MR BANK LIMITED
versus
ZIMBABWE REVENUE AUTHORITY

SPECIAL COURT FOR INCOME TAX APPEALS
KUDYA J
HARARE, 10 and 11 October 2017 and 28 November 2019

Income Tax Appeal

D Ochieng, for the appellant
T Magwaliba, for the respondent

KUDYA J: This appeal concerns, firstly, the meaning and application of s 16 (1) (r) of the Income Tax Act [*Chapter 23:06*] of the words "the expenditure on general administration and management" between a local company and a related foreign party and secondly, whether in the circumstances of this case the appellant was entitled to deduct the purported bad debts either as a loss incurred for the purposes of trade or in the production of the income in terms of s 15 (2) (a) or just as bad debts, in terms of s 15 (2) (g) of the Income Tax Act.

Background

The appellant, a commercial bank registered in Zimbabwe, filed an income tax self-assessment for the 2011 tax year on 5 June 2012. On 27 June 2012 the respondent's Commissioner Investigations and International Affairs commenced a tax review of the appellant's operations for the period January 2009 to May 2012. Between 10 October 2012 and 22 May 2013 the respondent requested and was supplied with various documents pertaining to the income status of the appellant. The respondent only responded to the appellant's letter of 22 May 2013 on 16 December 2015. The exchanges thereafter culminated in the raising of Amended Manual Notices of Assessment for Income Tax numbers 203324818 and 20324821 for the tax years ended 31 December 2010 and 2011, respectively on 14 April 2016. The amended tax assessment for the 2010 tax year was further amended on 23 October 2016 with the result that the recomputed tax on income was discharged.

In the amended assessment for the 2011 tax year issued on 14 April 2016, the respondent added back to income expenses in the sum of US$195 238.62 and bad debts amounting to US$2 250 365.17, which had been deducted by the appellant. In addition, it imposed penalties of 50% on these amounts and after taking into account the income tax which had been paid in the self-assessment, demanded payment of additional tax and penalties in the sum of US$944 614.80. The appellant objected to this amended assessment on 12 May 2016. The respondent disallowed the objections raised against the 2011 amended tax assessment on 31 August 2016. The appellant filed its notice of appeal and thereafter the appellant's case on 24 January 2017, while the respondent also filed the Commissioner's case on the same date.

<u>The issues</u>

At the pre-trial hearing held on 12 June 2017, the following issues were referred for determination on appeal.

1. Whether or not the service level agreement fees that were disallowed by the respondent in terms of s 16 (1) (r) of the Income Tax Act constituted expenditure incurred on general administration and management as envisaged by the said section?
2. Whether or not the debts written off by the appellant in 2011 were allowable deductions for that year of assessment in terms of s 15 (2) (a) or, alternatively, s 15 (2) (g) of the Income Tax Act?
3. Whether or not the penalty and interest levied by the respondent on the appellant in respect of the disallowed amounts were justified?

I deal with each issue in turn.

Whether or not the service level agreement fees that were disallowed by the respondent in terms of s 16 (1) (r) of the Income Tax Act constituted expenditure incurred on general administration and management as envisaged by the said section

<u>The facts</u>

It was common ground that the appellant was a subsidiary of a local holding company ME Holdings Ltd, which in turn was a subsidiary of a South African incorporated entity, N Ltd. It was further common cause that by virtue of the provisions of s 143 (1) (b) of the Companies Act [*Chapter 24:03*] the appellant was properly regarded as a subsidiary of N Ltd. The appellant and N Ltd concluded a Management Support Agreement, which took effect on 1 January 2009, in which N Ltd was the sole and exclusive provider, when requested to do so by the appellant, of the various services enumerated in clause 6 thereof encompassing risk management services, compliance management services, operations management services, organisation, finance and administration services, human resources management services, business development and marketing services, internal audit services, training services, legal management services, information technology and other services as may be agreed upon in writing between the parties. That these services were of a general nature is apparent from the contents of sub-clauses 6.1 to 6.1.7 which were made "without limiting the generality of the provisions of clause 3" and revolved upon making "recommendations with respect to overall policies for the conduct of business", "assist upon request with the formulation of policies", providing "consultation and advice", "specialised management and assistance", "adequate and appropriate policy and procedure manuals", "appropriate access to N Ltd's product development and marketing infrastructure, skills and expertise" and "assisting appellant with all major contract negotiations and other legal matters upon written request by the appellant." The phrases which precede the enumerated services are "without limiting the generality of the provision of clause 3 and 6.1" and "the general facilities and services of the N Ltd Group" and "without derogating from the generality of the foregoing". It is apparent from these quoted phrases that the provision of general services was in the contemplation of the parties. However, clause 6.2.1 of the agreement also contemplated the provision of "specialist services to the appellant reasonably required…..and on request", which included, *inter alia*, those derived from the generalised 10 clusters on the enumerated list.

In 2011 N Ltd met a number of expenses on behalf of the appellant and purported to have provided specific services to the appellant for which it was duly reimbursed or remunerated by the appellant. The specific services listed in para 6 of the appellant's case, concerned the provision of group technology infrastructure and operation support services, system support services for the Africa banking and e-commerce, strategic planning assistance, risk advisory service assistance, travel costs, telecommunications costs and postage and freight costs. These expenses and services were in addition to what the appellant termed "general administration costs and services such as staff costs packages, other fees on insurance management and sundry services such as head office printing and stationery".

The appellant accounted for all payments for expenses reimbursed, services rendered, and general and specific administration costs to N Ltd by debiting the amounts to a single ledger account headed "Operating Costs". However, in its return of income for 2011, it claimed a deduction from gross income in terms of s 15 (2) (a) of the purported specific costs and charges. During a review of the appellant's tax affairs, respondent treated the entire payments to N Ltd as general administration and management costs and in terms of s 16 (1) (r) (ii) of the Income Tax Act [*Chapter 23:06*] disallowed all the amounts in excess of the limit set in that section. It was common cause that the services were rendered, charged and paid for in the aggregate Rand equivalent of US$ 342 875.

The appellant contended that only general costs and not specific costs were covered by the deduction formula in s 16 (1) (r) of the Act and that the specific costs were deductible in terms of s 15 (2) (a) of the Act. The respondent made the contrary contention that the provisions of s 16 (1) (r) did not differentiate between general and specific costs but regarded all costs incurred by a subsidiary to its holding company as general administration and management expenses which fell to be deducted in terms of the formula prescribed by that provision.

