, or he then and there starts some trade or business or embarks on some scheme for selling such assets for profits, and in either case, the asset in question is taken into or used as his stock in trade."

Although the above case concerned the sale by the taxpayer of certain immovable property, it is considered that the above test is equally applicable in the case of moneys advanced which have proved irrecoverable. Thus, "something more" is required in order to change the nature of funds hither to held as capital in the hands of a taxpayer, and then advanced as a part of a speculative transaction, into floating capital.

In *Stone's* case [3] the court, when commenting on short term money lending transactions entered into by the taxpayer stated:

"The remuneration promised was, it is true, very rewarding - it was far in excess of normal (and even legal) rates of interest for such short term loans -

but I am unable to see how this can alter its essential character as a quid pro quo for the loan. Accordingly, in so far as a loan investment may signify the laying out of capital... these loans qualify as 'investments'."

Thus, *Stone* failed to persuade the court that the loan transactions under consideration had changed their nature; conversely he failed to persuade the court that he had changed his intention with regard to this capital thereby converting it to floating capital.

In a further case [4], which case concerned a taxpayer advancing monies by way of promissory notes which were subsequently dishonoured, the court stated that:

"The evidence did not establish that the dominant motive for the making of the advances was that of profit. On the contrary the limitation of the advances to companies in respect of which the appellant had an interest and a statement made by the witness called in support of the appellant's case that the loans were made to assist companies in which the appellant had a share interest, indicate positively that the dominant motive was not that of profit."

Thus, although there is legal precedent that a taxpayer

can change its intention with regard to assets held by it, converting those assets to stock in trade [5] or assets previously held as trading stock may become capital assets [6] or a taxpayer may hold similar assets with different objectives (namely that of a capital asset and a revenue asset) [7], taxpayers intending to embark on a money lending business, or taxpayers wishing to enter into isolated money lending transactions, would appear to have to discharge an onerous burden of proof should they be in the unfortunate position of wishing to deduct losses incurred as a result of these transactions.

Taxpayers embarking on any venture entailing money lending may, nevertheless, be in a position to show that this was the case, and thus the losses are deductible. In this regard, the courts of the United Kingdom have expressed the following view [8]:

> *"In my opinion, to say that if only one or two transactions can be proved, then as a matter of law, it cannot be said that they are transactions is a business, is too drastic a statement. I think that whether one or two transactions make a business depends upon the circumstances of each case. I take the test to be this: if an isolated transaction, which if repeated would be a transaction in a business, is proved to have been undertaken with the intent that it should be the first of several*

transactions, that is, with the intent of carrying on a business, then it is a first transaction in an existing business."

In applying the above principle, had *Crane* or *Stone* been in a position to argue that they had embarked on a new venture and the transactions in question were losses sustained on the commencement of this venture (which losses discouraged or prohibited pursuance of the venture) they may have been able to pursuade the courts that the losses were not of a capital nature.

2.3.4 Intention with Relation to Specific Transactions

Regarding the ability of taxpayers to deduct losses incurred flowing from specific transactions which were entered into with the objective of making a profit (which profit would otherwise have been taxable), but which, for whatever reason, subsequently failed resulting in a loss, is also relevant.

In this regard, the enquiry into the deductibility of an irrecoverable loan has, as stated above [1], been the subject of two enquiries, namely:

- Was the taxpayer involved in a business of money lending; and

- Was the specific transaction a part of that business.

Thus, each transaction must be viewed in order to ascertain a taxpayer's intention with regard to that transaction. Where the loss has been occassioned as a part of the taxpayer's ongoing business of money lending, or the loss was an adjunct to its business [2], then a taxpayer will not be precluded from claiming such a loss as a deduction from its taxable income.

Where, however, a taxpayer enters into a transaction where the purpose (intention) was not the furtherance of the taxpayer's business, then subsequent losses will be precluded from qualifying as a deduction for income tax purposes. In this regard, such an exclusion is within the ambit of Section 23(g) of the Income Tax Act as it is arguable that money so advanced was not advanced wholly and exclusively for the purposes of trade.

Where a taxpayer enters into a specific transaction with the sole intention of investing capital in order to generate a profit, and the transaction subsequently results in a loss, it is considered that, notwithstanding the overriding intention of the taxpayer to earn a profit, resultant losses will not be allowable unless the taxpayer can show that that particular transaction was the first in a series of transactions which would convert his otherwise

fixed capital into floating capital (namely changing him into a money lender).

In *Stone's* case [3], which case concerned losses arising from short-term speculative money lending transactions entered into by the taxpayer, Corbett AJA stated, at 130:

> *"There is however in my view no warrant for extending this principle (that is, the deduction of losses occassioned by money lenders) to loans by persons who are not conducting a business of money lending."*

This decision was upheld in *SIR v Crane* [4] where Boshoff AJP found that, although the taxpayer had entered into the transactions with the intention of earning a profit therefrom, *"the respondent has not shown that the transactions ... were transactions in a money lending business or any other business for that matter so as to render the capital involved floating capital"*.

Thus, it would appear that occassional losses arising from money lending transactions, even though a part of a company's business, will be viewed as being of a capital nature and not therefore allowed unless they are part of a money lending business. For example, in *Harry S Hopkins and Company (Pvt) Ltd's* case [5] the court found that, although loans to staff were made for the purposes of

trade, they were nevertheless on a capital account.

Notwithstanding the above, the courts have found [6] that, where a taxpayer can clearly demonstrate that he entered into a specific transaction which required he loan moneys to a company, and the loans were an integral part of that trade (namely to sell the shares and loans accounts as an indistinguishable unit for a profit), then the courts will accept that the transaction is of a revenue nature. Where, however, this specific intention cannot be clearly demonstrated then the loan account will be viewed as a item distinguishable from the shares and any subsequent loss on the realisation of the loan accounts will be viewed as being of a capital nature [7].

It should, however, be noted that the courts may distinguish between losses on loans advanced to fund "trading stock" and loans to earn interest or similar income. In *ITC 1344* [6] the taxpayer elected, for commercial and related reasons, to fund a property development conducted by a company in which he held shares by way of loans rather than through a subscription of share capital. At all times it was the clear intention of the taxpayer to sell, at a profit, his shares and loan account. This type of loan account has, it is considered, a different tax nature from a loan advanced where the taxpayer intends for that loan to be returned with a profit (see Part VII).

2.4 APPLICATION OF THE PRINCIPLES

Although the courts may be in a position to identify a number of indicative factors which point to losses being either of a capital or revenue nature, it is trite to say that the difficulty in applying these principles *lies not so much in the formulation of approach but in the application of the principles* [1]. Thus, the courts may be in a position to identify a number of characteristics which are common to money lenders and these characteristics may be evident in a particular taxpayer, yet the subjective circumstances surrounding the taxpayer's affairs may, notwithstanding the manner in which its business is conducted, reveal that it is, in fact, not carrying on the business of a money lender.

Thus, the approach followed by the court has been to, firstly, objectively analyse a taxpayer's business and then to look at the surrounding factors, and to weigh these factors against the results of the objective analysis identified. Thus, *"the determining factor is to be looked for in the intention of the company and the distinction... seems to me to be a difference of degree rather than a difference of kind"* [2].

With regard to the above, the issue was succinctly summarised in *Natal Estates Limited's* case [3] where, at 220 Holmes JA stated:

"In deciding whether a case is one of realising a capital

asset or of carrying on a business or embarking upon a scheme of selling land for profit, one must think one's way through all of the particular facts of each case... From the totality of the facts one enquires whether it can be said that the owner had crossed the Rubicon and gone over to the business, or embarked upon a scheme, of selling such land for profit, using his land as stock in trade.

Finally, one does not lose sight of the incidence of the onus of proving non-liability imposed by Section 82 of the Act, on the person claiming such non-liability, in the case the appellant."

Although the above case dealt with the issue of land being sold by the taxpayer, and the taxpayer maintaining that the proceeds were non-taxable, the issues and principles identified therein are, it is considered, relevant to the matter under consideration. In this regard, Natal Estates Limited was formerly a property holding company which, at no stage prior to the sales in question, held land as trading stock. Notwithstanding this, the courts found there had been a change of intention with reference to the land formerly held as a capital asset, and this asset had been converted into trading stock. Regarding taxpayers attempting to show that funds formerly held as fixed capital had been converted to floating capital, the degree of the new money lending activity would need to demonstrate that the taxpayer had *crossed the Rubicon* and

embarked on a business of money lending. Thus, the *totality of the facts* surrounding this activity should bear evidence to the assertion that the taxpayer's subjective intention had in fact changed. Failing this ability to clearly demonstrate the new business, the taxpayer will fail to discharge the onus placed upon him by Section 82 wherein the taxpayer is required to show that the loss suffered qualifies as a deduction from "Income", as defined (in Section 1).

To evidence this approach, *Plate Glass* [4] was able to demonstrate that it bore all the signs typical of a money lender in both the way it raised finance and systematically control its use, thereby generating an interest margin. In examining the case, the court stated [5] *"(one would) wish to guard against a conclusion... based solely on the nature of the taxpayer's business and on whether or not the appellant proved that its business was that of a bank of money lender"*.

In finding against the taxpayer, the court held:

> *"The money was nothing more or less than capital raised by the PGSI Group for use by companies in that Group, and the appellant's receipt and administration of the money was for that purpose and not for itself"* [6].

Thus, on the totality of the facts, *Plate Glass* was unable to show that, notwithstanding its *modus operandi*, it was involved in the business of money lending. As such, the resultant loss

(on foreign exchange) was a loss on the capital account.

Thus, the courts will endeavour to *"look at the substance and reality of the transaction"*. [7]

2.5 OTHER FACTORS

In addition to the factors outlined above, the courts have looked at certain factors specific to a taxpayer's business when deciding the deductibility or otherwise, of losses incurred on loans advanced. In particular, the following factors have proved relevant:

- The source of the funds advanced;
- The manner in which the funds were applied; and
- Nature of security required by the borrower.

In all of the above instances, the courts have looked to these factors in determining the nature of a taxpayer's capital namely whether the capital lost was fixed or floating.

2.5.1 Source of Funds

Businesses are funded through two principle mechanisms, namely via shareholders's equity or risk capital and from third party lenders or creditors. Each category would, in itself, comprise sub-categories.

