Z CO (PVT) LTD
versus
ZIMBABWE REVENUE AUTHORITY

HIGH COURT OF ZIMBABWE
KUDYA J
HARARE, 21 July and 22 October 2014

AP de Bourbon, for the appellant
T Magwaliba, for the respondent

KUDYA J: The question for determination in this appeal is whether the misappropriation of the US$1 004 833 of the appellant's money by a third party is deductible as an expense or loss suffered in the course of trade or business or in the production of income under s 15 (2) (a) the Income Tax Act [*Cap 23:06*]. The pith of the appellant's evidence and submissions was that it was while that of the respondent was that it was not.

The only evidence adduced at the appeal hearing came from a chartered accountant employed by the appellant as an accounts director. In addition, the appellant produced a 112 page bundle of documents. The respondent did not call any evidence.

The appellant company is duly registered with the Tobacco Industry and Marketing Board (TIMB) as a tobacco merchant and purchases both auction and contract tobacco, processes, packages, markets it for manufacturers and then exports it. It operates in conformity with the financial architecture designed in the Exchange Control (Tobacco) Finance Order SI 61 of 2004 and the Reserve Bank of Zimbabwe directive dated 2 May 2008 issued in terms of s 35 (1) of the Exchange Control Regulations SI 109 of 1996. These legal instruments directed that funds for the purchase of local tobacco and for financing contract tobacco growers should be sourced off-shore.

It was common cause that on 30 June 2010 the appellant through its designated public officer filed the tax return ITF 12C for the year ended 31 December 2009 on 30 June 2010. It disclosed in the return that the cost of sales included the amount of US$1 004 833 that was liquidated to the Reserve Bank of Zimbabwe for the purpose of purchasing tobacco in terms of exchange control regulations but which was not subsequently availed.

On 26 July 2012, the respondent issued an amended assessment in respect of the tax year in question. He added back into taxable income of the appellant for that year of assessment the amount in dispute that resulted in a tax liability of US$453 575.22. The figure was made up of the principal amount of US$200 966.20 interest of US$51 642.82 and penalty of US$200 966.20. The appellant objected to the amended assessment on 13 September 2012. By letter of 18 March 2013, the commissioner allowed the objection of waiver of penalty in full but disallowed the objections on the principal amount and interest. The appellant was obligated to and did pay the principal of US$ 200 966.20 and the interest thereon that had increased to US$ 58 690.40 by 12 April 2013. On 27 March the appellant gave notice of appeal. The appellant's case was filed on 11 May 2013. By consent of the parties, the commissioner's case was filed on 19 August 2013.

The chartered accountant outlined the business operations of the appellant. It was common cause that the tobacco season in Zimbabwe runs from April to October of each calendar year. The tobacco trade is strictly governed by certain legal instruments (SI 61/2004) and the Reserve Bank of Zimbabwe directive of 2 May 2008, and the loan agreement from an off-shore financier and TIMB rules. The TIMB issues a yearly trading licence to tobacco merchants such as the appellant on production of the approval of the loan facilities by the External Loan Coordinating Committee of the Reserve Bank of Zimbabwe covering the full season. The appellant often received its licence by February or March in any given year. It was common cause that there were five players that interacted with the appellant in the tobacco merchant operations. These were firstly the growers of the tobacco who interfaced with the appellant either as contract growers or auction floor vendors. The second was the TIMB, which registered the appellant each year as a tobacco merchant and issued it with a trading licence. The remaining players were financial institutions. These were the Reserve Bank of Zimbabwe, the off-shore bank that availed the foreign currency required by the appellant to purchase tobacco on the local market and the on-shore bank that acted as a conduit pipe for the channelling of the foreign currency requirements of the appellant and as the authorised dealer and interloper between the Reserve Bank of Zimbabwe and the appellant. All interactions with the Reserve Bank of Zimbabwe during the negotiation of the loan facility, draft agreement, receipt of a return sheet and summary of terms and External Loans Coordinating Committee approvals were carried out through the authorised dealer. There was no direct communication between the appellant and the Reserve Bank of Zimbabwe.