The determination of the issue revolves around the meaning and application of the phrase "expenditure incurred on general administration and management" found in s 16 (1) (r), which however must be considered under the backdrop of s 15 (1) and (2) (a) and 26 (2) of the Act.

The legislative provisions

Section 15 (1) and (2) (a) prescribe the allowable deductions that shall be made from the gross income of a taxpayer in the following terms:-

"**15 Deductions allowed in determination of taxable income**

(1) For the purpose of determining the taxable income of any person, there shall be deducted from the income of such person the amounts allowed to be deducted in terms of this section:

(2) The deductions allowed shall be—

(*a*) expenditure and losses to the extent to which they are incurred for the purposes of trade or in the production of the income except to the extent to which they are expenditure or losses of a capital nature;

Section 16 (1) (r) provides:

"**16 Cases in which no deduction shall be made**

(1) Save as is otherwise expressly provided in this Act, no deduction shall be made in respect of any of the following matters—

(*r*) in the case of <u>expenditure incurred on general administration and management</u> in favour of a company of which the taxpayer is the subsidiary or holding company or (where the company is a foreign company) the local branch—

(i) ` incurred prior to the commencement of trade or the production of income or during any period of non-production, any amount in excess of zero comma seventy-five *per centum* of the amount obtained by applying the following formula—

$$A - (B + C)$$

Where—

A represents the total expenditure qualifying for deduction in terms of section *fifteen*;

B represents <u>the expenditure on general administration and management</u> paid outside Zimbabwe by such local branch or subsidiary, whether or not such expenditure was incurred by the head office of that foreign company;

C represents expenditure qualifying for deduction in terms of section (2) of paragraph (*f*) of subparagraph (i) of section *fifteen*;

(ii) incurred after the commencement of trade or the production of income, any amount in excess of one *per centum* of the amount obtained by applying the above formula

And s 26 (2) stipulates:

"**26 Non-resident shareholders' tax**

(2) For the purposes of this section, any amount paid outside Zimbabwe by a local branch or subsidiary of a foreign company in excess of the amount allowable as a deduction in terms of paragraph (*q*) or (*r*) of subsection (1) of section *sixteen* shall be deemed to be the payment of a dividend upon which non-resident shareholders' tax shall be charged, and the term "dividend" shall be so construed for the purposes of the Ninth Schedule.

The rationale behind s 16 (1) (r)

Both Mr *Ochieng*, for the appellant and Mr *Magwaliba*, for the respondent, correctly recognised that s 16 (1) (r) of the Income Tax Act constitutes an anti-avoidance tax measure against a local taxpayer, which limits its allowable deductions in respect of general administration and management expenses incurred in favour of a foreign related party. It seems to me that the Legislature was alive to the real possibility of the related parties colluding to overload expenses on the local entity and concomitantly reducing its Zimbabwean tax liability while increasing the foreign entity's profits. That this was the clear intention of the Legislature is further underscored by s 26 (2) of the Act, which treats the excess payments as dividends susceptible to non-resident shareholder's tax.

The meaning of "expenditure on general administration and management"

The words "expenditure on general administration and management" are not defined in the Income Tax Act. They also do not appear to have been judicially defined. Mr *Ochieng* relied on the definition of the word "general" rendered in *Rampersad and Another* v *Tongaat Town Board & Ors* 1990 (4) SA (D) at 37B for the proposition first advanced by the tax consultant for the appellant that the word "general" excluded from the application of s 16 (1) (r) any specific expenditure incurred for the purposes of trade or in the production of the income, which was not of a capital nature. During the investigations, the tax consultant for the appellant suggested to the respondent that the word "general" was used in the disputed phrase as an antonym for "specific". The case involved the interpretation and application of the words "general purport" in a Natal Statute. At 37B ALEXANDER J stated that:

> "I have been told that the word 'general' is capable of two meanings. It can mean 'all-embracing' in the sense used in *The Shorter Oxford Dictionary*, i.e. 'completely or approximately universal within implied limits'. On the other hand, according to the same dictionary, it can mean 'wanting in details; indefinite, vague (opp to precise)'. The applicant presses for the former and the Board the latter. All I am prepared to say in this regard, when faced with two mutually inconsistent concepts that the answer is not to be found by examining the one word only."

In the present matter, the appellant pressed for the latter and the Commissioner the former. It seems to me that the phrase must be construed within the scheme and context of the Income Tax Act with particular reference to s 15 (1) and (2) (a), s 16 (1) (r) itself and s 26 (2).

The appellant called the evidence of its Finance Manager, TM, to testify on the issue of general administration and management expenses. He qualified as a chartered accountant in November 2010 and commenced employment with the appellant in August 2011. He, testified that even though the words we seek to construe were not defined in any accounting textbook, all practising accountants had a general understanding of what they entailed. He, however, readily conceded during cross examination that these words did not bear any universal meaning even amongst this group of professionals but depended on the value judgment of each and every accountant, which in turn was determined by the normative considerations of functionality and materiality. He maintained in this regard that the bane of every accountant in recording "general expenses" in an income statement was the fear of misstatement. He, however, conceded that even general expenses could be particularised under specific cost centres and line items.

He inferred the meaning he gave from the International Accounting Standard, IAS, 1, which deals *inter alia* with the compilation, presentation and disclosure of income statements in financial statements. This IAS prescribes the various headings and line items, such as rent, salaries and wages, security, audit and tax that may be used in allocating income accruals and expenditure incurred in any business operation. To his mind, these headings represented specific items which fell outside the ambit of the "general" category postulated in s 16 (1) (r) of the Act. He defined a general expense as an *ad hoc* expense that cannot easily be classified or categorised under the specific headings and line items specified in IAS1. He identified on the schedule of expenses incurred by N Ltd on behalf of the appellant and charges levied against the appellant for services rendered, supplied to the respondent by the appellant on 22 May

2013, on pages 5 to 7 of Exh 1, the appellant's bundle of documents, the general expenses and the specific expenses that N Ltd incurred on behalf of the appellant, which were in the aggregate sum of R 2 million. The only amount he attributed to general expenses was the sum of R 424 0000 under the 'Staff Expenses' heading, which he identified as the appellant's contribution to the bonuses of head office executives payable by all subsidiaries of N Ltd. This amount further excluded the amounts pertaining to bonus under the heading 'Net Direct Transfer Pricing' of R74 000, 'Corporate Shares Services' of R 14 000 and 'risk, security and shared services 'of R3 000 which were recorded in the schedule under general administration. The total amount of general administration recorded in the schedule were in the sum of R 501 000. He identified the remaining items in the aggregate sum of R 1 575 000.00, which were actually in the sum of R 1 619 000.00 as the specific expenses that were covered by the Management Support Agreement, also known as the Service Level Agreement, SLA, on pp 90-124 of Exh 1.