The question of losses incurred by a taxpayer on capital employed can often be addressed by looking, not at the use to which the funds were applied, but the nature of the funds so applied. Thus, "*the true enquiry seems to be to determine the function in the taxpayer's hands of the money which came to it... if that money was held by it on revenue account, it is working capital employed by it for the purpose of being turned over at a profit, and any loss so turning it over would prime facie be deductible.*" [1]

Further, it has been stated by our courts that:

> "*For income tax purposes, borrowed monies are colourless in the sense that the amount paid to the borrower is, for the borrower neither capital nor income... regard must be had to the purpose of the borrowing and what it actually effects.*" [2]

Thus, the courts have looked to the sources of finance as being indicative of the intention to which the taxpayer intended to apply them. The quote from <u>*General Motors*</u> case [2] shows:

- The first enquiry is into the purpose for which the funds were raised (that is, the intention of the taxpayer). This enquiry is of a subjective nature; and

- The second enquiry is the effect of the borrowing (that is, does the use of the funds support the contention made by the taxpayer in regard to the stated intention). This enquiry appears to be of an objective or factual nature.

To this end, the above approach is similar to the approach adopted by our courts in looking at the source of income earned on monies invested.

For example, in *Lever Bros* case [3] the court found that the enquiry into the source of income was twofold, namely:

- The first being to determine the source from which income has been received, and when that has been determined;

- To locate it.

Thus, although the enquiry into the source or capital nature of funds raised is fundamentally different, the approach is, in many respects, similar.

There is, however, a presumption that finance raised, even if it is by way of a bank overdraft, is *prima facie*, a loan on capital account. *In ITC 308 8 SATC 99*, Dr Manfred KC concluded, after considering foreign exchange gains made on an overdraft due by a taxpayer in the United

Kingdom, that "*the borrowing of money is prime facie a liability on capital account.*" The resultant gain was therefore of a capital nature and tax free. To this end, the court looked at the way in which the taxpayer treated the liability in supporting this conclusion.

Thus, loans raised can, subject to the intention of a taxpayer, fall into different categories of capital. McCreath J, in quoting with approval from Special Court judgement in *General Motors case* [4] stated:

> "*The (first three) loans were certainly not part of the company's infrastructure. Rather they were directly concerned with producing the revenue derived from the manufacture of the finished products...*"

Although the above case concerned the question of exchange losses, it provides insight into the manner in which finance raised is viewed by the courts. Where, for example, finance is raised in order to enhance the capital structure of an organisation, it will similarly be viewed as being of a capital nature; on the other hand, where it is raised as circulating capital, it will not form part of the company's "infrastructure" and will thus be of a revenue nature. The approach of the court in this case was to look at the commercial operation as such, and the character of the expenditure arising therefrom, rather

than the narrow legalistic nature of the transaction [5]. (However, where the taxpayer is unable to show a clear intention of trading with the finance so raised, the courts will, nevertheless, look at the strict legal nature of the loan lost, and at the underlying capital nature of the amounts so invested [6].)

Thus, where a taxpayer is endeavouring to show that its business is that of a money lender, the manner in which funds have been raised could prove to be an important consideration in assessing such a claim. To this end, Corbett AJA stated that the fact that a taxpayer used borrowed monies to make loans which had become irrecoverable *"could well have been a relevant factor had there been any question of a money lending business being carried on but this... was not the position"* [7].

In *ITC 1009* [8] the court reviewed the method in which the taxpayer conducted its business. Its principle business was that of a cattle auctioneer, in the course of which business it made a large number of short term loans to farmers, ranches and the like who were purchasing cattle from the taxpayer as well as making other lending transactions. During the course of this review the court noted that the nature of the business required it utilise short-term overdraft facilities for a period (when the cattle were sold), and during other periods it was self funding. The fact that overdraft facilities were used,

and funds so raised on lent at higher rates of interest, was regarded as indicative in concluding that the taxpayer conducted the business of a money lender.

On the other hand, where the finance so raised is clearly intended to be invested in the capital structure of the business, the courts will view losses arising on advances made from such capital as themselves being of a capital nature. For example, [9] where a company uses its share capital to invest by way of money lending transactions and the company's articles of association indicate that this capital is fixed capital, there will be a presumption that the investment so made constituted the utilisation of a part of the capital structure of the company. Thus, resultant losses, will, themselves, be regarded as being of a capital nature.

2.5.2 Application of Funds

As discussed, the courts have tended to look at the nature of the funds invested, rather than the investment itself, when determining whether or not loans made are of a capital nature. Nevertheless, the application to which the funds are put may be used as an indicative factor in determining the intention of a taxpayer, with regard to the nature of these funds.

A critical issue addressed by the courts is the purpose

for which the loan was made. Where this purpose is aimed at securing a long term right, any subsequent loss will, therefore, be of a capital nature. For example, in *ITC 812* [1] the taxpayer advanced certain sums to a tennant of property owned by him, in order to ensure that the tennant would remain on his property and thus the taxpayer would continue to earn rental income therefrom. In finding against the taxpayer, the court concluded at 476:

> *"Even, therefore, if we had been able to find that the appellant had been conducting such a business (of money lending) it does not follow that we would have been prepared to find that these particular items could be written off as losses of floating capital."*

Thus, it can be concluded from the above case that the application of floating capital can convert such capital into fixed capital, and, under certain instances, the reverse.

Further, where a loan is advanced in order to secure an "*advantage of an enduring nature*" [2] then the loan so advanced will be of a capital nature. As such, any resultant losses will, similarly, be of a capital nature. Thus, in *Harry S Hopkins and Company Pvt Ltd.* where amounts were advanced to employees in order to secure a tennure of service, the courts found that losses incurred

as a result of the employees being unable to repay the debt where losses incurred as a result of capital being invested to secure a right of an enduring nature and therefore represented a loss of fixed capital.

Where money lending transactions are made, with the view of earning interest income (as opposed to securing a right from the investment as discussed above), the courts have looked at the nature of the investment in assisting them to determine the fixed or floating capital nature of the investment. Thus, "*the habitual use of mortgages would indicate a parting with money of a permanent rather than a temporary nature.*" [3] In *Salisbury Board of Executors* case [4] the court looked at the length of time for which the funds were invested and concluded that the manner in which the funds were applied, as indicated above, did not "*give the transaction the character of a temporary parting with money*". (The court did, however, acknowledge that had the taxpayer been a money lender then this factor would not necessarily have been relevant.)

Further, the fact that a taxpayer lends money on a short term basis is, similarly, not necessarily relevant where the taxpayer has not shown itself to be a money lender. Thus, in *ITC 1003* [5] the court found that the issuing of short term promissory notes by a taxpayer at regular intervals did not constitute a money lending business, but merely reflected the desire by the taxpayer to merely put

his money to some "short term use". As the underlying funds were of a capital nature, the loss arising on an advance becoming irrecoverable was, similarly, of a capital nature.

The significance of *ITC 1003* lies in the fact that a taxpayer can enter into a series of transactions which require a systematic monitoring and reinvestment of his funds, but this activity may not, under the circumstances, be sufficient to constitute a "business of money lending". In order to demonstrate that such a business is being conducted, a taxpayer will be required to show the clear intention of embarking and carrying on such a business if losses incurred during the course of these transactions are to be regarded as a losses arising out of a money lending business.

For example, *ITC 257* concerned a taxpayer who derived his income from interest, directors fees and rents. Amongst other ways of investing his capital, he lent money on promissory notes for periods of approximately four months. In commenting on a loss made by the taxpayer as a result of a promissory note proving irrecoverable, Dr Manfred Nathan KC stated, at 66:

> *"The appellant does not deal in promissory notes, and there is no evidence before us that he buys and sells promissory notes, and we have come to the*

conclusion that so far as the evidence before us shows the transaction is that of an ordinary loan of money and the security of a promissory note carrying interest... The capital invested in effect is really fixed capital.... and it does not appear to differ from money put out on a fixed deposit or from money lent on security of a mortgage bond."

Further, in commenting on the period (being four months) of the loan, the judge did not feel that this was significant.

Where, however, a taxpayer utilises its resources to offer finance to purchasers of its goods and services, and these purchasers (debtors) subsequently fail to honour their commitments, any such losses will be deductible in terms of Section 11(i) of the Act, subject to the provisions of that section. Notwithstanding this, it would appear that a loss arising as a result of a debtor failing to pay amounts due would be floating capital, and therefore deductible. The converse of this (being bills given to a taxpayer's creditors) was considered in *ITC 308* [6]. The court found that gains made as a result of favourable exchange rate fluctuations on trading bills given in the course of trading were connected with the trade and such gains were therefore taxable.

Notwithstanding the fact that *ITC 308* concerned gains made

by a South African taxpayer on trading bills issued in the United Kingdom as a result of exchange rate fluctuations, it would appear that the principle contained therein is applicable to the matter in question.

Where, however, a taxpayer can show that loans were made as part and parcel of its existing business, with the intention of securing an advantage of a revenue nature, any losses incurred may be losses on a revenue account and therefore deductible [7]. In this regard, the courts have looked to "*the paramount motive which operated upon the mind of the lender in entering into the agreement*" [8].

Thus, for example, where a category of taxpayers, such as shippers, make loans to their clients in the ordinary course of their business, losses incurred as a result of clients subsequently being unable to honour loans made will be regarded as being losses of floating capital, and therefore deductible. Where the funds are therefore applied in the course of a taxpayer's normal business operations, any losses will, similarly, be regarded as "normal" and therefore be deductible. In *ITC 434* [9] Dr Manfred Nathan KC concluded:

> "*These transactions (being advances to clients of shippers) were in their nature in the ordinary course of the appellant firm's business. That being the case, it is clear that these transactions were*

on income account... In these circumstances, the court must allow the appeals as to the deduction of what has been described as a doubtful debt though it is really a bad debt."

Further, where a taxpayer can show (even though the practice of advancing funds to customers, clients, suppliers or the like is not normal for that kind of business) that advances are made in the manner adopted by the taxpayer to conduct its specific business, losses will be allowed where they are incurred on monies advanced, providing the advances are attached to the revenue operations of the company.