The purchase of tobacco was regulated in part by SI 64/2004 and the directive from the Reserve Bank of Zimbabwe. In a nutshell the currency of account for all purchases of local tobacco, whether from contract growers or auction floors, was denominated in United States Dollars. These had to be sourced off-shore and transmitted through the on-shore bank to the Special Tobacco Foreign Currency Account for the appellant in the Reserve Bank of Zimbabwe. The account in the Reserve Bank of Zimbabwe represented a pre-payment of the anticipated tobacco purchases during each calendar year trading season. The on-shore bank kept a mirror account of the funds. The appellant would participate on the auction floor only after confirmation by the Reserve Bank of Zimbabwe of the deposit of off-shore funds into the Special Tobacco Foreign Currency Account. On purchasing the tobacco, the appellant would be invoiced in the currency of account. It would transmit the invoice to the on-shore bank which would in turn dispatch it to the Reserve Bank of Zimbabwe. The Reserve Bank of Zimbabwe would transfer the local currency equivalent of the invoiced amount to the on-shore bank. The amount would be deposited in the Zimbabwe Dollar Tobacco Special Account of the appellant held in the on-shore bank. The local currency would be paid over to the tobacco grower at the auction floor or to the contract farmer**.** The on-shore bank would make a corresponding debit in the mirror United States Dollar Special Tobacco Account it held for the appellant**.** In a nutshell the process was such that the tobacco merchant purchased the tobacco in foreign currency but paid for it in local currency. The foreign currency was sold to the central bank which converted the amount into local currency for transmission to the tobacco grower by the appellant through the on-shore bank.

In his evidence the chartered accountant basically confirmed the movement of funds between the off-shore bank and the Reserve Bank through the on-shore bank. He set out how the balance of US$1 004 833 that remained outstanding in the Special Tobacco Foreign Currency Account was calculated (p 41-42, 47, 50 and p 108 of the appellant's bundle of documents). The amount in question was part of the US$5 million that on instruction of the appellant was remitted to the on shore bank and deposited with the RBZ for the purchase of tobacco by the appellant in August 2008 for that year's tobacco purchases. There were inadequate supplies of tobacco on the market to exhaust the amount. A balance of US$2 299 070.04 remained outstanding. The Reserve Bank of Zimbabwe and the appellant agreed to roll over the amount to the 2009 tobacco season. The appellant was issued with a trading licence for 2009 in February 2009 by TIMB after it was satisfied that it had the required off-shore funds to purchase tobacco for the full season. The difference between the balances outstanding after the 2008 tobacco season and the amount in issue was set off against third parties in mutually agreed transactions amongst all the involved parties. It was common cause that the remaining US$1 004 833 was not converted by the Reserve Bank into local currency in the 2009 tobacco trading season. At that time, the local currency had been demonetised and the currency of account due to contract growers and on the auction floor was in United States dollars and not local currency. The Reserve Bank failed to avail these funds to the on-shore bank for payment of the appellant's obligations to the tobacco sellers. The chartered accountant stated that the appellant was entitled to buy tobacco to the value of the United States dollars held by the Reserve Bank of Zimbabwe and not to receive Zimbabwe dollars. In addition, the appellant remained indebted to the off-shore supplier of funds and repaid the funds and interest (p 109-112 of the appellant's bundle) in terms of the loan agreement between the parties. The loan was settled in four instalments of US$1 606 503.36 on 12 December 2008, US$632 175.88 on 31 December 2008, US$1 789 815.54 on 26 January 2009 and US$1 086 408.22 on 25 February 2009. A total of US$5 114 903 inclusive of interest was repaid to the offshore bank by 3 March 2009. The money was paid from the proceeds derived from the sale of tobacco as demonstrated by the figures on page 38 to 39 of the appellant's bundle of documents.

