TAX & EXCHANGE CONTROL
ALERT

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IN THIS ISSUE

If it doesn't quack like a moneylender, then it probably isn't one

In the recent Tax Court judgment of *Taxpayer H v Commissioner of the South African Revenue Service* (IT 14213) (9 February 2022), the court was tasked with determining whether the interest expense incurred by the taxpayer stood to be deducted in terms of section 24J(2) of the Income Tax Act 58 of 1962 (ITA) and whether the South African Revenue Service (SARS) had successfully discharged the onus on it for the imposition of an understatement penalty against the taxpayer.

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In the recent Tax Court judgment of *Taxpayer H v Commissioner of the South African Revenue Service* (IT 14213) (9 February 2022), the court was tasked with determining whether the interest expense incurred by the taxpayer stood to be deducted in terms of section 24J(2) of the Income Tax Act 58 of 1962 (ITA) and whether the South African Revenue Service (SARS) had successfully discharged the onus on it for the imposition of an understatement penalty against the taxpayer.

FACTS

The taxpayer in this case was a private investment holding company with assets comprising predominantly of unlisted shares in subsidiary entities, loans advanced to those subsidiaries, and cash.

In respect of the 2011 year of assessment (YOA), the taxpayer contended that it conducted a trade in money lending with the specific purpose of making a profit from on-lending borrowed funds to its subsidiaries. To this end, the taxpayer deducted from its income, in terms of section 24J(2) of the ITA, the interest expense it incurred in respect of the funds that it had borrowed.

SARS disallowed the full interest deduction of R68,133,602 and instead allowed a deduction that was limited to the amount of interest income received by the taxpayer, which was an amount of R34,936,000. This was done in accordance with SARS' long-standing practice set out in Practice Note 31 read with section 5(1) of the Tax Administration Act 28 of 2011 (TAA). SARS' disallowance of the full interest expense was based on the following facts:

- The taxpayer borrowed funds at an interest rate of 8,29% per annum, yet it extended loans to its subsidiaries at interest rates ranging between 0%, 5,29%, 6,22% and, at times, 8,29% per annum.
- The taxpayer's borrowings in relation to the on-lending were far less than its receivables.
- The lending transactions by the taxpayer extended only to its subsidiaries.
- There were no terms attached to the loans advanced by the taxpayer to its subsidiaries.

Having regard to these facts, SARS concluded that the interest expense incurred by the taxpayer had not been incurred while carrying on a trade, and had further not been incurred in the production of income. On this basis, the requirements set out in section 24J(2) of the ITA had not been met and the interest was therefore not deductible. SARS then also imposed an understatement penalty of 10% on the basis that the taxpayer had made a substantial understatement.

The taxpayer disputed SARS' conclusions, with its main contention being that, notwithstanding that its lending trade was not profitable in the 2011 YOA, it was profitable in the 2012 YOA. This, it contended, demonstrated its intention to earn a profit such that it could be concluded that it (i) carried on a money lending trade and (ii) incurred the interest expense in the production of income.

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JUDGMENT

The issue before the court was whether (i) the interest sought to be deducted by the taxpayer was incurred whilst carrying on a trade; (ii) the interest was incurred in the production of income; and (iii) SARS was justified in imposing an understatement penalty. Each of these issues are dealt with separately below.

The first issue: Whether the taxpayer was carrying on a trade as a money lender during the 2011 YOA

At the outset, the court considered whether the taxpayer was indeed carrying on a trade as a moneylender. To this end, it reiterated that the existence of a moneylending trade must be determined based on the specific facts of each case.

The court referred to the guidelines set out in the case of *Solaglass Finance Co. (Pty) Ltd v Commissioner for Inland Revenue* [1991] 1 All SA 39 (A) and stated that in order for a moneylending trade to be recognised, “*there had to be an intention to lend to all and sundry provided they were, from the taxpayer’s view, eligible*”. The following principles were then highlighted by the court:

- The lending had to be done based on a system or plan which disclosed a degree of continuity in laying out and getting back the capital for further use and which involved a frequent turnover of the capital.
- The obtaining of security was a usual, though not essential, feature of a loan made in the course of a moneylending business.
- The fact that money had on several occasions been lent at remunerative rates of interest was not enough to show that the business of moneylending was being carried on. There had to be a certain degree of continuity about the transactions.
- As to the proportion of the income from loans to the total income: the smallness of the proportion could not be decisive if the other essential elements of a moneylending business existed.