Thus, where there is evidence to show that it is a custom of a company to carry on the business of lenders of money as an adjunct of their business [4], then losses resulting on such loans will not be regarded as being of a capital nature.

In *ITC 807* [10] the taxpayer carried on the business of a wholesale merchant. In order to overcome difficulties obtained in securing supplies of certain goods, it purchased shares in a company engaged in the manufacture of such goods, and made cash advances to that company. The cash advances were made in order to secure a supply of the required goods. Following the collapse of the company, the advances proved irrecoverable. In finding

for the taxpayer, Price J stated, at 341:

> *"It seems to me that it is not essential to find that the making of advances is a customary way of carrying on the kind of business carried on by the appellant, so long as it has been shown to have been the way in which the appellant itself carried on its business... The real question is, how does the appellant carry on its business, not how do other people carry on their businesses."*

2.5.3 Nature of Security Required

General

As discussed in Part I, a contract of loan creates personal rights, with each party being at the same time the debtor and creditor of the other party. In the normal course of events, the non-performance by the borrower of his duties in terms of a loan agreement would simply give the lender certain contractual rights; the lender's remedies under these circumstances may take time and prove valueless. Such a right may be extended by the lender seeking additional security through a suretyship obtained from a third party. The lender may wish to have security in addition to any personal rights obtained and acquire a real right (that is, "*a right in a thing which is good against the world*" [1]) in the form of a mortgage, pledge, lien or hypothec.

Any such security is an accessory to the obligation secured, and in the absence of such an obligation a security cannot exist. [2]

From a statutory point of view, the above securities require certain formalities are to be met before they will be recognised by a court of law. For example, in the case of suretyship, Section 6 of the *General Law Amendment Act 50 of 1956* (as amended) requires that a contract of suretyship be embodied in a written document signed by, or on behalf of, the surety; and a mortgage bond over immovable property requires registration of such a bond.

Income Tax Considerations

The issue of security has been defined as "*a usual, though not essential, feature of a loan made in the course of a money lending business*" [1].

Notwithstanding the discussion under "General", the question of what security is from a tax point of view, and the importance placed upon it, has been vague and contradictory. For example, in *ITC 1138* [2] the court commented that no security was requested or obtained in regard to certain loans made, which loans were the subject of a promissory note. On the other hand, *ITC 1009* [3] indicated that the use of a promissory note was a form of security. In this regard, it would appear that the former

case was looking to tangible security whereas the latter accepted an acknowledgement of debt as such security.

Regarding the actual effect of security, in *Salisbury Board of Executors Limited*'s case [4] the court commented that the obtaining of a real right *via* a mortgage bond represented the acquisition of a "capital" asset, and this asset was acquired in exchange for funds advanced. Thus, as the asset acquired was of a long term or enduring nature, funds advanced to secure this asset were similarly of such a nature.

Further, the Court in *ITC 1009 supra*, considered a taxpayer's long acquaintance with people to whom funds were advanced to be a form of security and in *Fairway Estate's* case [5], an Australian decision, the Court noted that the insistence on a seat on the board of directors of the debtor was taken as a means of "*participating in the control of the borrowing company's affairs by way of security for the money advanced*". Whereas in *ITC 807* [6] the court commented that an advance to a company in which the taxpayer held shares, represented an unsecured loan.

Notwithstanding the above, the question to be addressed is: does the taking of security, and the nature of the security obtained, impact the taxpayer's contention that it is carrying on a business of a money lender?

The answer to this question would appear to be to look at, firstly what is normal for a particular taxpayer's kind of business, and secondly how that taxpayer elects to conduct its own business (as discussed in 2.5.2 above).

The taking of security is, most certainly, a normal prerequisite for any money lending transaction. It would, however, appear that in *Salisbury Board of Executors Limited*'s case *supra* the court viewed the taking of security as predominant in the taxpayer's mind and it was this asset (being the mortgage) which gave rise to the income generated, rather than the loan itself. On the other hand, a money lender would have viewed such security as a normal business requirement, and not an end to itself.

The degree to which security is required would, it is considered, be dependent on a number of variables. For example, where a taxpayer has an in depth knowledge of a particular borrower, security requirements may be lesser where a particular client is of good standing, when compared to another party about whose affairs the taxpayer has little knowledge. Such factors would, as already discussed, be indicative of the nature of the taxpayer's business, rather than decisive.

The conclusion to be drawn from the above cases is that security taken, and the nature thereof, will provide

evidence to support a taxpayer's stated intention, rather than contradict it. Thus, security is one of the factors to be considered when concluding on whether or not a taxpayer is carrying on the business of money lending in the light of other complementary factors.

PART III EXPENDITURE (AND LOSSES) WHOLLY OR EXCLUSIVELY LAID OUT FOR THE PURPOSES OF TRADE

EXPENDITURE (AND LOSSES) WHOLLY OR EXCLUSIVELY LAID OUT FOR THE PURPOSES OF TRADE

1. GENERAL

As discussed under "General" in Part II, for any loss to be deductible, it must meet the conditions laid down in the "general deduction formula". An integral part of this formula is the provisions of Section 23(g). Thus, what Section 11(a) provides positively, Section 23(g) provides negatively [1]. Section 23(g) reads:

> *"23 No deduction 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 wholly or exclusively laid out or expended for the purposes of trade;"*

In *Solaglass'* case [2] the courts have, at 16, described and analysed Section 23(g) as follows:

> *"The prohibition is of wide ambit. This can be seen when that against which the prohibition is directed is dissected into its component parts as follows:*

(i) Deduction

(ii) in respect of

(iii) any moneys

(iv) claimed as a deduction from income derived from trade

(v) which are not wholly or exclusively laid out for the purposes of trade."

1.1 LOSSES

As discussed in Part II, irrecoverable loans represent losses incurred by a taxpayer. In *Solaglass'* case *supra* counsel for the appellant argued that Section 23(g) did not apply to losses as it only referred to moneys claimed as a deduction from income.

In commenting on the taxpayer's contention, the court stated, at 16:

> *"The expression in itself is not concerned with "losses", neither inclusively or exclusively; it is entirely neutral in relation to the concept of "losses"... Re-casting it (Section 23(g)) in positive terms, the requirement is that any moneys sought to be deducted must be moneys which are laid out or expended in the manner specified. The requirement comprises two component notions:*
>
> *(a) Moneys which are laid our or expended; and*
>
> *(b) In a particular manner, i.e. wholly and exclusively*

for the purposes of trade.

> *But the requirement in no way touches upon the question whether moneys which are laid out or expended have been lost or not. That is immaterial for the purposes of this section, according to its wording... There is nothing in this section to support the argument that the prohibition does not apply when moneys which are laid out or expended happen to result in losses."*

Thus, the judge went on to conclude that the fact that moneys were lost, did not preclude them from falling within the ambit of Section 23(g). In fact, it was apparent that moneys had been expended by way of making a loan in a previous tax year.

Regarding the annuality of a taxpayer's affairs, the judge passed no comment; this factor was not, it would appear, considered relevant, notwithstanding the decision in *Concentra's* case [1] where it was held that expenditure and losses are to be brought to account at a year end. Thus, one can conclude that Section 23(g) is not restricted to expenditure incurred in the year of assessment, but refers to any expenditure incurred by the taxpayer in the current or previous years of assessment. Precedent for such an approach would appear to arise from *De Beer's* case [2]. This case concerned the deductibility of certain shares classified as trading stock up to and including 1979, when they were purchased in 1973. In addressing the question of the effect of Section 23(g) on the

1973 assessment Corbett JA commented:

> *"The consequences of finding that Section 23(g) precluded the deduction of the purchase price of the shares on the 1973 assessment do not arise for decision."*

In this regard, the fact that the "deduction" in the 1979 year of assessment arose through an "automatic" claim as opening stock (Section 22 of the Act) and not as a result of expenditure was not, it would appear, considered relevant. Thus, the court, in considering whether or not a loss on the sale of such trading stock (arising as a result of Section 22) was deductible in year so incurred, even if the amounts expended in acquiring such stock were expended in a previous year of assessment, found that Section 23(g) was applicable. (In the alternative, the court found that the shares should never have, in the first instance, been classified as trading stock.)

In applying the above principle to transactions involving losses arising on loans advanced, the following is apparent:

- If it were to be argued that Section 23(g) is not applicable to the losses, then it would be apparent that the nature of the intended benefit of the transaction (that is non-taxable interest earned, trade generated or the like) would nevertheless disqualify the loss as a deduction as it falls outside the ambit of the word "purposes" in this section. Thus, in *De Beer's* case

supra, the cost of the shares claimed as a deduction in 1973 should never have in the first instance, been regarded as stock in trade; or

- Alternatively, if the losses are as a result of the taxpayer's money lending business, then the year in which the expenditure was so made would appear to be irrelevant and any such losses would be as a result of moneys expended thus falling outside the ambit of Section 23(g), thereby qualifying as a deduction.

- Finally, if the granting of the advance is not "expenditure", the incurral of the loss is.

1.2 WHOLLY OR EXCLUSIVELY

The phrase "wholly or exclusively" would appear to be the focus of most enquiries when considering the implications of Section 23(g) on the deductibility of irrecoverable loans for income tax purposes. To this end, and as discussed in Part II, there appear to be two fundamental enquiries, namely:

- Whether or not a taxpayer was carrying on the business of money lending; and

- If the taxpayer was carrying on such a business, was the loan in question advanced in the course of that business.

Although earlier cases do not make reference to Section 23(g) (or that sections predecessor [1]), frequently concluding that loans advanced outside the scope of a taxpayer's business are of a capital nature or were not advanced in order to produce income, it would appear that the enquiry was frequently into the purpose for which the loan was made; that is, was it "wholly or exclusively laid out for the purposes of trade"? It would further appear that such an enquiry should have properly been conducted within the ambit of what is now Section 23(g). This phrase was considered in *Pick 'n Pay's* case [2]. In analysing the term, Nicholas AJA at 147, commented:

> *"The first question to be considered is the meaning of the words 'moneys' ... which are not wholly or exclusively laid out or expended for the purposes of trade."*
>
> *The answer was provided by the analysis of similar words in the judgement of Romer LJ in Bentley, Stocks and Lowess v Benson (1952) 33 TC 491 ..."*

The above judgement concluded as follows:

- "Wholly" is in reference to the quantum of the money expended;
- "Exclusively" refers to the motive or object in the mind of the (two) individuals responsible for the activities in question.

