IN THE TAX COURT OF SOUTH AFRICA

(HELD AT CAPE TOWN)

Case No: IT 24614

In the matter between:

ABC (PTY) LTD Appellant

and

COMMISSIONER FOR THE SOUTH AFRICAN REVENUE SERVICE Respondent

Date of hearing: 5-8 November 2019

Date of judgment: 15 November 2019

JUDGMENT

SAVAGE J

Introduction

[1] In issue before this Court is whether, for income tax purposes, the amount of R18 273 271.26 should have been allowed as a deduction from the income of the appellant, ABC Ltd ("the taxpayer") in the 2014 year of assessment; and whether an understatement penalty of 50% should have been imposed by the respondent, the Commissioner for the South African Revenue Service ("SARS"), against the taxpayer. The taxpayer accepts that R698 568.11 and a CIPRO fee should not have been included in its calculation of the amount

deductible and those amounts are no longer in issue. Although initially sought, SARS does not persist in seeking costs against the taxpayer in this matter.

[2] In issue in this matter is whether expenditure or loss of R18 273 271.26 incurred by the taxpayer was of a capital or revenue nature given that in terms of section 11(*a*) of the Income Tax Act 58 of 1962 ("the ITA") a taxpayer may deduct from its income:

> "…expenditure and losses actually incurred in the production of income, provided such expenditure and losses are not of a capital nature."

[3] The material facts set out in the respective rule 31 and rule 32 statements of the parties and evident from the evidence of Mr A, Financial Manager of the taxpayer, and SARS auditor, Mr B, are largely common cause. The taxpayer and D Exporters (Pty) Ltd ("D") were subsidiaries of XYZ Holdings (Pty) Ltd. Both conducted the business of purchasing fruit locally and selling it to the export market. The taxpayer was the principal trading entity, with D used on occasion for strategic purposes such as to avoid conflicts with customers in competition with one another. For a year or two before 2014 D had not been actively trading.

[4] In 2014 one of the taxpayer's major suppliers of fruit for the export trade, E (Pty) Ltd ("E"), was in financial difficulty. The taxpayer contracted with it to acquire its business pertaining to F Fruit with the aim of ensuring that the supply of F fruit for the export business was retained. The major asset purchased was the F fruit, which fruit was at various stages in the production process, some on trees and others in the process of picking or packing. None of this fruit had yet been sold or marketed for export purposes. The purchase price for the fruit made up the bulk of the purchase price paid for the E business.

[5] The taxpayer's normal finance facility through W Bank, which involved the advance of funds on proof of shipping, was not available to assist the taxpayer to finance the E purchase. An alternative financier, V Exchange, therefore provided finance against the production of *pro forma* invoices issued to purchasers for fruit sales based on purchase commitments made. Because the taxpayer was not able to deal directly with V Exchange given its relationship with W Bank, it was agreed orally between the taxpayer and D that the taxpayer would sell the E fruit to D on a consignment basis and that D would then sell the fruit to the export market. D issued the *pro forma* invoices required by V Exchange to provide finance to assist the taxpayer in paying the purchase price to E. The terms of the consignment sale were that the sale price to D was not fixed upfront, but that the taxpayer would receive whatever D was able to sell the fruit in the market for, after deduction of its costs. D would first repay V Exchange for its provision of finance with any remainder then paid to the taxpayer.

[6] The sale agreement was implemented in accordance with its terms. D sold the fruit in the export market to the relevant purchasers, and issued the necessary invoices. Purchasers either paid D directly where V Exchange had not financed a sale, or paid into a V Exchange collection account on behalf of D, with V Exchange releasing any excess amounts to D. These amounts paid in foreign currency were then converted into South African rands by D and paid into the taxpayer's bank account. The price for the fruit sold to D was included in the taxpayer's trading revenue for 2014, and the cost of the fruit from E was included in its cost of sales line.

[7] Since D lacked the infrastructure to enable it to market the fruit and to make logistical arrangements in relation to the sale of the goods, it was orally agreed between the taxpayer and D that the taxpayer would provide the necessary resources, would incur the expenditure for items such as shipping and logistics, and would charge D an equivalent amount for so doing. This was required in that otherwise the taxpayer would have received nothing from D for the sale of the fruit, since its sale price was dependent, under the consignment arrangement, on D selling the fruit in the market.

[8] The taxpayer and D duly implemented this part of the transaction. The taxpayer incurred expenditure which was charged to D via an account which recorded the various inter-company debts and payments pertaining to this business. The main components of the expenditure were recorded as debits in the accounting entries and took the form of logistical costs, fruit purchase costs, personnel costs, professional and accounting fees, legal fees and Telkom expenses. Credits to the account were amounts paid over from D's bank account and an amount paid directly to the taxpayer by a D client. The result was a net indebtedness of R18 273 271.26 on the part of D to the taxpayer on the inter-company trading account at the end of the 2014 year of assessment.