Reference was also made to the judgments in *ITC 1771* 66 SATC 205 and *ITC 812* 20 SATC 469 in which the following statements were made (respectively):

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

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and

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

When faced with the facts in light of the principles outlined above, the taxpayer appeared to change its approach during the proceedings and discontinued with its averments that it was a moneylender (although it maintained that it carried on a trade comprising of "*interest earning and interest incurring activities*").

More specifically, it had to be conceded by the taxpayer that (i) it had no documentary evidence substantiating its moneylending trade or its lending policies; (ii) the loans made to its subsidiaries were not memorialised in any manner and carried no terms (in particular no repayment terms); (iii) there was no security provided for the loans; and (iv) it could not provide evidence of a plan of laying out and getting in its money as evidence of continuity.

In light of the above, considered in conjunction with the fact that the taxpayer had indicated in its 2011 tax return that it had not concluded any transactions in terms of section 24J of the ITA, the court concluded that the taxpayer did not carry on a trade in moneylending.

The court then considered whether the taxpayer had a profit-making motive that would indicate that (despite not being a moneylender) it still carried on a trade pursuant to which the interest expense was incurred. The following findings of the court are noteworthy in this regard:

- The taxpayer borrowed money at high interest rates and on-lent that money to its subsidiaries at interest rates lower or equal to the rate at which the original funds were borrowed by the taxpayer. On this basis, the taxpayer had no possibility of making a profit in respect of the loans advanced by it and the taxpayer was thus advancing the interests of the group rather than its own profit-making interests.
- Advancing loans to its subsidiaries boosted the earning capacity of those subsidiaries, which made commercial sense for the taxpayer as an investor and the sole shareholder of the subsidiaries. However, at issue was whether the approach adopted by the taxpayer made commercial sense in facilitating the taxpayer's trade and generating trade income (and not facilitating the taxpayer's investment activities and the exempt dividend income derived in respect thereof).
- The lack of terms attached to the subsidiary loans such that there was no objectively ascertainable system for the taxpayer to recover its capital or the interest suggests that there was no profit-making motive.

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- Reliance could not be placed on section 24J(3) (which references "*all accrual amounts*") to argue that SARS ought to have taken into account the interest earned by the taxpayer from its positive bank balance in assessing the taxpayer's profit-making purpose.

The court therefore concluded that the taxpayer did not have a profit-making motive in respect of its borrowing and on-lending activities.

The second issue: Whether the interest expense was incurred in the production of income

In considering this issue, the court highlighted that the most important (and sometimes overriding) factor is the purpose for which the expenditure was incurred and what it actually effects. To this end, a court is required to assess the closeness of the connection between the expenditure incurred and the relevant income earning activities undertaken by a taxpayer.

The taxpayer contended that the fact that the interest it earned did not exceed the interest incurred is not indicative that the interest was not incurred in the production of income. Furthermore, on the basis that the interest received from the subsidiaries constituted income that was not exempt, the taxpayer argued that the "*in the production of income*" requirement in section 24J of the ITA had been met.

SARS, on the other hand, contended that the "*purpose of the borrowing was to provide the [taxpayer's] subsidiaries with advantageous loans to benefit the group by increasing their earning capacity*" and that there was no evidence to suggest that the taxpayer had the intention of generating income.

The court found in favour of SARS and concluded that, on an analysis of the taxpayer's lending transactions, it could not be shown that the taxpayer had a profit-making purpose or an intention to produce income, but rather an intention to further the interests of the group in order to increase the subsidiaries' profits and reap substantial dividends.