In proceeding with his judgement, Nicholas AJA went on to state, at 149:

> *"The question is one of fact, the fact of the state of mind of those responsible for making the donation at the time it was made."*

It is important to note the disinction between the wording of Section 23(g) and the wording of the United Kingdom statute quoted. The South African Statute refers to "wholly or exclusively", whereas the United Kingdom statute refers to "wholly and exclusively". From the above quote, it is apparent that this distinction has been ignored by our courts and the enquiry has been into the state of mind of the taxpayer as well as the expenditure in question. Thus, even if the amount expended was expended wholly for the purposes of trade, yet there was an altruisic motive in making such expenditure, the prohibition provided by Section 23 would be applied. The courts failure to acknowledge the difference in the wording was noted in *Solaglass'* case [4].

In commenting on the judgement of *Solaglass'* case [3], and the courts interpretation of Section 23(g) the authors, with reference to the relevance of the said section, argued that it is redundant and that "it is obviously most undesirable that practice should differ from the law"; it would, in addition, appear equally undesirable where the court's application of the law differs from its apparent meaning.

The authors argument for redundancy arises from the ability to apportion expenditure in terms of Section 11(a). Such an apportionment may not be necessary if Section 23(g) were to be applied in two parts; thus were the expenditure in question to be measured against the both "wholly and exclusively", and only it if failed both, would such a disqualification arise. Thus, the word "wholly" appears to have been overlooked and could itself be viewed as being redundant. The Court's emphasis in this regard has been on whether or not expenditure was "exclusively" laid out for the purposes of trade.

As indicated in *Pick 'n Pay's* case above, the question necessary to determine whether the contemplated expenditure was exclusively laid out for business purposes is: what was the motive or objective in the mind of the individual responsible for the activity in question?

In *Solaglass'* case [4] Botha JA commented, on the distinction between motive and purpose, as follows:

> *"So, for instance, the distinction between motive and purpose in this context seems to me to be a nebulous one: it may sometimes be found to be helpful, but at other times it may be conducive more to confusion that to clarity... The truth is, in my judgement, that there are no hard and fast rules for deciding whether a taxpayer's expenditure falls within or outside the ambit of this section; it is not possible to devise any precise*

> *universal test for determining whether expenditure comprises moneys 'exclusively laid out or expended for the purposes of trade'. In general, one can say no more than that the issue is to be resolved by examining the particular facts of each individual case."*

In finding against the taxpayer, Botha JA looked at the link between *Solaglass'* business and that of fellow subsidiaries. He commented, at 20:

> *"If it is accepted that in the latter situations the benefits are too remotely connected with the trading activities to be brought home under the word "purpose" in this section, I am nevertheless satisfied that the link between the appellant's activities and the furthering of the group's interests is sufficiently close, on the evidence, to cause the latter to fall within the ambit of the word "purposes" as used in this section."*

It would, therefore, appear that the court looked to factors both internal and external to the taxpayer to determine not only the nature of its business, but reason for existence. As the reason for its existence was not to trade as a money lender, but to serve an administrative function for the Plate Glass Group, losses incurred by it on loans advanced to fellow subsidiaries were precluded from its taxable income as a deduction, notwithstanding the courts finding that it carried on a business of money lending. The finding of the court in this instance was

similar to that found in *Plate Glass'* [5] where, at 112, the court found that certain loans raised by the company were raised for *"the specific purpose of making such (loans) available to certain importers in the group... and (the loans) were not raised to enable the appellant to trade. The money was nothing more or less than capital raised.... for use by companies in that group and the appellant's receipt or administration of the money was for that purpose and not for its self."*

Thus, where a taxpayer is engaged in a business of money lending, as was *Solaglass* [4], and the taxpayer in *ITC 1009* [6] (discussed in Part II), the courts will endeavour to analyse the specific reasons for which the loan transactions were entered into. In the case of *Solaglass*, the court found that the business itself, although being that of a money lender, would not warrant the deductibility of losses as the reason for its existence was mixed, namely to trade at a profit, and to assist the group. On the other hand, the taxpayer in *ITC 1009* made certain advances to a club, which advances were made for purposes not exclusively related to trade; the fact that this loan proved irrecoverable did not, it would appear, affect the taxpayer's right to claim as a deduction any other losses resulting from its money lending business.

What is interesting to note in *Solaglass'* case [7] is the fact that the courts accepted that operating expenditure attendent on its business continued to be deductible, thus differentiating such expenditure from losses incurred as a result of loans proving

irrecoverable. In commenting on this distinction, Botha JA stated:

> *"One would have to examine the nature of the activities carried on, the nature of the expenditure, and the closeness (or remoteness) of the connection between the expenditure and the benefit derived therefrom from the group. For example: in the present case the appellant presumably incurred ordinary day to day expenses in the running of its business... There is no doubt that the deduction of such expenses from the appellant's income is not precluded by Section 23(g). The reason for this is that the connection between such expenditure and the benefit to the group flowing from the appellant's activities is too remote for the latter to qualify as a 'purpose' in terms of this section. But the appellant's expenditure in the form of loans advanced to subsidiairies in the group stands on quite a different footing. Such expenditure is a part and parcel essential substance, in fact, of the very activities which were designed and carried out in order to benefit the group. The connection between this expenditure and this benefit is both direct and immediate. In these particular circumstances the 'benefit' falls within the ambit of the word 'purpose' in the section"*

Thus, it would appear that the enquiry into the ambit of Section 23(g) is not only directed towards the purpose for which expenditure was

made, but also the closeness of the link between the expenditure, and income earned. Where the activities flowing from the expenditure so incurred are too remote to be a 'purpose' not related to trade, then the expenditure incurred is probably deductible; where, however, the expenditure (or loss in this case) is directly linked to the purpose then the provisions of Section 23(g) apply.

The distinction in thus one of degree which is confusing and one which is likely to create uncertainty, rather than lead to clarity.

Notwithstanding the above, it would appear that the phrase "wholly or exclusively" should be analysed thus:

- The expenditure should first be examined in order to ascertain if it was "wholly" laid out for trade;

- Assuming it was, the purpose motivating the laying out of the funds in question is to be ascertained;

- If this purpose is directly linked to a trade of the taxpayer, notwithstanding the fact that the taxpayer's activities may have been entered into with a dual motive, namely to trade and to benefit a third party, then the attendant expenditure may nevertheless be deductible; or

- If the expenditure (or loss) is so closely linked to the taxpayer's dual motive, so as to be indistinguishable from the carrying out of that motive, then such expenditure or losses

will be precluded by Section 23(g) from qualifying as a deduction for income tax purposes.

The above principle, although not articulated by the courts prior to the cases referred to above, appears to have been consistently applied. In this regard Watermeyer AJP [8] noted that the question of whether an item of expenditure was incurred "in the production of income" is "*the same one as is dealt with negatively in Section 13(b) (Section 23(g), which prohibits a deduction unless the expenditure is made 'wholly and exclusively for the purposes of trade'*".

For example *ITC 44* [9] concerned a company which guaranteed certain loans owing by a third party building contractor in order to obtain work from the contractor. The guarantees were subsequently called up and the taxpayer was not allowed to deduct the resultant losses as the court found that the granting of guarantees fell outside its scope of business.

2. CORPORATE VEIL

It is noteworthy that, in the *Pick 'n Pay*, *Plate Glass* and *Solaglass'* cases referred to above, the courts have tended to look beyond the immediate framework in which the taxpayer operated to factors external to it, when concluding that certain transactions were entered into for reasons other than pure trade. In all of these cases they have looked to the motives of the shareholders and found that the shareholders' intention impinge on the company's intention.

This finding was made notwithstanding evidence led by executive directors of the taxpayer. For example, in *Pick 'n Pay's* case [1] the financial director of the company stated:

> *"We are a very aggressive company. Our advertising is extremely aggressive in particular we work tremendously hard on this public relations aspect... It is all part of the public relations.. part of advertising ... it was just like a special event advertising campaign."*

And, in *Solaglass'* case [2] a director of the company described operations of the company thus:

> *"In the structure and design of the method whereby it performed this function (the money lending function) it sought at all times to make a profit ...."*

It is, it is considered, appropriate for the courts to look to those parties responsible for the day to day operations of a company in determining the intention with which transactions were entered into. In *Trust Bank's* case [3], which case concerned the capital or revenue nature of an investment disposed of, the court stated:

> *"The respondent being a company, the special court held that its intention in regard to the share transaction in question had to be sought in the thoughts and acts of the persons who manage and control its affairs. That would ultimately be the board of directors but, because the evidence showed that considerable*

powers were conferred by the board upon the management committee... the special court concluded that the intention of the management committee would, to some extent, depending upon the nature of the matter and the circumstances, represent the intention of the company..."

As already indicated, the courts have, notwithstanding the comments of management, and its finding in *Trust Bank's* case *supra*, looked beyond the immediate realms of a taxpayer's affairs in determining the purposes for which money has been expended. The approach taken in *Pick 'n Pay's* case and *Solaglass'* case deviates from the previously accepted norm wherein the courts looked at specific transactions, and the factors motivating them, rather than looking at the purpose for which a taxpayer was formed and using the conclusion of such an observation to comment on the specific transaction. Such an approach may, it is considered, ignore the dynamic nature of a modern company's objects, as these objects change over time.

In *Solaglass'* case, for example, the company may have been administratively orientated at its inception but over time became profit orientated. Such a change is contemplated within Section 33 of the Companies Act [4]. Section 33(3) of the said Act provides:

"Notwithstanding anything contained in the memorandum of any existing company, the main business which it actually carried on... shall be deemed to be its main object."

Such an approach has, nevertheless, been adopted by the courts in the

past. For example, in *Richmond Estate's* case [5] the courts stated that *"a company is an artificial person with no body to kick and no soul to damn no ifs and the only way of ascertaining its intention is to find out what its directors acting as such intended..."*

In this case, as the director was the sole shareholder, the court felt that it was competent to say that the mind of the shareholder was also the mind of the company.