The specific services fell into 14 headings and covered 28 line items. The table below sets out the main headings and the line items and their respective charges.

NO	HEADING AND LINE ITEM	RANDS in 000's
1	**Computer process costs**	**28**
	Processing charges	3
	Computer Terminal costs	1
	Depreciation-Computer E	12
	Operation Lease charges	7
	Mainframe	4
	Data Communications	1
2	**Communication and Travel**	**64**
	Other Travel Costs	50
	Postage and Freight	1
	Telecommunications	13
3	**Marketing and Public Relations**	**2**
	Entertainment	1
	Marketing	1
4	**Office Equipment & Requisition**	**2**
	Stationery and Printing	2
5	**Other Sundries**	**80**
	Sundry expenses	80
6	**Net Direct Transfer Pricing**	**83**
	Property	48

	Insurance	35
7	**N Corporate**	**334**
	Transactional banking	230
	Corporate Centre	104
8	**Balance Sheet Management**	**104**
	Alco	38
	Bsmd Other	66
9	**Group Technology**	**733**
	Infrastructure & Operations	285
	Africa Banking & E-Commerce	448
10	**Total Finance**	**18**
	Property & Catering	2
	Gssc Excl Property	3
	Finance Shared Services	13
	Finance Other	13
11	**Strategic Planning**	**7**
12	**Risk**	**114**
	Risk Other	114
13	**Consulting fees**	**5**
14	**Appellant**	**5**
TOTAL		**1 619**

The witness testified that these “specific services” were, as prescribed in the SLA, requisitioned by the appellant from the holding company in those areas where the appellant was incapacitated.

Under cross examination he indicated that the SLA covered almost all the core aspects of banking. He further intimated that these special services would in any event have had to be requisitioned from unrelated parties had the appellant and N Ltd not made the strategic decision to keep them in-house. In his evidence in chief he indicated that N Ltd offered a cheaper, efficient and convenient service. However, when questioned under cross examination whether the relationship did not breach the arm’s length principle he substituted competitive and comparable pricing for cost efficiency. It was clear from his testimony both in chief and under cross examination that the profit motive, the benefit to shareholders, was at the core of the SLA. Notwithstanding the existence in clauses 7.5 to 7.7 of the SLA agreement of the prescribed procedure for raising an adjusted invoice by N Ltd it did not appear from his evidence that the appellant could dispute the charge out determined by N Ltd given that in terms of clause 7.1 of that agreement "the calculation of the amounts payable in respect of the fees and expenses shall be as provided for in the budget based on a cost-to-time ratio for the estimated time expected to be spent on the rendering of services."

Assessment of the evidence of the finance manager.

I found him to be an educated, knowledgeable and experienced chartered accountant. In the final analysis, his definition of the phrase under consideration was intrinsically incoherent, impractical and superficial. He failed to distinguish between specific and general expenses. The long and short of his definition was to confirm the averment of the respondent in para 22 of the Commissioner's case that "there is no expense that is not capable of being specified." The examples of general administration and management cost centres identified by the appellant such as staff costs, insurance premiums and sundries are capable of particularisation and specificity. The holding company was, in my view, capable of specifying the amount of time and the nature of work head office staff devoted to the business of the appellant so as to cost such work in accordance with clause 7.1 of the SLA.

There are three further factors that militate against the definition proffered by the appellant. The finance manager did not appear to have studied the schedule submitted to the respondent on 22 May 2013 which sought to differentiate between general administration and specific services partially reproduced in the table above. The line items under general covered not just bonus but staff packages and training and corporate shared services in the aggregate sum of R 501 000 and not R 424 000. The principle that I was able to extrapolate from the schedule was that N Ltd equated general administration services with head offices services that were universally and simultaneously rendered without distinction to all its subsidiaries and specific services with those services that were specially rendered to the appellant only. This distinction was not made in the evidence of the chartered accountant. There are line items such as 'sundries' and 'finance shared service' which should properly fall into the ambit of general expenses as recognised by the appellant in it pleadings and evidence but which were included under specific expenses.

The other weakness in the testimony of the witness was that a closer examination of the headings and line items under the specific services shows that these services could very well have been offered by N Ltd simultaneously to both the appellant and some of its other subsidiaries. The appellant demonstrably failed to call evidence to establish the logged requests made to N Ltd for such services. The services were rendered by N Ltd, which again compiled the schedule. It seems to me that the scope and nature of the specific services, if any rendered by N Ltd could only have been established by a witness in the employment of N Ltd who compiled the schedule. In my view, the finance manger's testimony failed to establish the contention that was advanced by the appellant.

It was on the basis of this evidence that Mr *Ochieng* sought to persuade me that the phrase "expenditure on general administration and management" encompassed arbitrary group expenditure which fell outside the headings and line items prescribed in the IAS 1 of the International Financial Reporting Standards, IFRS, and did not confer any tangible benefits to the payer. The effect of the contention being that the disallowed expenditure constituted specific expenditure deductible under the general deduction formula. I must confess that I find the definition proffered by both the witness and counsel for the appellant incomprehensible for the reasons already covered in the assessment of the finance manager's testimony.

On the other hand, Mr *Magwaliba* relied on the online business dictionary **http://www.businessdictionary.com** definition of general and administrative expenses for the submission that all the expenses incurred and paid by the appellant were general administration and management expenses whose deductibility was limited to the formula prescribed in s 16 (1) (r) (ii) of the Act. The online business dictionary defines general and administrative expenses as:

> "Money spent in operating a business (rent, salaries, telephone charges etc.) that is not directly associated with production of goods or services".