The third issue: The imposition of an understatement penalty

SARS contended that the taxpayer incorrectly adopted the tax position that the interest expense was deductible in full, as a consequence of which the taxpayer understated its income.

Of critical importance to SARS' case was that the taxpayer had been requested to provide documents supporting its contentions that it was a moneylender, but had failed to do so. Moreover, all of the information that was uncovered during the audit had always been within the taxpayer's knowledge and it had thus always known that it had no records to substantiate its moneylending trade assertions. In addition, it was submitted that the taxpayer also failed

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to lead evidence to (i) demonstrate that the understatement of its income was the result of a *bona fide* inadvertent error or (ii) contradict SARS' findings that the penalty was appropriately levied.

It was the taxpayer's view that (should the interest expense not be deductible) the resultant understatement was the result of a *bona fide* inadvertent error.

The court ultimately rejected the taxpayer's contention that, prior to imposing an understatement penalty, SARS had a duty to satisfy itself that the understatement did not result from a *bona fide* inadvertent error. The court reasoned that such an assertion misconstrues the burden of proof set out in section 102(2) of the TAA. It reiterated that the burden of proving that the interest was deductible and that there was no understatement of income remains with the taxpayer.

In this case, the taxpayer had led no evidence that the understatement was due to an inadvertent *bona fide* error and had also led no evidence to support its claim that it had acted honestly and reasonably and had relied on expert advice when it claimed the interest expense as a deduction.

As such, the court dismissed the appeal with costs.

COMMENT

This judgment is significant for a number of reasons.

First, it is a firm reminder that care must be taken when completing a tax return in order to ensure that the activities undertaken by a taxpayer and the information pertaining to that taxpayer are accurately reflected in the return. Any failure to do so may have substantial negative consequences for the taxpayer.

It is also a reminder that companies that participate in intra-group loans should be mindful of the structure and terms associated with the loans. In particular, it is generally advisable not to enter into long-term loans but rather to have loans that are payable on demand or repayable in accordance with set terms, the repayment period of which should not be excessive.

Further to the issue of the structure of the "*interest earning and interest accruing*" operations that ought to be considered in this context, it should be borne in mind that the taxpayer was unsuccessful in claiming the full interest expense, to a large extent, on the basis that the related interest income it received did not exceed the interest expense it incurred. Based on the structure of the lending operations of the taxpayer, the taxpayer was precluded from relying on the interest income it received

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from the bank in order to prove that the taxpayer's intention was to make a profit. This was primarily because there was a direct link between the money borrowed by the taxpayer and the money lent to the subsidiaries and there was "*no basis to add interest from the bank when evaluating the appellant's profit-making purpose on its money lending*".

Had the taxpayer adopted a "*co-mingling*" approach to its "*interest earning and interest accruing*" operations (as was the case in *CIR v Standard Bank of SA Limited* 47 SATC 179) the outcome may have been that the interest income from the bank had to be taken into account to show that the taxpayer had a profit-making motive, such that the interest expense would have been allowed as a deduction.

Lastly, this case is important in the context of understatement penalties because it appears that the court recognised and accepted that a *bona fide* inadvertent error will be present in the event that the taxpayer (i) has acted honestly and reasonably and (ii) has relied on expert evidence in adopting the relevant tax position. On the basis that recent case law appears to suggest that a *bona fide* inadvertent error would only exist in very limited circumstances, the aforementioned development (that seems to broaden the scope of the circumstances in which such an error may occur) is interesting and well received.

LOUISE KOTZE

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Emil Brincker ranked by **CHAMBERS GLOBAL 2003 - 2022** in Band 1: Tax.

Gerhard Badenhorst was awarded an individual spotlight table ranking in **CHAMBERS GLOBAL 2022** for tax: indirect tax. **CHAMBERS GLOBAL 2009–2021** ranked him in Band 1 for tax: indirect tax.

Mark Linington ranked by **CHAMBERS GLOBAL 2017 - 2022** in Band 1: Tax: Consultants.

Ludwig Smith ranked by **CHAMBERS GLOBAL 2017 - 2022** in Band 3: Tax.