The above principle was further expanded in *Elandsheuwel's* case [6] where the courts found that a company changed its intention as a result of a change of shareholders. Thus, the company which had held land for a number of years as a capital asset, was found to have changed its intention with reference to that land and its subsequent disposal was a disposal of trading stock and therefore taxable.

Although various branches of commercial law may accept the principle that a taxpayer is a separate juristic person, as was strongly argued in *Plate Glass's* case, income tax law does not appear to fully accept this principle when examining the intention with which a taxpayer has entered into a transaction. Thus, the courts will look, not only at the immediate acts of the parties responsible for implementing and carrying on a transaction, but also the reasons why the business itself was formulated, and therefore, the motives of its shareholders, even where these shareholders may be passive and uninvolved with management. Thus, in *Pick 'n Pay's* case it would appear that Mr Raymond Ackermann's (indirect) controlling of the affairs of Pick 'n Pay was a significant factor in the finding that the "donation" by

Pick 'n Pay had a dual purpose, one of which was philanthropic. This dual purpose was sufficient to disqualify the donation as not being wholly or exclusively expended for the purposes of trade.

A slightly contradictory approach was adopted in *ITC 1321* [7] where the courts held that a taxpayer who had invested in a company by way of shares and loan accounts in order to fund a company which acquired and developed immovable property was precluded from deducting the loss incurred on the subsequent realisation of the shares and loan accounts as it was, in their view, the company that was trading and not the appellant. This case, however, indicates that the direction of the court's enquiry has been from the shareholders to the company, rather than the other way around.

PART IV ACTUALLY INCURRED

1. INTRODUCTION

2. DURING THE YEAR OF ASSESSMENT

3. INCURRED

   3.1 DEBTOR/MONEY LENDER DUTIES

   3.2 EXTERNAL FACTORS

   3.3 CONSTRAINTS SPECIFIC TO MONEY LENDERS

   3.4 TIME AND QUANTIFICATION OF LOSS

ACTUALLY INCURRED

1. INTRODUCTION

As noted in Part II of this report, part of the general deduction formula requires that a loss arising from an irrecoverable loan be "actually incurred" before it can qualify as a deduction in terms of Section 11(a), read with Section 23(g).

Discussing the meaning of "actually incurred", Watermeyer AJP [1] stated:

> "*that expenses actually incurred cannot mean actually paid. So long as the liability to pay them has actually been incurred they may be deductible*".

In applying the above (which is accepted as a general principle from an interpretative point of view) so long as losses have actually arisen, even though they may not yet have been funded, they will be incurred for the purposes of Section 11(a). Thus, where these losses arise in a particular year of assessment, they have been actually incurred in that year of assessment, notwithstanding the fact that a taxpayer may only be required to pay for these losses at a future date (for example, by way of honouring guarantees) or only be entitled to receive the repayment of an advance at a future date. In *Caltex Oil's* case [2] Botha JA said:

"It is in the tax year in which the liability for the expenditure is incurred, and not the tax year in which it is actually paid (if paid in a subsequent year), that the expenditure is actually incurred for the purposes of Section 11(a)."

This principle has been upheld in so far as it applies to losses. In this regard, *Plate Glass* case [3] extended the reference to "expenditure" in the above quote from *Caltex Oil's* case to include 'expenditure and losses' actually incurred.

The practical aspects relating to a claim of this nature were discussed by C Divaris [4] wherein he commented:

"The difficulty,of course, lies in regarding a loss as being payable... The liability to pay attaches to the loan and not the loss. When the times comes for payment a loss may be suffered, but when was that loss incurred?..."

Divaris was referring to the deductibility of losses incurred as a result of exchange rate fluctuations on loans owing by a taxpayer. Nevertheless, the comments made would appear to be relevant as great difficulty may be experienced by a taxpayer in ascertaining exactly when a loss is either incurred, or to be recognised. Thus, the affairs of the debtor of a taxpayer may deteriorate over a period of time, with the value of the debt diminishing; the date at which the taxpayer finally acknowledges that the debt is no longer worth its face value could, therefore, be different from the date in which the

loss was actually suffered.

In discussing the concept of "incurred" with reference to losses in *ITC 1218* [5], the court made the following comments:

- 'Incurred' means either 'paid' or 'become liable for';
- The words 'expenditure actually incurred' seem to be to mean:

  (1) moneys actually paid out; or

  (2) moneys which a trader is legally liable to pay.

Applying the above to the concept of a loss of the nature envisaged, the term incurred could read 'no longer recoverable'(by a trader) (as compared with 'become liable for').

The distinction between a mere provisions and an actual loss is, notwithstanding the importance attached to recognising the timing of the loss, relevant. A provision for expected or anticipated losses will be disqualified as a deduction in view of Section 23(f) which prohibits the deduction of "*income carried to any reserve fund...*" (that is, provisions created for anticipated losses) (See Part V).

2. DURING THE YEAR OF ASSESSMENT

In *Concentra's* case [6], which case concerned the question of whether expenditure incurred by the taxpayer's directors on its behalf, but only submitted to it subsequent to the year end, was deductible in the year submitted, the court, in finding against the taxpayer stated:

"From the wording of the Act it is clear that the intention of the legislature was to fix some definite day in the past on which the assets employed in trade of all persons should be ascertained and it cannot be limited to assets employed on the whole of the day unless so expressed. The definition seems to me to cover all assets employed at any time on that day."

Thus, the principle identified in *Concentra's* case requires that expenditure (and thus losses, based on the comments made in *Plate Glass's* case [3] with reference to the decision in *Caltex Oil* case [2]) be deducted as and when it is actually incurred. Thus, it would appear that it is important for taxpayers involved in money lending businesses to objectively assess the recoverability of debts due to them at the end of each year in order to ascertain whether any losses have been "incurred" during that year of assessment and to claim as a deduction any portion of those debts which are likely to prove irrecoverable. (See Part V.)

3. INCURRED

The actual incurral of a loss does not appear to have been directly considered by the Courts when deciding on income tax matters. Thus the question of what is incurred (when referring to losses) remains open. The issue appears uncertain as a taxpayer's affairs are frequently subjected to changing fortunes. For example, the debtor of a money lender may, in one year, be operating under insolvent or near insolvent conditions and the following year reflect a strong financial position; or a debtor with apparently healthy financial affairs may be

the victim of some vagary which could result in its inability to continue trading.

From an accounting point of view, financial statements are prepared on the assumption that the business is a "going concern" unless there is clear evidence to the contrary [7]; that is, that it will continue as a viable entity into the foreseeable future. Thus, financial statements may not reflect the realistic value of a business, but merely its historical cost.

In considering the above, the expectation that a business is a "going concern" presumes that it will be in a position to meet its financial commitments. Thus, a debtor which is experiencing financial difficulties may not necessarily generate a loss. From the money lender's point of view accounting "prudence" [8] may, under these circumstances, require a loss be anticipated and thus provided for but tax parlance may not recognise the incurral of such a loss. The question is thus: when does an anticipated loss become a loss incurred?

There is, to a limited degree, precedent in using the accounting approach to the recognition of certain items of income and expenditure where the actual receipt (or incurral) is derived over a period of time.

For example, in *X Co (Pty) Limited* [9], which case concerned the taxability of a surplus arising on the repayment of debts purchased at a discount, the court stated:

> *"The question remains, however, whether the Commissioner has right in assessing the amount of taxable income at $4,923. That depends on whether the Commissioner should have taken the actual surplus received by X Co, $998, as representing the profit arising during the relevant income year from the carrying out of the scheme, or whether he was entitled to assess the profit on an ongoing basis. In the absence of some definite direction in the Act, the Commissioner should, in the assessment of income, adopt the method of accounting which is in fact appropriate to the circumstances of the case, or which in other words 'is calculated to give a substantially correct reflex of the taxpayer's true income'..."*

Similarly, and with reference to losses Margo J Stated in Plate Glass case [10]:

> *"...it seems to me that there is logic is adopting the accounting method to determine liabilities or losses, whether on capital account as set forth in a balance sheet as at a particular date, or on a trading account covering a particular period..."*

Notwithstanding the above, it is considered that there is no incurral of a loss until the debtor is in default, as discussed in 3.1 or some other factor intervenes as discussed in 3.2. Thus, incurred has been defined [5] as meaning either "*paid*" or "*become liable for*"; in this context it would mean a receipt to which the lender is unconditionally "*entitled to*"", but which receipt is irrecoverable.

The recognition of such a loss could therefore flow from one of two eventualities:

- The acts of the debtor *vis a vis* the money lender; or
- The acts of parties external to both the debtor and the money lender.

3.1 DEBTOR MONEY/LENDER DUTIES

In dealing with the relationship between the debtor and the money lender, the relationship would be covered by a contract (formally or informally) concluded between the two parties.

A contract has been described thus:

"...a lawful agreement, made by two or more persons within the limits of their contractual capacity, with the serious intention of creating a legal obligation, communicating such intention, without vagueness, each to the other and being of the same mind as to the subject matter, to perform positive or negative acts which are possible of performance". [1]

Thus, and with reference to losses, the concepts of "legal obligation", and "performance" are crucial. To this end, it would appear that until there is non-performance by the debtor there can be no breach of the debtor's legal obligation; as such there can (subject to 3.2) be no loss until the contract has

been breached. To this end, it has been assumed that the non-payment of an amount due in terms of a loan agreement (be it interest or capital) is a breach of a material condition of that agreement.

In the event of there being a breach of the contract, the money lender can either:

- Treat the contract as cancelled; or
- Sue for specific performance. [2]

(In reality, however, a money lender may be reluctant to pursue these actions as further losses may be incurred.)

Thus, as it is only at the time of non-performance that a debtor is in breach of its contract, would it appear that it is only at this stage that a loss can be regarded as being "incurred".

Further, the fact that a debtor may not elect to cancel the contract or sue for specific performance or damages does not, it is considered, affect this principle. The election to permit a debtor to default on certain payments may, for valid commercial reasons, be necessary to protect the entire debt due, as an insistence on the payment of an amount at a particular time may prejudice the entirety.

One can therefore conclude as follows:

- The mere fact that a money lender is suspicious about a debtor's ability to fund payments due in the future is not sufficient to conclude that a loss has been incurred;

- In the event of the debtor failing to pay an installment, be it of interest or capital, the entire contract is voidable. As such, a "loss" has been incurred.