Mr *Magwaliba* contented that all the expenses attributed to N Ltd were not directly associated with the production of the appellant's goods and services, which the parties agreed were the money lending banking operations of the appellant, but were merely in respect of the support services rendered by N Ltd. Of course, the words defined in the online business dictionary are not the same as the words in dispute. They, however, appear to be analogous to the words that are under discussion. Mr *Magwaliba* also relied on the definitions of technical, managerial, administrative and consultative in *G Bank Zimbabwe Ltd* v *Zimbabwe Revenue Authority* 2015 (1) ZLR 348 (H) for proposition that general administration and management have a wide import by reference to the definition of fees in para 1 (1) of 17th Schedule.

In the absence of any allusion to any recognised trade usage of the words under consideration, I must again defer to the ordinary English meaning of general, administration and management. *The Shorter Oxford English Dictionary* provides 9 permutations of the definition of "general". The relevant ones are "pertaining to all or most of the parts of a whole;

completely or approximately universal within implied limits; opp to partial or particular; prevalent, widespread, usual, common", "directed to the main elements, features etc., hence wanting in details, indefinite, vague (opp to precise, in special, in particular". Administration is defined as "the action of administering, management" while management means "the action or manner of managing, administrative skill". In the present case, it is not really necessary to define administration or management because almost all of the contracted functions are headlined as management of sorts.

The only word, which requires serious consideration is "general". I have already discounted the meaning preferred by the appellant in my assessment of the financial manager's evidence. That finding further eliminates the application of permutations relating to "directed to the main elements, features etc., hence wanting in details, indefinite, vague (opp to precise, partial, in special, in particular)". The upstanding meaning remains that suggested by Mr *Magwaliba* of all-embracing by reference to the *G Bank* case, *supra* and the first formulation by ALEXANDER J in *Rampersad* case, *supra,* which resonates with "pertaining to all or most of the parts of the whole, completely or approximately universal within implied limits". This latter definition of "general" accords with the SLA. It was common cause that it covered almost all the major core functions of the appellant and was only limited by the requests made by the appellant.

In the present case, the costs charged for such a request were determined in the sole and absolute discretion of N Ltd, based on a time-to cost ratio marked-up 10%. Thus even if the expenses in question were capable of deduction under the general deduction formula, their actual deduction would be limited by the provisions of s 16 (1) (r) (ii). That provision was not intended to make a distinction between specific and general expenses but was intended to qualify the deductions which could have been deducted under section 15 (2) (a) of the Act on the sole basis that these expenses would have been incurred in favour of a foreign related party of a local entity. It was common cause that the section works in tandem with s 26 (2) of the Act and is an anti-avoidance provision which seeks to prevent the shifting of profits from Zimbabwe to another jurisdiction.

It seems to me that all the expenses incurred in accordance with the SLA fell into the "general administration and management" category. This finding is fortified by two factors. The first, derived from my findings in *D Bank Ltd* v *Zimra* 2015 (1) ZLR 176 (H) at 183A-C and 189G, and approved on appeal in *Zimra* v *Stanbic Bank Zimbabwe Ltd* SC 13/2019 and followed in *DEB (Pvt) Ltd* v *Zimra* HH 664/2019 at p 18 that the expenses relating to the purchase of both computer hardware and software and the costs associated with these items such as training, travel and reconfiguring were of a capital nature. They are all precluded from deduction under the general deduction formula. Clearly, computer processing costs, group technology costs, total finance, office equipment and requisition, net direct transfer pricing, other sundries would all constitute capital expenditure. The scope and nature of the remaining expenditure heads was not established. If they were ancillary to the expenses of a capital nature, then they would not be deductible under s 15 (2) (a) of the Act.

Conclusion on the first issue

It is on the basis of the above findings that I hold that the expenditure relating to what the appellant termed "special services" in the 2011 tax year of assessment fell into the category of general administration and management expenses and were properly disallowed by the Commissioner.

Bad debts

Whether or not the debts written off by the appellant in 2011 were allowable deductions for that year of assessment in terms of s 15 (2) (a) or, alternatively, s 15 (2) (g) of the Income Tax Act.

The Facts:

The facts giving rise to the appellant's claim for bad debts in the 2011 tax year were provided by its head of credit, PM, with 30 years banking experience in his quiver. His testimony was in tandem with the documentation pertaining to these "bad debts" and filed of record. The appellant deducted from its 2011 tax assessment bad debts incurred by four Bulawayo based corporate clients in the sum of US$2 250 365.71 by the end of the 2011 tax year, which the appellant declared as bad debts. The share of AC (Pvt) Ltd, the first borrower, was in the sum of US$2 300 445 plus 15% interest from 1 February 2011, while that of, SI (Pvt) Ltd, the second borrower, was in the sum of US$ 50 000. BI (Pvt) Ltd, the third borrower and ERC, the fourth borrower, were in the respective sums of US20 000. His factual evidence was reinforced by a variety of documents that he referred to in both exh 1 and the r11 documents. The appellant claimed a deduction of this amount under the rubric of bad debts in the 2011 tax year. The amount was added back into income by the respondent in the amended tax assessment for the 2011 tax year issued on 14 April 2016. The objection lodged by the appellant on 12 May 2016 was disallowed on the basis that the appellant had failed to satisfy the respondent on a balance of probabilities that each amount constituted a bad debt.

The operations of the appellant are governed , *inter alia,* by the statutory provisions of the Banking Act [*Chapter 24:02*] and the Banking Regulations SI 205/2000, the group internal policies, procedures and practices and international best practices delineated in the Basel II standards. These provide the general framework within which the appellant conducts its commercial banking activities. The appellant plays a financial intermediation role between lenders and borrowers and also accepts deposits from both individual and corporate customers. Its niche market is mainly in the corporate sector. It earns its income mainly from fees, commission and interest.