He stated that the missing money did not constitute planned voluntary expenditure. The appellant did not spend the money before it was lost. The funds were sitting in readiness to purchase tobacco and awaiting draw down. It was lost in the hands of the exchange control authority, a body mandated by law to be part of the core business cycle of the appellant's tobacco trading operations. The appellant would require use of the money after a sale at the stage it sought conversion into local currency to pay the farmer. The amount remains outstanding. Liability has been acknowledged. The Reserve Bank is willing but unable to pay (p 47 to 70 and especially p. 68 of the appellant's bundle of documents covering the period 15 April 2009 and 7 January 2013).

He conceded under cross examination that the loss was not a cost of sales in the ordinary sense. He, however, stated that it was money lost in the tobacco chain that constitutes the core business of the appellant. The appellant was required by law to avail the United States dollars upfront to the Reserve Bank before it could purchase tobacco. It was lost in the appellant's revenue or trading account where it was reflected as a cost of sales. He was adamant that the missing amount fell into the category of working capital before sales for which the appellant did not receive value. It constituted a normal loss in trade. It was lost in pursuit of trade. The process of the purchase of tobacco started with accessing the off-shore funds without which the appellant's trade would be stillborn. He revealed that the appellant would only access the money when it wanted it liquidated to pay the farmer.

He conceded that although the appellant had described the debt as bad in meetings and correspondence with the respondent (13 September 2012 objection in which 6 points justifying the bad debt status of the balance on p. 71 of plaintiff's bundle), it was not a bad debt as contemplated by s 15 (2) (g) of the Income Tax Act, for the reason that it did not arise from a sale. He was adamant that the loss fell into the provisions of s 15(2) (a) of the Act.

The chartered accountant gave his evidence well. He was not shaken in cross examination. His evidence was credible, relevant and material to the business operations of the appellant. The respondent did not lead any contrary evidence. His evidence stood uncontroverted. It was confirmed by the documents filed in the appellant's bundle of documents. I believed his version on how the US$5 million was sourced and drawn down. I accepted his testimony on how the sum was reduced to the sum of US$1 004 833 that was rolled over to the 2009 trading season. I accepted his version under cross examination that the funds were not availed in 2009 after the appellant had purchased tobacco and sought to draw down the lost funds.

The issue for determination is whether the appellant is entitled to rely on the provisions of s 15 (2) (a) of the Income Tax Act for the deduction of US$1 004 833 in the 2009 tax year.

The section reads:

"(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."

In *Commissioner of Taxes* v *Rendle* 1965 (1) SA 59 (SRA) at 62H-63D (which was followed by SMITH J in *S (Pvt) Ltd* v *Commissioner of Taxes* 1985 (4) SA 34 (ZH) at 38I-39D) BEADLE CJ stated that:

> "The broad test which is now universally applied there was laid down by WATERMEYER, A.J.P., in *Port Elizabeth Electric Tramway Company v Commissioner for Inland Revenue*, 1936 CPD 241 at p. 246. This test, with slight alteration in the wording, was approved by the Appellate Division in the *Commissioner for Inland Revenue v Genn & Co. (Pty.) Ltd*., 1955 (3) SA 293 (AD) at p. 299, and the test as modified by the Appellate Division has

subsequently been approved by that Division in the *Commissioner for Inland Revenue v [.p.62:] African Oxygen Ltd.*, 1963 (1) SA 681 (AD) at p. 688, and in *Commissioner for Inland Revenue v Allied Building Society*, 1963 (4) SA 1 (AD) at p. 13. This broad test, which may now be regarded as the accepted standard test, is as follows:

> 'All expenses attached to the performance of a business operation *bona fide* performed for the purpose of earning income are deductible whether such expenses are necessary for its performance or attached to it by chance or are *bona fide* incurred for the more efficient performance of such operation provided they are so closely connected with it that it would be proper, natural or reasonable to regard the expenses as part of the cost of performing the operation.'