- When a loss has been incurred, it would appear that the money lender would be entitled to value the entire debt due and claim, as a loss, the difference between the face value of the debt and its estimated realisable value. To this end, the money lender must be able to show that the question of the loss claimed has been considered with reference to extraneous factors, such as suretyships given by third parties.

The question of whether a loss was actually incurred was discussed in *ITC 1138* [3]. This case concerned loans advanced to a company, which loans were guaranteed by directors of this company. The guarantee was evidenced by the endorsement of a promissory note given to the taxpayer by the company. On the company becoming unable to repay the loan, the debt was claimed as bad. The taxpayer did not appear to attempt to recover the loans advanced from the directors who guaranteed payment.

The judge, in concluding that no loss had been incurred, stated:

"There was no evidence before me to establish that the appellant was precluded from proceeding against these directors or that, if it did so, it would not be able to recover the sum from them.

As no proceedings were taken for the recovery of this sum... the appellant has not established that the sum is irrecoverable. This being so, it is my opinion that the appellant has not established that it suffered a loss..."

Based on the above, it can be seen that the following approach has been adopted by the court in analysing whether in fact a loss had been incurred:

- The first enquiry is into the ability of the debtor to fund the repayment of the loan raised;

- If the debtor is unable to meet this liability, the courts will look to see if the taxpayer has alternative recourse;

- If such alternative avenue is available, the taxpayer will need to ascertain whether or not its pursuance of that avenue will result in the loss being recovered.

Failing the above, the court will find that no loss has, in fact, been incurred.

3.2 EXTERNAL FACTORS

Notwithstanding the above, it would appear that a money lender can claim a loss has been incurred where extraneous factors indicate that a debtor will not be able to fund payments due in the future, even though there may be no immediate obligation to make such a payment.

For example, a declaration of insolvency by a debtor, or its liquidation could give rise to a loss.

3.3 CONSTRAINTS SPECIFIC TO MONEY LENDERS

Where, for various reasons unrelated to the debtor, a money lender is of the opinion that a loss has been incurred, the Courts may accede to such a claim where it can be shown that for all practical purposes a loss has been suffered.

Where, however, a loss is voluntarily for non-trade related reasons incurred, it will not be admitted. In commenting on the action required by a taxpayer to prove a loss, the court stated in *Cathart's* case [1]:

> *"In the present case, as I have pointed out, the taxpayer has nowhere said that he paid because he was liable to pay. In fact, in his statement of case before the special court, he makes reference to the fact that the legal proceedings in question were to be lengthy and*

expensive... In other words he takes up the attitude that the reason for admitting the claim is irrelevant; all that matters is that he has in fact made the payment... It does not seem to me that the learned Judge President (of the special court) was justified in drawing the inference that the sum paid in settlement was paid in pursuance of a legal liability."

Cathcart was an architect who had given certain warranties with regard to a building designed and developed by him. Following certain claims made by the owner of the building, *Cathcart* agreed to pay a sum representing damages. It was this claim for damages that was considered by the courts.

In applying the above principle to losses arising on irrecoverable loans, it would appear that the mere fact that a loan has been written off is not sufficient for it to have been "actually incurred". It would appear that the courts will require more substantive evidence that the loan is, in fact, irrecoverable. The mere aversion by a taxpayer to persue its legal right of recourse, for whatever reason is, therefore, insufficient to warrant the conclusion that the amount is so deductible. In this regard, an analogy can be drawn to the provisions of Section 11(i), which Section permits the deduction of bad debts. One of the conditions precedent for such a deduction to be granted is that the debt must be proved bad to the satisfaction of the Commissioner. Thus, the mere opinion of the taxpayer is insufficient.

In *ITC 1327* [2], the taxpayer made a loan to a private company controlled by him and, in addition, guaranteed certain debts. Following a compromise sanctioned by the court after the company had been put into judicial management, the taxpayer was released from the guarantees given, provided he waived his claim against the company. The taxpayer sought to deduct the loss of the loan resulting from his waiver of claim against the company.

In considering whether the taxpayer had incurred the loss, *albeit* via a voluntary waiver of the claim, the court found that he had actually incurred a loss. In coming to this conclusion, the court noted that had the taxpayer not waived this right the company would have gone into compulsory liquidation and the taxpayer would have been called upon to honour his guarantees thereby putting at risk his whole estate. The court held:

> *"If, in order to save himself from ruin, or even in less extravagant terms, save himself having to pay four or five times the amount in question, a taxpayer abandons his right to that amount, (the loan) it can legitimately, in my view, be discussed as an involuntary loss."*

The judgement emphasized the fact that the potential loss to be suffered by the taxpayer if the loan was not waived was greatly in excess of the amount actually waived. It would appear, based on the decisions in *Cathcart* and *ITC 1138 supra*, that the courts will only consider a voluntary waiver under circumstances

similar to those in *ITC 1327*. Where a taxpayer cannot show such a waiver is commercially sensible, then it is unlikely that the courts will follow this approach, instead requiring that the taxpayer prove that a loan is, in fact, irrecoverable.

3.4 TIME AND QUANTIFICATION OF LOSS

Regarding the time at which losses are actually incurred and the quantification of the loss, the Courts stated in *ITC 1284* [1] that, in quoting from *New Zealand Flax Investments v FCOT (1938) 61 COR 179 at 207*:

> *"Incurred does not mean only defrayed, discharged or borne but rather includes encountered, run into or fallen upon. It is unsafe to attempt exhaustive definitions of a concept intended to have such a various or multivarious application. But it does not include a loss or expenditure which is no more than impending, threatened or expected."*

Thus, the mere fact that the extent of a loss cannot be quantified at the year end but only the fact that such a loss has been incurred, will nevertheless require that the date of incurral and quantification of this loss is the year in which it is incurred, and not necessarily quantified (for example, the insolvency of a debtor will indicate a loss has been incurred even though it may only be quantified in the future).

PART V TRADING STOCK

1. NATURE OF ADVANCES MADE

2. TRADING STOCK

3. CONCLUSION

TRADING STOCK

1. NATURE OF ADVANCES MADE

A common thread which links many of the cases discussed is the analogy drawn between a banker's or money lender's floating capital, and the stock in trade of an ordinary merchant. The purpose of this part is to consider these comments and to examine the nature of the right acquired by a money lender, being the right to receive the repayment of moneys advanced, in order to ascertain whether this right would be correctly classified as "trading stock".

In *Meyerowitz and Spiro on Income Tax* [1] the authors state:

> *"In the case of the banker or money lender the loan or advance constitutes circulating capital or stock in trade..."*

In *ITC 257* [2] the court, in contemplating the deductibility of losses incurred on promissory notes issued by the taxpayer commented that *"the main question.... is whether this promissory note can be regarded as a portion of the stock in trade..."*

Further, in *Salisbury Board of Executors Limited's* case [3] Blakeway J, in commenting on the appellant's argument, stated

> *"...it was suggested that a money lender is entitled to regard*

the money lent by him as his stock in trade..."

Although the court did not find it necessary to decide on this issue, it is important to note that they used the word "regard" as opposed to "treat" or such a similar word.

The importance of the distinction is thus:

- In the event of a loan due to a taxpayer proving irrecoverable, or declining in value, and such a loan is "*trading stock*" as defined in Section 1 of the Act, then Section 22(1) permits the taxpayer to reduce the value of the closing stock where it has been "*diminished by reason of damage, deterioration, change in fashion, decrease in the market value or for any other reason*", subject to a discretion granted to the Commissioner for Inland Revenue. Thus, the "write down" permitted in terms of Section 22 would allow a money lender to value loans due to it at the end of each year, and to claim as a tax deduction losses anticipated in that year of assessment if the loans were trading stock; or

- If the debts due are not properly classifiable as trading stock, any anticipated decline in value will be regarded as a provision and therefore not claimable as a loss until the loss is clearly incurred, as discussed in Part IV. In this regard, Section 23(e) prohibits the deduction of any amount classifiable as a "provision".

2. TRADING STOCK

Trading stock is defined in Section 1 of the Act as follows:

> *"'Trading stock' includes anything produced, manufactured, purchased or in any other manner acquired by a taxpayer for purposes of manufacture, sale or exchange by him or on his behalf, or the proceeds from the disposal of which forms or will form part of his gross income."*

The above provision was discussed in *De Beers'* case [1] wherein Corbett JA stated the following:

> *"The definition falls naturally into two parts:*
>
> *(1) Anything produced, manufactured, purchased or in any other manner acquired by a taxpayer for purposes of manufacture, sale or exchange by him or on his behalf, or*
>
> *(2) Anything the proceeds from the disposal of which forms or will form part of his gross income."*

In applying the above to loans, it would appear in the first instance that part (2) would not apply, as, by definition, a taxpayer does not generally dispose of funds advanced (even though it may part with ownership) to a borrower (see Part VII). A loan of money does not constitute a disposal but merely the temporary parting of the funds, namely a *'mutuum'*.

In contemplating the first consideration, it would appear that a loan could not be regarded as anything "produced, manufactured or purchased". On the other hand, a loan could clearly be regarded as "anything... acquired by a taxpayer"; the asset acquired being the right to demand repayment of moneys due, together with *quid pro quo* for the advance, in terms of a contract. Conceptually, this contract could be disposed of or traded by the taxpayer. (In this regard, certain loan agreements, being debentures or stock (in the financial sense) are traded on a stock exchange). However, in the normal course of events such a right would not have been acquired for the "purposes of manufacture, sale or exchange by him..." (unless the individual circumstances indicate the contrary). Thus, it would appear that loans made by money lenders would not be correctly classifiable as "trading stock", for income tax purposes.

3. CONCLUSION

It therefore appears that the courts, in referring to "stock in trade" were describing the attitude, or intention, with which a money lender views its floating capital. In the ordinary sense, a merchant views its stock in trade as something which it holds temporarily only to dispose of at the earliest opportunity and thereby earn a profit. Similarly, a money lender would view capital raised as an asset to be parted with at the earliest opportunity (subject to interest rates payable and security provided) in order to maximise its profitability.