Stephan Spamer ranked by **Chambers Global 2019-2022** in Band 3: Tax.

Cliffe Dekker Hofmeyr

OUR TEAM

For more information about our Tax & Exchange Control practice and services in South Africa and Kenya, please contact:

Emil Brincker
Practice Head & Director:
Tax & Exchange Control
T +27 (0)11 562 1063
E emil.brincker@cdhlegal.com

Sammy Ndolo
Managing Partner | Kenya
T +254 731 086 649
+254 204 409 918
+254 710 560 114
E sammy.ndolo@cdhlegal.com

Lance Collop
Director:
Tax & Exchange Control
T +27 (0)21 481 6343
E lance.collop@cdhlegal.com

Mark Linington
Director:
Tax & Exchange Control
T +27 (0)11 562 1667
E mark.linington@cdhlegal.com

Gerhard Badenhorst
Director:
Tax & Exchange Control
T +27 (0)11 562 1870
E gerhard.badenhorst@cdhlegal.com

Jerome Brink
Director:
Tax & Exchange Control
T +27 (0)11 562 1484
E jerome.brink@cdhlegal.com

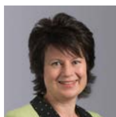
Petr Erasmus
Director:
Tax & Exchange Control
T +27 (0)11 562 1450
E petr.erasmus@cdhlegal.com

Dries Hoek
Director:
Tax & Exchange Control
T +27 (0)11 562 1425
E dries.hoek@cdhlegal.com

Heinrich Louw
Director:
Tax & Exchange Control
T +27 (0)11 562 1187
E heinrich.louw@cdhlegal.com

Howmera Parak
Director:
Tax & Exchange Control
T +27 (0)11 562 1467
E howmera.parak@cdhlegal.com

Stephan Spamer
Director:
Tax & Exchange Control
T +27 (0)11 562 1294
E stephan.spamer@cdhlegal.com



Tersia van Schalkwyk
Tax Consultant:
Tax & Exchange Control
T +27 (0)21 481 6404
E tersia.vanschalkwyk@cdhlegal.com

Louis Botha
Senior Associate:
Tax & Exchange Control
T +27 (0)11 562 1408
E louis.botha@cdhlegal.com

Varusha Moodaley
Senior Associate:
Tax & Exchange Control
T +27 (0)21 481 6392
E varusha.moodaley@cdhlegal.com

Ursula Diale-Ali
Associate:
Tax & Exchange Control
T +27 (0)11 562 1614
E ursula.diale-ali@cdhlegal.com

Louise Kotze
Associate:
Tax & Exchange Control
T +27 (0)11 562 1077
E louise.Kotze@cdhlegal.com

Tsanga Mukumba
Associate:
Tax & Exchange Control
T +27 (0)11 562 1136
E tsanga.mukumba@cdhlegal.com

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Our BBBEE verification is one of several components of our transformation strategy and we continue to seek ways of improving it in a meaningful manner.

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JOHANNESBURG

1 Protea Place, Sandton, Johannesburg, 2196. Private Bag X40, Benmore, 2010, South Africa.
Dx 154 Randburg and Dx 42 Johannesburg.
T +27 (0)11 562 1000 F +27 (0)11 562 1111 E jhb@cdhlegal.com

CAPE TOWN

11 Buitengracht Street, Cape Town, 8001. PO Box 695, Cape Town, 8000, South Africa. Dx 5 Cape Town.
T +27 (0)21 481 6300 F +27 (0)21 481 6388 E ctn@cdhlegal.com

NAIROBI

Merchant Square, 3rd floor, Block D, Riverside Drive, Nairobi, Kenya. P.O. Box 22602-00505, Nairobi, Kenya.
T +254 731 086 649 | +254 204 409 918 | +254 710 560 114
E cdhkenya@cdhlegal.com

STELLENBOSCH

14 Louw Street, Stellenbosch Central, Stellenbosch, 7600.
T +27 (0)21 481 6400 E cdhstellenbosch@cdhlegal.com

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KIETI LAW LLP, KENYA