<u>The first borrower</u>

The relationship between the appellant and the first borrower, a clothing manufacturer, commenced in 1996. The first borrower accessed offshore and onshore lines of credit from the appellant for its export markets in South Africa and Germany. One such offshore line of credit was the trade finance loan facility of US$3.8 million procured from the Afreximbank and guaranteed by the appellant. It was secured by four mortgage bonds in the sum of US$3 million against a business stand in Bulawayo in the name of the holding company of the first borrower, three unlimited guarantees from two sister companies and a director of the first borrower and a deed of pledge of shares from the first borrower. In addition, the first borrower was to cede and pledge its insurance policy in the sum of US$ 3.4m on plant and US$3.6m on stockholdings to which another financial institution held a US$ 3m notarial general bond over movables excluding raw materials and CD1 proceeds and confirmed order of US$280 000 every four months to the appellant. The other special conditions were that two foreign creditors of the first borrower subordinated their claims to that of the appellant and agree to give to the appellant prior notice before seeking the liquidation of the first borrower. The facility was last renewed in 2007 and was to expire on 30 September 2008. It was rolled over to 2 March 2009. The dire straits of the first borrower were enumerated by its managing director in his letter to the appellant of 2 April 2009.

Two exogenous factors adversely affected the first borrower’s export business and its ability to service the loan. These were the protectionist policies in the export markets and the expropriation of US$2.5 million in the appellant’s FCA account by the Reserve Bank of Zimbabwe. The change into casual wear failed to lift the fortunes of the first borrower. The appellant called up the debt in February 2009 and issued final demand against the principal debtor, sureties and guarantors for the settlement of the debt on 10 December 2009. It, however, withdrew the demand in preference to the loan agreement of 30 April 2010 in which it restructured the capitalised debt of US$ 2 519 582 on the same security. The restructuring agreement was conditional upon the procurement of recapitalisation funds of not less than US$3.8m by 31 July 2010 by the first borrower. The monthly capital and interest payments were rescheduled to run from 1 May 2010 to 30 April 2014. The first borrower failed to secure the recapitalisation funds by 31 July 2010. In November 2010 the appellant demanded settlement of the debt from the principal debtor, sureties and co-principal debtors and guarantors.

The directors of the first borrower were confident they would turn around the fortunes of their company notwithstanding their inability to pay both the principal and interest on the cumulative debt of US$6 111 054.65 owed to 5 creditor banks including the appellant. In order to exploit the strong order book to August 2011, the first borrower called two meetings, on 24 January and 11 February 2011 with the bank creditors which culminated in the inter-creditor agreement, ICA, with these 5 banks on 16 March 2011 but with retrospective effect to 11 February 2011. The agreement was initiated by the first borrower. At that time the amount owed to the appellant was US$2 278 331.65 plus interest of 15% per annum. The respective amounts owed to the other banks were US$ 2.5m, US$ 982 723, US$ 200 000 and US$150 000 plus interest ranging between 11% and 18% per annum above the minimum lending rates of these banks, respectively. These creditor banks declined to refinance the first borrower but agreed to a principal and interest, demand, litigation and execution moratorium for 5 months to 31 July 2011. The moratorium was based on three suspensive conditions that were requested by the first borrower. It had engaged three financiers for bridging and recapitalisation finance to enable it to trade out of its debt. One of the three financiers, NSSA, was scrutinising the sale and lease back proposal advanced by the first borrower, in which the first borrower sought to sell its factory for US$5.4m and lease it back. It would apply the proceeds to retiring a portion of the debt and to working capital. The other local financier was requested to supply US$1m bridging finance during the moratorium for the purchase of raw materials to fulfil the confirmed orders. In addition a South African customer was willing to make advance payments of 60% on its confirmed orders. The suspensive conditions were predicated on positive responses from the two local financiers by 23 and 24 March 2011. On 23 March 2011 the board of the potential sale and lease back entity requested the first borrower to reconsider its asking price of US$5.4m in view of an independent valuation procured by that entity of US$2.7m.

On 8 April 2011 [p 108-110 of r 11 documents] a document tracing the history of the relationship between the appellant and the first borrower was prepared for the appellant's credit committee. Amongst other things it highlighted the financial status of the mortgaged security. The first borrower at that stage was unable to pay the insurance premiums in the sum of US$22 000 for the property, plant and machinery and holding stock, which was paid on its behalf by the appellant. On 29 April 2011 the appellant's credit committee agreed to partially write down the mortgaged security from the market value of 31 March 2011 of US$2 300 445 [p 105 of r 11 documents] by US$2m to the forced sale advance value of US$300 445. Apparently, the security had been evaluated by an independent valuator on 11 February 2010 at a market value of US$1.1m and forced sale value of US$330 000.

The failure of the rehabilitation efforts drove the first borrower to seek provisional judicial management on 5 April 2011, in the renewed hope of finding a suitable suitor to revive its fortunes. The state of the first borrower on that date was highlighted in the Provisional Judicial Manager's report of 21 November 2013. The net liabilities were in the sum of US$11m against net assets of US$4.2m. He held the third creditors meeting on 23 November 2011 when the net liability position was US$10 834 169. The objective facts were that the first borrower was technically insolvent and ideal for liquidation. He concluded in regards to the various securities held that the dollar value lent was at the time greater than the dollar value of the security held through the first borrower and third parties and the guarantees by directors. He did a trial manufacturing run for 6 months with a Harare based clothing manufacturer. He got the factory running at 80% capacity with 350 employees. He concluded after the trial run that it was impossible for the first borrower to trade out of its net liability position. On 23 November 2013 he proposed a scheme of arrangement with members and creditors, which involved the disposal of the first borrower as a going concern to the Harare suitor who had participated in the trial run. The book value of the factory stood at US$4.2m, which in his considered opinion based on the general industrial decline in Bulawayo and the clothing industry in particular, the specialised nature of the plant and machinery at the factory and its amalgamation with another property, which did not belong to the first borrower, the state of disrepair and good quality sewing machines in need of spare parts, the book value was unlikely to be realised.

The scheme was approved by the requisite 75% by value vote of the creditors on 14 January 2015 and was thereafter sanctioned by the High Court and registered by the Registrar of Companies as mandated by the Companies Act. The Harare suitor's conditions were accepted. All the mortgages registered against the property, the notarial general bond against stocks and debts and the sureties and unlimited guarantees against the directors were cancelled. The property encumbered by the appellant was sold for US$300 000 while the amalgamated property was sold for US$400 000.

The total amount written off by the appellant in the 2011 tax year was in the sum of US$ 2 170 131.88 comprising of US$ 1 869 686 written off on 29 April 2013 and US$ 300 445 written off on 24 May 2011.