PART VI IN THE PRODUCTION OF INCOME

IN THE PRODUCTION OF INCOME

A further condition to be met by losses in order to be deductible, is that losses incurred arose through a transaction entered into *"in the production of the income"*. [1]

In discussing the term, Watermeyer AJP [2] stated the following:

> *"Now, as pointed out..., income is produced by the performance of a series of acts, and attendant upon them are expenses. Such expenses are deductible expenses, providing they are so closely linked to such acts as to be regarded as part of the cost of performing them.*
>
> *A little reflection will show that two questions arise (a) whether the act, to which the expenditure is attached, is performed in the production of income, and (b) whether expenditure is linked to it closely enough..."*

It is considered that the above comments are equally applicable in the case of losses [3].

Thus, the first question to address is whether the act (the lending of the money) to which the loss (expenditure) is attached, is performed in the production of income.

Typically, for such a loss to be considered in the production of income, the taxpayer would need to be in a position to show that the loans were advanced to earn income, either of the nature of interest or allied income, or income via another means, for example by a shipper providing its clients with finance, thereby enabling it to earn its normal form of income.

Thus, in *ITC 44* [4] a taxpayer who guaranteed certain obligations by a third party contractor, in the hope of obtaining work from the contractor, had to fund these guarantees when the contractor's business failed. The court, in finding against the taxpayer's claim to deduct the losses incurred, concluded that as "*the guarantee involved an undertaking to complete the building if the contractor failed to do so, and this was an operation entirely outside the scope of the company's objects...*". It was therefore a loss or outgoing incurred not in the production of the income of the company.

Thus, the court in this instance found that the link between the guarantees given, and the company's ordinary activities was not linked to the income the company would have ordinarily made in the course of its operations.

With regard to the second question, that is whether the loss (expenditure) is linked to the income closely enough, Watermeyer AJP went on to state:

> *"Now, at first, it would appear that only acts necessary to earn the income and expenditure necessarily attendant upon such act should be deducted; but this is not so. As pointed out..., businesses are conducted by different persons in different ways. The purpose of the act entailing expenditure must be looked to. If it is performed for the purpose of earning income, then the expenditure attendant upon it*

is deductible." [5]

Thus, in applying the above to *ITC 44 supra*, the court found that the losses arising through the guarantees given were to remote to the income earning operations of the company for them to be considered a part thereof.

Similarly, in *ITC 1009* [6] the court found that a loan advanced to a social club by a taxpayer who was a member of that club, who carried on the business of money lending, could not be considered as a part of that business as the loan was not entered into in order to produce income; as such, the loan could not be regarded as being advanced in the production of income.

In *ITC 1009 supra* [7] the court noted that two criteria were to be considered in determining the deductibility of losses incurred on irrecoverable loans. These criteria are:

- Did the taxpayer carry on a business of money lending;
- If so, was the loan in question made as a part of that business.

Thus, the first question to be addressed is: were the funds advanced fixed or floating capital;

If floating capital was so used the second question to be addressed was, was the loan made in the production of income, being income generated through the business of money lending.

In *Cathcart'* case [8] the taxpayer, being an architect, gave certain guarantees

on premises erected by him. The owner of the premises claimed damages and in order to avoid the unpleasantness of legal action, the taxpayer agreed to settle the claim. The court, in finding against the taxpayer's claim for a deduction of the losses incurred, stated:

> *"That the giving of a guarantee in order to secure employment as an architect could be regarded as an undertaking for the purposes of earning income; but that in the absence of evidence that the guarantees were necessarily met, the taxpayer failed to discharge the onus of establishing that the amounts paid by him had been wholly and exclusively expended in the production of his income".*

In this instance Cathcart failed to show that there was a necessary and direct link between the expenditure incurred and the income earned. Similarly, where there is no direct link between the granting of credit and the earning of income, subsequent losses will not be permitted as a deduction as they were not advanced either in "the production of the (taxpayer's) income", or were not advanced "wholly and exclusively for the purposes of trade". [9] (In this regard, Watermeyer AJP commented in *Port Elizabeth Electric Tramway Company Limited's* case [10] that what Section 11(a) provided positively, Section 23(g) provided negatively.)

A further aspect which requires consideration would be the eventuality occasionally confronted by money lenders wherein it is apparent to them that they need to advance further funds to a debtor in order to protect that debtor from bankruptcy. Under these circumstances it could be argued that the funds advanced were not advanced in the production of income but to prevent further losses, and may therefore be regarded as being expenditure

incurred in order to protect a taxpayer's (floating) capital base.

For example, in *ITC 585* [11] a landlord incurred certain costs in resisting an action brought by his tennants to reduce their rentals, which action was successful. In attempting to deduct this expenditure, the court found that the legal expenses in no way added to or increased the taxpayer's income but merely had the effect of protecting it and preventing it from diminishing. As such, it did not constitute expenditure incurred in the production of income.

A contrary conclusion may be found in *Stellebosch Farmers' Winery's* case [12], which case concerned the deductibility of legal expenses incurred in opposing the registration of a trade mark by a competitor where the taxpayer felt such registration would adversely affect its turnover. The courts stated at 391 that:

> *"The main purpose of the expenditure was not to protect its (the trademarks) design but to oust the rival competition and so maintain and increase its profits, and in carrying out this object it incurred legal costs it now seeks to deduct."*

In considering the above two actions, it is clear that the courts have recognised that the expenditure incurred merely to protect income is not deductible, whereas expenditure incurred in order to enhance the income earning ability of a taxpayer is.

It would, notwithstanding the above, be clear that it is within the reasonable contemplation of a money lender that, firstly, a portion of debts

advanced will prove bad. Secondly, a money lender should expect to be confronted by circumstances wherein it is faced with the choice of either liquidating a debtor and thereby ensuring a loss is realised, or advancing further funds in the hope of enabling that debtor to resuscitate its affairs and pay back not only the original debt, but the fresh moneys advanced. The actual event elected would logically be based on the assessment by the money lender as to the ability of the borrower to so resuscitate its affairs. If this is likely income will be anticipated on both new funds advanced and existing debts; if this is unlikely, then the money lender may well elect to liquidate the borrower. (These moneys may take the form of a new loan, a deferral of interest payments or the like.)

As such an eventuality is likely, it would appear that the deduction of losses incurred on funds advanced to resuscitate debtors would be loans advanced in both the production of income, with the overriding expectation that additional income (on the new loans advanced) will be produced as well as enabling existing loans to continue to produce income. Furthermore, if it were to be contemplated that such advances were to protect a taxpayer's income earning ability, the fact that these advances were protecting floating capital rather than fixed capital would similarly indicate their revenue nature. As such, it is considered that such advances (subject to the other conditions discussed) would be deductible for tax purposes.

PART VII SPECIAL CIRCUMSTANCES

1. CREATION OF LOAN ACCOUNT

2. ACQUISITION OF SHARES AND LOAN ACCOUNT

SPECIAL CIRCUMSTANCES

During the body of this analysis on the tax nature of losses incurred on loans, the concept of two types of loans was alluded to. Specifically, these types are:

- Loans advanced to borowers wherein the lender intends to seek a return through the repayment of the loan together with a profit in the form of interest or the like; or

- Loans advanced to third parties, typically companies owned by the lender, wherein the lender intends to sell the shares of the company together with the loans accounts, in order to realise a profit on the sale of the two. In this instance, the lender may have no intention of requesting the borrower to repay the amounts loaned; the contrary has often been the case wherein it has been clearly acknowledged that the borrower is unlikely to be called upon by the lender to repay such amounts.

Notwithstanding the above distinction the courts have looked upon the strict juristic nature of such a loan and considered the nature of the funds advanced in the taxpayer's hands, rather than the taxpayer's intended use with the asset (being the loan) created.

Examples of the first type of loan would include those discussed in *Stone's* and *Crane's* cases [1], with examples of the second being *Burman's* case and *ITC*

1344 [2].

In discussing this distinction, Goldstone JA commented in *Burman's* case [3]:

> *"There are two points of distinction between the facts of the present case and those in Stone's case. In the latter case the capital amounts of the loans were intended to be repaid to the lender directly by the borrower. In the present case the intention was that the capital amounts of the loans would be recouped by means of payment in shares in the public company and the immediate resale of those shares... It appears to be these distinctions which have lead Nicholas AJA to the conclusion that the loans in a case such as the present were:*
>
> *'A component, together with a shareholding, of the members interest in the company'.*
>
> *That approach, in my respectful opinion, ignores the commercial reality and legal consequences of the loans made by Burman... At all times the borrowers of the moneys were Burman's debtors and must have been so regarded by him..."*

In further commenting on the decision in *ITC 1344*, which case concerned similar facts with an opposite conclusion being reached, Goldstone JA concluded:

> *"The decision in that case is only explicable upon the agreed facts which recorded, inter alia, that:*

'It was at all relevant times his intention to sell the said shares and loan accounts as soon as the development was completed with a view to making a profit'.

The intention expressed was that the shares as well as the loan accounts would indeed be sold at a profit".

In comparing the above two quotes, it is clear that the courts placed emphasis on the following factors:

- The legal nature of loans owing to a taxpayer; and

- The intention with which that loan was held. In this regard, Goldstone JA emphasised that *"at all times the borrowers of the moneys were Burman's debtors and must have been so regarded by him"* [4].

It would therefore appear that one of the fundamental enquiries into the nature of a loan, as discussed in Part II, is the intention with which that loan is held or acquired. Thus, where a taxpayer advances funds to a third party without a clear intention to merge the loans so advanced with another asset (for example shares issued by the debtor) then the courts will presume that the loans are separate and distinct from that asset. In this regard, there would appear to be three instances under which a merging of shares and loan accounts into a single tradeable entity could arise. These are:

- Instances where the taxpayer is in a position to show a clear intention to trade with shares and loan accounts as a single asset, as

discussed in *ITC 1344*; or

- Where the fusion of the two assets is achieved through contract. Examples of such a transaction can be found on the Johannesburg Stock Exchange wherein certain property companies have shares linked to variable rate loans. Under these circumstances, the sale of a share necessitates the sale of the loan account. Similarly, the purchaser has no choice but to buy both assets; or

- Where shares and loan accounts are linked by statute. For example, in the case of companies registered in terms of the Share Blocks Control Act [5], the seller of shares is obliged to sell or cede, amongst other things, his loan obligation.