[9] The evidence of the taxpayer was that the trading operation involving the E fruit was not as successful as had been hoped, with lower volumes being available and quality issues arising. This led to credit notes having to be issued, with a net loss realised on this set of transactions, which reflected in the net amount owed by D to the taxpayer. At the end of the 2014 year, the taxpayer recognised that D had no resources to settle its indebtedness to it and the amount was written off. This, it is common cause, gave rise to a loss in the hands of the taxpayer, which the taxpayer claimed as a deduction and which is in issue in this matter. SARS in due course took the view that the amount is of a capital rather than a revenue nature because the net debt of D to the taxpayer, at the end of the year of trading between them, was accounted for as a loan between the taxpayer and D.

[10] When the debt was written off in favour of D, D accounted for this as additional income and for tax purposes declared this amount as part of its taxable income, therefore as revenue rather than as a capital gain. SARS agreed that this was the proper tax treatment in D's books.

Discussion

[11] In issue in this matter is whether, when the taxpayer wrote off the amount owing to it by D at the end of the 2014 tax year, it had in the determination of its taxable income incurred a revenue or capital loss. A loss suffered by a taxpayer as a result of writing off an indebtedness of another party can be categorised as either capital or revenue in nature and there is no single definitive yardstick for distinguishing between capital and revenue expenditure.[1] Each case falls to be decided on its own facts,[2] having regard to the substance and reality, or the "*true nature*", of the transaction,[3] with the onus on the taxpayer to prove that an amount or item is deductible or may be set off from taxable income in a year of assessment in terms of section 102(1)(*b*) of the Tax Administration Act 28 of 2011 ("the TAA").

[12] Although SARS accepted that the amount owing to the taxpayer by D pertained to deductible (non-capital) trading expenditure incurred by D in the 2014 year of assessment, the deduction by the taxpayer of the amount was disallowed on the basis that it had accounted for the debt in what it described as a loan and that the expenditure or loss was of a capital and not a revenue nature.

[13] Whether an amount lost or written off was advanced or treated as a loan is not in itself determinative of the capital or revenue nature of the loss or expenditure, since the accounting treatment applied by a party is not to be regarded as determinative of either the legal position or the correct tax position. The question is always one of substance rather than form, and is to be decided on all the facts of the case.[4]

[14] What is important is the circumstances giving rise to the indebtedness, and more particularly whether the expenditure equips the taxpayer's income-earning machine or structure as capital, or forms part of the costs of actually performing the income-earning operations as revenue. This may involve an analysis of the nature of the capital to which the expenditure relates, with a distinction drawn between fixed capital, which is deployed by the taxpayer so as to equip the business on a non-recurring basis and is treated as capital in nature,[5] as opposed to floating capital, which frequently changes form from money to goods

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1 *Sub-Nigel Limited v CIR* 1948 (4) SA 580 (A).
2 *CIR v George Forest Timber Co Ltd* 1924 AD 516 at 523.
3 *New State Areas Ltd v CIR* 1946 AD 610 at 627; *SIR v Cadac Engineering Works (Pty) Limited* 1965 (2) SA 511 (A) at 529A-B.
4 *SIR v Eaton Hall (Pty) Ltd* 1974 (4) SA 953 (A) at 958 B-D; *Stellenbosch Farmers' Winery Limited v Commissioner, SARS* 2012 (5) SA 363 (SCA) in paragraph 20.
5 *New State Areas* (supra) at 620-621.

and *vice-versa* for purposes of making a profit and is regarded as revenue. In *Burman v CIR*[6] the majority held that having regard to the true legal nature of the transactions which gave rise to the losses it was apparent that long-term loans were made on a "*once and for all basis*", they did not frequently change their form and constituted the deployment of fixed rather than floating capital.[7]

[15] In *ITC 167*[8] it was found that the losses were incurred not for the purpose of assisting the subsidiary company as a separate entity, but for the purpose of developing and assisting the appellant's own trade. These losses were incurred in the course of trading and were found not to be of a capital but of a revenue nature and as such deductible. The court stated that:[9]

> "Now, in this case there are five of these subsidiary companies which are affected. The sums of money claimed as losses are not sums which have been subscribed for shares or debentures by the [taxpayer] or invested in any of the subsidiary companies. They are losses made in the course of the trading operations carried on between the Appellant and its customers in the form of these subsidiary companies … [T]hese sums of money represent not only purchases made, but also, in some instances, cash lent for the purpose of enabling the customer to make purchases. … In no instance was there a different loan of a fixed sum of money for a fixed period. A series of amounts were due in respect of goods sold, money lent, or commissions earned, and they all appeared in one account, and in respect of none of the items was there a loan of any particular amount for a fixed period. The whole amount was a fluctuating amount. It was an ordinary trading account which reflected the position between the supply on the one hand, the Appellant, and on the other hand, the customer."[10]