The statutory regulations

The Banking Regulations SI 205/2000 prescribe the operations of a banking institution such as the appellant. A quarter refers to the 3 month periods ending 31 March, 30 June, 30 September and 31 December in each year. Every banking institution is mandated to file a BSD 1 form and the reports or returns enumerated in para 19 (a) to (e) as read with para 8 of the Third Schedule to the Banking Regulations with the central bank within 14 days of the end of each quarter. In terms of specified Schedules R 1, RI-B, RC-A, RC-B, RC-C the banking institution is obliged to record in the income statement the accrued interest derived from the 8 categories listed therein, provisions against bad debts, bad debts recoveries and written offs, the asset qualities, whether past due by 30 days, 90 days, 180 days or 360 days. Schedule RC-C deals with the classification of assets under A-special mention, B-substandard, C- doubtful and D- loss.

The term “past due” in relation to any asset is defined as that principal or interest which is due and unpaid for 30 days or more or interest payments equal to 30 days or more that have been capitalised, refinanced, or rolled over. The terms “provision for loan losses account” means amounts set aside for loan losses and “suspended interest account or interest in suspense” means the account in which interest is credited when a loan ceases to perform as agreed and there is doubt as to the ultimate collection of the interest. In terms of para 19 (1) an asset is deemed to be non-performing when the principal or interest or both is due and unpaid for 90 days or more or interest payments equal to 90 days or more have been capitalised, refinanced or rolled over.

In terms of para 20 (1):

> (1) `”Every banking institution shall review the quality of its loan portfolio not less frequently than each quarter, with a view to achieving the following objectives-
>
> (a) To ensure the conformity of the loan portfolio and lending function to a sound lending policy documented, approved and adopted by the board; and

(b) To keep executive officers and the board frequently informed regarding portfolio risk; and
(c) To properly identify and classify problem credits and, as necessary place them on a non-accrual basis in accordance with this Part; and
(d) To ensure that appropriate provisions for potential losses are made to the provision for loan losses account so as to maintain the account at an adequate level at all times; and
(e) To ensure that write-offs of identified losses are made in a timely manner

In terms of s 22 (e) every banking institution is obliged to classify all assets *inter alia* under:

(e) Loss, if the asset in question-
  (i) Is past overdue for more than 360 days unless such asset is well secured and legal action has actually commenced which is expected to result in the timely realisation of the collateral or enforcement of any guarantee relating to the assets; or
  (ii) inapplicable
  (iii) Is otherwise considered uncollectable or of such little value that its continuance as an asset is not warranted
  Provided that a loss classification shall not preclude the possibility of recovering the asset or securing a salvage value for it.

Para 24 requires a loan asset graded "loss" to be immediately written off whether the or not the banking institution intends or is in the process of attempting to recover the loan or asset.

Para 25 (1) deals with the establishment of a provision for losses account and requires 100% provisioning for the loss classification but exempts such provisioning to the extent the loss is secured by *inter alia* net realisable value of any collateral or a reliable guarantee.

The second borrower

The appellant granted SI (Pvt) Ltd, the second borrower, which operated a supermarket business, a credit facility of US$50 000 on 2 July 2009. It was secured by a mortgage bond of US$55 000 over a residential property in one of the high density suburbs of Bulawayo and the unlimited guarantees of the two shareholders of the second borrower. The facility was utilised to purchase trading goods. The second borrower faced stiff competition from the bigger players and failed to trade profitably. It failed to pay the principal and interest obligations due to the appellant. On 2 November 2010 the second borrower was in arrears of US$41 682.26. On 31 December 2011, the appellant wrote off from the loan amount US$ 7 670.11 to align the balance owing with the estimated value of the pledged security, which stood at US$32 000 at the time of initiating litigation. It issued summons in the High Court, in case number HC 286/2011, demanding settlement of the debt and execution of the security. At that time the second borrower was owing in the sum of US$40 000. The second borrower contested the claim. Judgment was granted after a protracted legal battle and the property auctioned at a Sheriff's sale in execution in March 2015 for US$57 500. The confirmation of the sale was contested by the guarantors and at the date of appeal, the appellant had not been paid. The second borrower managed to make intermittent payments of US$17 191.31 during the contested action.

<u>The third borrower</u>

The third borrower, B (Pvt) Ltd, a manufacturer of virgin soft plastic packaging products was granted a credit facility of US$20 000. The facility was secured by a surety mortgage bond of US$55 000 over a residential property in Bulawayo and unlimited guarantees by the two shareholders of the third borrower. The third borrower failed to service the facility. On 23 December 2011 the amount written off by the appellant was in the sum of US$12 897.16. This partial write off managed to adjust and align the balance owing to the estimated value of the pledged asset, which stood at US$10 000 at the date of initiating litigation. The appellant issued summons under case number HC 290/2011 for the outstanding indebtedness of US$26 677.27. The property was sold by public auction in November 2013 for US$35 000 but the Sheriff was not satisfied with the price and reset it for sale by private treaty, the results of which were still pending at the time of the appeal hearing.

<u>The fourth borrower</u>

On 2 March 2009, the appellant availed a credit facility of US$20 000 to the fourth borrower, ERW (Pvt) Ltd, a clothing company based in Bulawayo. It was secured by a surety mortgage bond of US$31 250 over a residential property situated in one of the high density suburbs of Bulawayo and unlimited guarantees from the fourth borrower's shareholders. The fourth borrower failed to provide sufficient cash cover to service the debt. On 30 December 2011 the appellant wrote off the sum of US$ 18 569.83. After contested action, the appellant took judgment in case number HC 407/2011 in the sum of US$ 26 225.78 against the fourth borrower and the security was declared executable. It was sold by public auction by the Sheriff in March 2015 for the sum of US$7 000. In the meantime the fourth borrower had made intermittent payments of US$13 123.55 in reduction of the debt.