In the case of a taxpayer selling loans due it under the circumstances envisaged, a further two scenarios can be contemplated. Firstly, where the taxpayer creates that loan account, as did *Burman*, or where the taxpayer acquires that loan account by purchasing it from the taxpayer.

1. CREATION OF LOAN ACCOUNT

In *Burman's* case [2] the taxpayer advanced moneys to a company in which he held shares, in order to enable that company to develop certain properties. The taxpayer then intended to sell his shares and loan accounts to a listed company in exchange for shares in it, which shares were to be sold to the public in exchange for cash.

The court found that the loan accounts "created" by Burman were

separate and distinct from the shares, and resultant losses on the disposal of these loans represented losses of fixed capital and were not therefore deductible for income tax purposes.

This principle now seems clearly entrenched in our law with the exception of the circumstances noted in *ITC 1344* [2]. This case, which concerned similar facts to *Burman's* case with the difference being that the taxpayer and the Revenue authorities agreed that the taxpayer entered into the loan transaction with the clear intention of selling the loans as a part of the whole. Thus, where a taxpayer can discharge such a burden of proof the taxpayer may be able to persuade the courts to reach a conclusion different to that reached in *Burman's* case *supra*.

On the other hand, circumstances can be envisaged where developers similar to *Burman* create loan accounts with the clear intention of selling them at a loss. For example, the developer of a timeshare unit using a share block company will sell its shares and loan accounts to the public, with each share and loan obligation entitling the purchaser to the use of that property as stipulated in the "use agreement". The timeshare developer may either, voluntarily or out of necessity, sell certain timeshare weeks at a loss, whilst selling others at a profit. For example, weeks in peak holiday periods would attract a premium, whilst those in off peak times may well be sold at a discount. The cost of actually constructing the unit to be sold would be independent of the price which could be obtained by the selling of a use of that unit at various times of the year and, as such, the sale of some units would necessitate a notional loss, whilst

others would generated a sizeable profit.

Under these circumstances, the loans and the share accounts of the time share developer could be regarded as its "stock in trade" (see Part V).

In discussing losses incurred by a taxpayer intentionally through its trading activities Corbett JA noted in *De Beers's* case [6] the following:

> *"Of course, the attainment of a profit is not necessarily the hallmark of a trading transaction. A trader may for commercial reason be compelled to resell goods at a loss. Conceivably also he may elect to resale goods at a loss in order to gain some other commercial advantage for his business. The practice of putting on sale the so-called 'loss leaders' by some merchants would fall into this category; and there seems little doubt that the merchandise so sold would constitute stock in trade and the proceeds thereof gross income."*

Although the assertion that losses made on the sale of loans would be disallowable for the reasons enunciated in *Burman's* case *supra*, it would appear arguable that parties who entered into transactions wherein loans are advanced to companies and the shares and loan accounts sold in some instances intentionally at a loss, and in others with a view to making a profit, could be viewed as using their elected *modus operandi* of trading; as such, it would appear logical to assume

that the losses intentionally incurred would be deductible for tax purposes. A contrary conclusion would not only be inequitous but contrary to the generally accepted method in which the Income Tax Act is to be applied wherein "normal" trading expenditure and losses are deducted from income derived.

It is noted that the example of time share developers clearly reflects instances where loans can be sold intentionally at a loss. It would, notwithstanding this, appear that other types of property developers may be hard pressed to prove such an intention exists where they embark on a scheme wherein property is developed by a company owned by them and shares and loan accounts are merely to be sold, as was *Burman's* intention.

2. ACQUISITION OF SHARES AND LOAN ACCOUNT

Where parties, other than the lender in the first instance, acquire loan accounts (either linked or unlinked to shares) it would appear that the courts will view the transaction in a different light to instances where loan accounts are created by the debtor. For example, in *B.S.A. Company Investment Limited's* case [7] the court considered certain losses incurred by the taxpayer when the taxpayer acquired a portfolio of investments, one of which was a loan the taxpayer knew would not realise the purchase price paid. In finding for the taxpayer the court commented:

> *"So long as the goods purchased are goods which form part of a traders normal stock in trade and are purchased for the purposes*

of being disposed of in the course of his normal trade, the motives which prompted the trader to purchase that stock in trade are irrelevant..."

In this case, the court identifies the difference between loans arising through advances made by a taxpayer, and loans acquired by a taxpayer. A similar conclusion was reached in an Australian case, *XCo (Pty) Limited* [8], wherein loans were acquired at a discount with subsequent profits being taxed.

In the first instance, and as previously discussed, loans arising through advances made by a taxpayer cannot be viewed as "trading stock" as defined, whereas loans acquired, providing they meet the criteria identified in that definition, may be viewed as trading stock. As such, where loans are acquired with the intention to trade with them, they may be properly viewed as trading stock, with the provisions of Section 22 of the Act applying.

Notwithstanding the above, where loans are inextricably linked to shares (or any other asset) through statute or contract, then the above conclusion would be reinforced, with the two assets taking on the identity of trading stock, if applicable.

It would, therefore, appear acceptable for a taxpayer to contend that losses arising as a result of loans acquired by that taxpayer from third party lenders will be losses of a revenue nature, rather than losses of its fixed capital, where a trading intention can be clearly demonstrated. The importance of this difference lies in the fact that

the taxpayer can clearly identify the asset acquired as being separate and distinct from its fixed capital whereas loans made by the taxpayer arise from that fixed capital and are not therefore separate.

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PART III EXPENDITURE (AND LOSSES) WHOLLY OR EXCLUSIVELY LAID OUT FOR THE PURPOSES OF TRADE.

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2. Solaglass Finance Company (Pty) Limited v CIR *supra* at 12.

3. SIR v The Trust Bank of Africa Limited 37 SATC 87, 1975 (A), at 105.

4. The Companies Act of 1973, as amended.

5. CIR v Richmond Estates (Pty) Limited 20 SATC 355, 1956 (A), at 361.

6. Elandsheuwel Farming (Edms) Bpk v SBI 39 SATC 163, 1978 (A).

7. ITC 1321 (1980) 42 SATC 269 at 272.

PART IV ACTUALLY INCURRED

1. Port Elizabeth Electric Tramway Company Limited v CIR 8 SATC 13, 1936 CPD, at 15.

2. Caltex Oil SA Limited v SIR (AD) 37 SATC 1, 1975 (A), at 12.

3. Plate Glass and Shatterprufe Industries Finance Company (Pty) Limited v SIR 41 SATC 103, 1979 (T), at 108.

4. C Divaris: Foreign Exchange Losses on Loans : The Plate Glass case (1980) 9, Income Tax Reporter 29 at 35.

5. ITC 1218 36 (1974) SATC 212 (at 215).

6. Concentra (Pty) Limited v CIR 12 SATC 95, 1942 CPD, at 100.

7. See Accounting Standard AC 101, paragraph .03 wherein the "going concern" concept is described as a "fundamental accounting concept".

8. See AC101 supra; "prudence" is similarly a "fundamental accounting concept".

9. X Co (Pty) Limited v FCOT (Australia) 124 CCR 343 (1971)

10. Plate Glass *supra*, at 108

11. CIR v People's Stores (Walvis Bay) (Pty) Limited 49 SATC 132, 1987 (A)

3.1 DEBTOR/MONEY LENDER DUTIES

1. South African and Mercantile Company Law, 6th Edition, Juta and Company, Cape Town, 1988 at 10.

2. South African Mercantile and Company Law, supra, at 102.

3. ITC 1138 (1969) 32 SATC 3 at 7.

3.3 CONSTRAINTS SPECIFIC TO MONEY LENDERS

1. COT(SR) v Cathcart 27 SATC 1, 1965, at 8.

2. ITC 1327 (1980) 43 SATC 47.

3.4 TIME AND QUANTIFICATION OF LOSS

1. ITC 1284 (1978) 41 SATC 45.

PART V TRADING STOCK

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1. **NATURE OF ADVANCES MADE**

1. Meyerowitz and Spiro on Income Tax, Permanent Volume; Advocate D Meyerowitz SC, Advocate E Spiro; The Taxpayer, Cape Town, paragraph 713.

2. ITC 257 (1932) 7 SATC, at 65

3. Salisbury Board of Executors Limited v COT (SR) 12 SATC 1, 1941 (SR), at 10.

2. **TRADING STOCK**

1. De Beers Holdings (Pty) Limited v CIR 47 SATC 229, 1986 (A), at 255.

PART VI IN THE PRODUCTION OF INCOME

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1. Section 11(a) of the Income Tax Act of 1962 as amended.

2. Port Elizabeth Electric Tramway Company Limited v CIR 8 SATC 13, 1936 CPD, at 16.

3. See Introduction in Part IV, Caltex Oil SA Limited v SIR 37 SATC 1 1975 (A), at 12, as quoted in Plate Glass and Shatterprufe Industries v SIR 41 SATC 103 1979 (T), at 108.

4. ITC 44 (1925) 2 SATC 116 at 117.

5. Port Elizabeth Electric Tramway Company Limited, *supra* at 16.

6. ITC 1009 (1963) 25 SATC 277.

7. ITC 1009 *supra* at 278.

8. COT(SR) v Cathcart 27 SATC 1, 1964.

9. See Part IV

10. At 16

11. ITC 585 (1945) 14 SATC 120

12. CIR v Stellenbosch Farmers' Winery 13 SATC 381, 1945 CPD.

PART VII SPECIAL CIRCUMSTANCES

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1. Stone v SIR 36 SATC 117, 1974 (A)
   SIR v Crane 39 SATC 191, 1977 (T)

2. Burman v CIR 53 SATC 63, 1990 (A); ITC 1344 (1981) 44 SATC 19

3. Burman v CIR *supra* at 71

4. ITC 1344 *supra* discussed in Burman's case at 73

5. Share Blocks Control Act, Act no. 59 of 1980

6. De Beers Holdings (Pty) Limited v CIR 47 SATC 229 1986 (A), at 254

7. COT v B.S.A. Co Investments Limited 28 SATC 1 1966 (AD).

8. XCo (Pty) Limited v FCOT (Australia) 124 CCR 343 (1971)

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