(Note: This is WATERMEYER, A.J.P.'s test as modified by the Appellate Division).

It will be seen that this passage deals with three types of expenditure:

(1) Expenses which are necessary for the performance of the business operation;

(2) Expenses which are attached to the performance of the business operation by chance, or

(3) Expenses which are *bona fide* incurred for the more efficient performance of such business operations.

All these types of expenditure are deductible provided that they are so closely connected with the performance of the business operation that it would be

> 'proper, natural or reasonable to regard them as part of the cost of performing the operation'."

Mr *de Bourbon*, for the appellant and Mr *Magwaliba*, for the respondent, were in agreement that the determination of this matter turns on the second rung of the formulation by BEADLE CJ , that is, whether the US$1 004 833 falls into the category of "expenses which are attached to the performance of the business operation by chance."

Mr *Magwaliba* correctly submitted that the loss was not planned expenditure; the kind BEADLE CJ at 61A termed "money voluntarily and designedly spent-designed expenditure" by the taxpayer for the purpose of his trade. Put in another way, he correctly submitted that the loss was not an actual cost arising from a sale. He further submitted that the money did not fit into the category of expenditure "involuntarily spent because of some mischance or misfortune which has overtaken the taxpayer-fortuitous expenditure". He argued that the taxpayer had failed to show that the risk or mishap giving rise to the involuntary expenditure was an inseparable or a necessary incident or inherent risk of the carrying on of its business operations.

He argued that the appellant did not suffer any loss as the Reserve Bank of Zimbabwe acknowledged liability and is willing to repay the money. It seems to me the acknowledgement of a debt does not change the character of the loss to the appellant. The uncontroverted testimony of the chartered accountant was that the prepayment to Reserve Bank of Zimbabwe constituted working capital. It was designed to produce income once the Reserve Bank of Zimbabwe was advised to make good the funds to the seller of tobacco. According to LEWIS JP in *Commissioner of Taxes* v *A Company* 1979 (2) SA 409 (RA) at 410C as read with 412H-413A and 420A working or floating capital is deductible under 15 (2) (a).

Mr *Magwaliba* further argued that when the money was deposited into the Reserve Bank of Zimbabwe account it became the Reserve Bank money for which the Reserve Bank was entitled to defray as it pleased. He argued that the appellant was only entitled to payment of an equivalent amount in local currency. The money was rolled over to 2009. In my view, when payment to farmers became due in 2009, the entitlement of the appellant was not receipt of local currency but transmission of the payment in the currency of account to the authorised dealer for payment. In fact it was not correct that the money once deposited into Reserve Bank was for the Reserve Bank to utilize it as it pleased. The chartered accountant stated that the Reserve Bank was entitled to convert the currency on presentation of the invoice by the authorised dealer for payment to the farmer.

Mr *Magwaliba* further submitted that the loss was not a cost to any sale. He was correct. He was merely underscoring that it was not designed expenditure. It was common cause that the loss was for intended cost of sales. Such loss, in my view, falls into the category of expenses attached to the performance of business by chance.

In *Commissioner of Taxes* v *Genn & Co (Pty) Ltd* 1955 (3) SA 293 (AD) at 299G SCHREINER JA stated that:

> "In deciding how the expenditure should properly be regarded the Court clearly has to assess the closeness of the connection between the expenditure and income-earning operations, having regard both to the purpose of the expenditure and to what it actually effects."