<u>The resolution of the second issue</u>

Whether s 15 (2) (a) applies to bad debts

The appellant contended on the authority of *Stone* v *SIR* 36 SATC 117 (AD) at 130 that bad debts sustained by a banking institution or money-lending business from loans constitute the type of losses contemplated in the general deduction formula. In that case, CORBETT AJA, as he then was, said:

> "It has been accepted in a number of cases, mainly in the Special Court, that where the taxpayer can show that he has been carrying on the business of banking or money lending, then losses incurred by him as a result of loans, made in the course of his business, becoming irrecoverable are losses of a non-capital nature and deductible." (See *Salisbury Board of Executors Ltd v Commissioner of Taxes* SR 12 SATC 1, 1941 SR 147, *ITC 257*, 7 SATC 65, *ITC 812*, 20 SATC 469, *ITC 933*, 24 SATC347, *ITC 1003*, 25 SATC 237, *ITC 1138*, 32 SATC 3). The rationale of these decisions appears to be that the capital used by a money lender to make loans constitutes his circulating capital and that consequently losses of such capital are on revenue account. I shall accept for the purposes of this case that these decisions are correct, provided that the business is purely that of money lending and the loans are not made in order to acquire an asset or advantage calculated to promote the interest and profits of some other business conducted by the taxpayer (cf *Atlantic Refining Company of Africa (Pty) Ltd v CIR* 1957 (2) SA 330 (AD). There is however in my view no warrant for extending this principle to loans by persons who are not conducting a money lending business."

The respondent, on the other hand, contended that the bad debts deducted in the 2011 financial statements were not the type contemplated in the general deduction formula.

The appellant relied on the definition of loss espoused in para 22 (e) of the Banking regulations. It does not appear to me that the asset referred to in this para is the mortgaged security, because the mortgaged security does not become past due. The asset contemplated must be the debt, if regard is had to the wording of s 24 of the regulations which uses the term "loan asset". The 360 days or more past due loan cannot be categorised as a loss where the loan is well secured and legal action to satisfy it has commenced. In respect of the first borrower legal proceedings had not commenced when the bad debt was written off. The loan may also be classified as a loss if it is otherwise uncollectable. The appellant did not discharge the onus on it to show on a balance of probabilities that the loan was uncollectable. The appellant declared the losses on 29 April 2011 and 23 May 2011. At that time it was the mortgagee of the encumbered property, which belonged to a third party and not the first borrower. That property had been independently valued by valuators engaged by appellant a year before, on 11 February 2010 at US$1.1m. The appellant did not conduct another independent valuation before declaring the loss. We know from the letter written by NSSA on 23 February 2011 that independent valuers engaged by NSSA between 11 February and 23 March 2011 had valued the property at US$2.7m. The pleadings and the evidence of the head of credit never did explain why the appellant never sought satisfaction of the loan from that property and other properties encumbered by unlimited guarantees such as the amalgamated contiguous building guaranteed by LB (Pvt) Ltd, which according to the letter of the borrower's managing director of 2 April 2009 was unencumbered. There was no explanation on why satisfaction was not sought from the pledged shares. I am not satisfied that the appellant established on a balance of probabilities that the debt was uncollectable when it declared a loss. Thus, even if the purported bad debts could be deducted as losses under the general deduction formula, I am satisfied that the appellant failed to establish the existence of the loss envisaged by para 22 (e) of the Banking Regulations.

Notwithstanding the high legal pedigree of the sentiments expressed in the *Stone* case, *supra*, it seems to me that bad debts are not the type of losses contemplated in the general deduction formula. In my view, once a taxpayer characterises the transaction as a bad debt, it perforce is obliged to apply the provisions of s 15 (2) (g) of the Act and not the general deduction formula. The key words, neigh, the overriding words, which subordinate s 15 (2) (a) to the provisions of s 15 (2) (g) are the opening words of the latter para-"the amounts of any debts due to the taxpayer". Thus as long as the amount can be characterised as "any debt", and in compliance with the Banking Regulations it must be so regarded, it falls to be treated under s 15 (2) (g). I do not know how the bad debt provision in the Income Tax Act with which CORBETT AJA was concerned was worded but one detects hesitation in the words that I have underlined for emphasis in the sentiments he expressed. In any event, he was not in that case dealing with bad debts, so insofar as those sentiments are attributed to bad debts, they would merely be *per incuriam*. In my view, s 15 (2) (g) of the Income Tax Act provides the specific mechanism for dealing with bad debts, which appear to me to preclude the application of the general deduction formula. The application of the general formula to bad debts would defeat the legislative intention of enacting s 15 (2) (g) and enable a taxpayer to escape the four criteria, which must be satisfied before any bad debt becomes eligible for deduction. It seems to me that the nature of the transaction determines the legislative provision that governs the deduction.

The above sentiments apply with equal force to the purported bad debts arising from the actions of the other three borrowers. The appellant failed to establish the value of each security at the time the purported loss was incurred. Again, the key words in s 15 (2) (g) preclude the treatment of bad debts as losses. The contentions taken by the appellant in this regard must fail.

Should the Commissioner on objection and the Court on appeal be satisfied that the four debts were bad in the 2011 tax year?

My answer is in the negative. Section 15(2) (g) provides:

> "(2) The deductions allowed shall be—
>
> (*g*) the amount of any debts due to the taxpayer to the extent to which they are proved to the satisfaction of the Commissioner to be bad, if such amount is included in the current year of assessment or was included in any previous year of assessment in the taxpayer's income either in terms of this Act or a previous law;"

In *BT (Pvt) Ltd* v *Zimra* 2014 (2) ZLR 640 (H) at 655D-F, I set out the four prerequisites of a bad debt. The only factor for determination is whether the Commissioner considers (is satisfied that) the amount is unlikely to have been recovered at the end of the financial year. I must, at the outset, hasten to stress that the facts in the present case are fundamentally different from the facts in the *BT* case. In that case the gold bonds, which were held as security, were not only foisted upon the creditor but were also invalid and valueless. In the present case the security provided by each borrower was chosen by the appellant and valid with inherent value. Again, in the former case, while the creditor could sue the debtor, it was precluded by law from executing on the assets of the debtor. In the present case there was a legal barrier to litigate against the borrower, but the appellant could realise the securities by litigating against the sureties and guarantors. The contention by Mr *Ochieng* that the two cases are on all fours was therefore incorrect.