[16] In *ITC 434*[11] the taxpayers, as shipping and commission agents, advanced amounts to merchants who imported goods that the taxpayers were required to clear. Some of the amounts advanced became irrecoverable. SARS disallowed deduction of the loss on the basis that it was capital in nature. The court disagreed, finding that there was no difference between an independent debtor or a subsidiary company debtor. The loss was found to be of a revenue nature in that cash advances on income account were made for the purpose of producing income and, as such, were "*simply part of the ordinary business of the particular trade.*"[12] Similarly, in *ITC 807*[13] the court found that so-called loans to a manufacturing company were not a capital investment and the loss incurred was *"integrated in and … an adjunct of the*

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6 1991 (1) SA 533 (A).
7 At 535D-E and 537D-F, with reference to *Stone v CIR* 1974 (3) SA 584 (A) at 594D-595H.
8 5 SATC 87.
9 At 87-89.
10 With reference to the English decision of *Reid's Brewery Co. Limited v Male* 3 TC 279.
11 10 SATC 447.
12 At 448-50.
13 20 SATC 338 at 339, 432-434.

ordinary trading of the appellant", "incurred in the production of the Appellant's income and is not an outlay of a capital nature". As such, the loss was of a revenue nature and deductible.[14]

[17] It is clear that it is not the treatment of an amount as a loan which is determinative, but whether the loss was incurred in the conduct of the appellant's own revenue-earning trade or not. Mr A's evidence, which Mr B did not dispute, was that there was no advance of money by the taxpayer to D, as would usually happen where a loan had been advanced. Rather, the account recorded the results of the ongoing trading transactions between the parties in the year in question. What was owing as between the parties related to the sale of the E fruit to D on consignment, taking account of payments made in part-settlement of D's indebtedness on that account. The expenditure was incurred by the taxpayer for purposes of providing logistical support to D to ensure the success of the taxpayer's own business involving the sale of fruit to D on consignment. As much is apparent from the treatment of such expenditure, which was accepted as correct by SARS, in the books of D. It matters not that, as Mr A indicated, the account in the books of the taxpayer ought not to have been called a "*loan account*" but rather a "*trading account*" or a "*control account*" since this is not in itself determinative of the nature of the expenditure or loss.

[18] What is apparent is that the true nature of the expenditure was that related directly to the taxpayer's own taxable business of selling fruit and was concerned with its revenue stream via the sale of fruit to D. As much is evident from the fact that the taxpayer could have made a trading profit on the fruit but did not, with the result that it incurred a trading loss after the writing off of D's indebtedness. This was not an investment concerned with supporting an extraneous business of D and the expenditure or loss incurred did not amount to the deployment of the taxpayer's fixed capital to equip its income-earning machine. It was rather an indebtedness that arose from its trading activities with D and as such is a clear example of the deployment of floating capital, insofar as it was not intended to remain outstanding but intended to be converted back into cash in the ordinary conduct of the taxpayer's trade.

[19] The nature of the expenditure or loss in question therefore clearly relates to a trade debt arising on the sale of fruit and is not a loan. D's treatment of the corresponding benefit to it as a taxable revenue receipt makes as much patently clear. In the circumstances, the facts of this matter are plainly analogous to those in *ITC 167, ITC 434* and *ITC 807* referred to above. The loss or expenditure was of a revenue nature and should have been permitted as a deduction.

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[14] See too *Ex Parte Commissioner of Taxes* 1959 (4) SA 509 (SR).

[20] An understatement penalty of 50% in terms of section 222 of the TAA was imposed on the taxpayer on the basis that there were "*no reasonable grounds for the tax position taken*". Mr B stated that the decision to impose this penalty was taken by a SARS penalties committee of which he is not a member, but stated that the "*tax position*" related to the disallowed deduction claimed by the taxpayer. Since the deduction should have been allowed, save for the erroneous inclusion of two amounts the inclusion of which were not suggested to constitute an unreasonable tax position, the 50% understatement penalty cannot stand and falls to be set aside.

[21] In such circumstances, the appeal must succeed with an order that a fresh assessment is to be issued by SARS. Costs were not sought and no order as to costs is made.

Order

[22] In the result, the following order is made:

1. The additional assessments raised against the taxpayer are set aside.
2. The sum of R18 273 271.26 is permitted as a deduction from the taxpayer's income in the 2014 year of assessment.
3. The understatement penalty is remitted in its entirety.
4. A fresh assessment is to be issued by SARS.

K M SAVAGE

Judge of the High Court