Now, in both his letter of 14 April 2016 and determination of 31 August 2016, the respondent expressed his dissatisfaction with the basis upon which the appellant treated the debts as bad. While the explanation proffered in the first letter was rather cryptic; the one in the determination was instructive. In para 2.2.2 the Acting Commissioner-General opined that:

> "The explanation that you provided in your objection letter for all the debts that were disallowed as bad debts indicate that as at end of year in 2011 there was no evidence that the debts could not be recovered through security that had been offered against default on payment. It must be highlighted that failure by the bank to recover amounts owed from the principal debtor does not render the debt bad if a chance still exists to recover the debt through the security that was advanced to secure against default by the principal debtor."

In essence, the appellant was required to provide evidence to establish on a balance of probabilities that each debt was unlikely to be paid in the 2011 tax year. It was common cause that the amounts were not actually paid. At the time the appellant prepared its financial statements well after the end of the 2011 tax year, it was aware that the debts had not been paid.

That position is irrelevant to the question whether the debts were unlikely to be paid. The test is objective and not subjective. It is whether there was a reasonable probability that payment would not be made. See *BT, supra,* at 658E.

It was common ground that during the course of the 2011 tax year none of the four borrowers would have been able to trade out of the economic difficulties that confronted each of them and pay up the amounts owing. In the absence of collateral security to which the appellant could realise, the debts would have properly been proved to be bad. The head of credit did not produce any evidence of the valuations done in 2011 either by an independent valuer or by a desktop valuer. He did not intimate that any such evidence was availed to the investigators or the Commissioner. I have already highlighted the weaknesses in the evidence provided by the appellant in respect of the first borrower. Those findings apply with equal force in the consideration of the satisfaction issue. I am not satisfied that there was an unlikelihood of realisation of the securities held by the appellant against the debt of the first borrower.

In regards to the second borrower, the security would have been sufficient to meet its indebtedness had it been executed in 2011. The debt went 360 days past due in July 2010. The head of credit was wont to say *ad nauseum* that properties were overvalued in 2009 when the United States dollar was introduced into the multicurrency monetary basket in Zimbabwe and progressively fell in nominal terms in subsequent years. Apparently, the trend was debunked by the residential property that secured the second borrower's debt for it was sold in by the Sheriff in 2015 for US$57 500 and the surety still complained that the price was too low. I agree with Mr *Magwaliba,* that these facts demonstrated that the property could have been worth much more in 2011. It would have been able to cover the second borrower's debt. The appellant wrongly considered the debt bad. The Commissioner properly disallowed it from the appellant's 2011 income tax return.

In respect of the third borrower, the debt went 360 days past due in May 2010. The security was disposed of in the Sheriff's sale in execution in November 2013 for US$35 000, an amount which was greater than the debt owing but which the Sheriff considered too low such that he invoked the private treaty route. The reasoning adopted in the second borrower's case applies with equal force to the present matter. I am satisfied that the value of the security would have most likely covered the debt that was considered bad by the appellant in the 2011 tax year. The Commissioner correctly disallowed it from the appellant's 2011 income tax return.

Lastly, the debt of the fourth borrower went 360 days past due in March 2010. The debt had increased to US26 225.78 from the original amount of US$20 000 by the time judgment was taken in 2011. The property was valued at US$ 31 250 at the time the facility was availed to the fourth borrower. The property attracted the highest bid of US$7 000 at the Sheriff's sale in execution conducted in March 2015, a price which at the date of hearing of this appeal was still awaiting the Sherriff's confirmation. The appellant did not produce any valuation evidence which would have tended to justify the partial write off of the debt. The appellant failed to show on a balance of probabilities that the security was inadequate to cover the outstanding debt in 2011. I am not satisfied that the security was inadequate to cover the outstanding amount. The Commissioner correctly disallowed the deduction claimed in respect of the fourth borrower in the appellant's 2011 income tax return.

Conclusion on second issue

The dismissal of the appellant's claims in respect of all four borrowers portrays a faulty application of value judgment by the appellant. The failure to produce any documentation justifying the write offs betrays an absence of objective criteria to value collateral security prior to writing off these atypical debts. The Commissioner properly disallowed the bad debt deductions in question and correctly added them back to the appellant's income in the 2011 income tax year.

Whether or not the penalty and interest levied by the respondent on the appellant in respect of the disallowed amounts were justified

The consideration of penalties on appeal is in the discretion of the appeal court. The application of the triad of the offender, offence and interests of society rarely produces a full waiver for the errant taxpayer. In the present appeal, I consider the factor considered by the Commissioner of co-operation as mitigatory. The appellant is a first time offender and a good corporate citizen which has, other than in the present matter, paid its tax dues timeously. In regards to the offence, the failure to pay the correct amount of income tax at the appropriate time is always treated in serious light. It has the unfortunate consequence of shifting the burden of taxation onto the shoulders of the law abiding citizens. The tax burden should be equitably shared by all citizens. While a cursory and superficial look at the construction of s 16 (1) (r) (ii) of the Act postulated by the appellant appeared attractive, it was in substance both fallacious and sterile. To my mind, the bad debt deductions were made without a proper appreciation of the efficacy of the existing securities. These factors do raise the moral turpitude of the appellant. In my reading, section 46 (6) of the Act reposes a discretion on the Commissioner to either reduce or waive the penalty from the obligatory 100% imposed for deliberate acts of avoidance, postponement or evasion of income tax. These non-negotiable prescripts are absent from the present matter. I am, however, of the view that the infringement of the relevant provisions of the Act called for the penalty such as was imposed by the Commissioner. I am not persuaded that the Commissioner erred in insisting on a penalty of 50%. I would impose the same penalty.

The imposition of both penalty and interest is not offensive but is permitted, if not encouraged by s 71 (2) of the Act. Interest is always designed to compensate for the lost time value for money while the penalty serves to punish the offender and to provide both individual and general deterrence to both the offender and other like-minded taxpayers.

Costs

I do not consider the claim of the Commissioner to have been unreasonable nor the grounds of appeal frivolous as to warrant an imposition of an adverse order for costs against either party. Rather, each party should bear its own costs.

Disposition

Accordingly it is ordered that:

1. The appeal be and is hereby dismissed in its entirety.
2. The amended assessment number 20324821 issued by the Commissioner on 16 April 2016 in respect of the tax year ended 31 December 2011 be and is hereby confirmed.
3. Each party shall bear its own costs.

Atherstone & Cook, the appellant's legal practitioners