To the same effect was MELAMET J in *ITC 1485* (1990) 52 SATC 337 (T) at 341-2 and van DIJKHORST J in *ITC 1587* (1994) 57 SATC 97 (T) at 103 and Van Zyl in *ITC 1588*

(1994) 57 SATC 148 (C) at 151-152. MELAMET J held that "an absolute and unconditional legal obligation must be incurred" to qualify for deduction. VAN DIJKHORST J held that expenditure actually incurred did not mean expenditure actually paid in the year of assessment but meant "all expenditure in respect of which the taxpayer incurred an unconditional legal obligation" in the year of assessment and not in the year of actual payment if the two are different. He did not limit incurred to defrayed, discharged or borne but he excluded impending, threatened or expected expenditure. In *ITC 1588* (1994) 57 SATC 148 (C) at 151 VAN ZYL J stated that:

> "The words 'expenditure actually incurred' have been authoritatively interpreted as meaning expenditure in respect of which there is an unconditional legal liability to make payment, regardless of when the liability as such is discharged. There is hence no prerequisite that payment must be effected during the year of assessment, provided the said liability has been incurred in that year. *Caltex Oil SA Ltd* v *SIR* 1975 (1) SA 665 A at 674D-E. *Nasionale Pers Bpk* v *Kommissaris van Binnelands Inkommste* 1986 (3) SA 549 (A) at 564A-B *Edgars Stores Ltd* v *CIR* 1988 (3) SA 876 (A) at 888G-889C. *CIR* v *Felix Schuh (SA) (Pty) Ltd* 1994 (2) SA 801 (A) at 807I-808A."

The unconditional liability to repay the money, the borrowed working capital was to the off-shore lender. It was an unconditional liability incurred in the previous year of assessment that was also carried forward into the 2009 year of assessment. The initial loan amount of US$5 million inclusive of the US$1 004 833 in issue had been repaid to the off-shore financier by 3 March 2009. In fact two repayments of US$1 789 815.54 and US$1 086 408.22 were made to the off-shore financier on 26 January and 25 February 2009, respectively.

Mr *de Bourbon* disagreed with the submission made by Mr *Magwaliba* that the loss was not closely connected to the appellant's business operations. He forcibly submitted that the loss of the money was an incidental risk inherent in the business of the appellant. The money was borrowed for the purpose of purchasing tobacco. It was deposited with the Reserve Bank by operation of law for payment after the purchase. It was a legal requirement for the money to be deposited with the Reserve Bank in advance of the purchase otherwise the appellant would be disallowed from buying tobacco. It is clear to me that Mr *de Bourbon* was correct. *ITC 807* (1955) 20 SATC 338 (T) is in point. In that case the taxpayer owned half the shares in a manufacturing concern that supplied it with some of its stock-in-trade. It was the taxpayer's custom to make cash advances against future purchases to its suppliers. It also made such cash advances to the manufacturing subsidiary. In the relevant year of assessment the subsidiary failed to supply stock valued at € 4 807. It was held that the outstanding balance was not a prepayment for specific goods but was a prepayment against business and was therefore deductible as a cost of doing business in terms of the South African section equivalent to our s 15 (2) (a). At 342-3 PRICE J stated:

> "We are of the opinion that the loss incurred in the present case is deductible against the income of the appellant for the purposes of assessment for tax because it was integrated in and an adjunct of the ordinary trading of the appellant. It was the way in which it carried on its business. The amount in our opinion, was correctly brought up in the trading account and is expenditure incurred in the production of the appellant's income and is not an outlay of a capital nature. In our opinion the loans were made wholly and exclusively for the purposes of trade, in the ordinary course of the appellant's business operations."

In the present matter, the appellant made advance payment to the Reserve Bank of Zimbabwe for the purpose of paying for tobacco purchases. It was the normal, customary and legal practice for the appellant to conduct its business operations. The payment was therefore integrated in and an adjunct of the ordinary trading of the appellant. The chartered accountant, in his uncontroverted testimony, stated that the money was reflected as a cost of goods in the trading accounts of the appellant and was never held as an investment. It was not revenue but working capital.

The effect of the failure to avail the amount in question was that other funds were used to pay for tobacco purchases and pay off the off-shore financier. It is clear to me that the loss of the money constitutes fortuitous expenditure that is closely linked to the business operations of the appellant.

I am satisfied that the appellant has established on a balance of probability that the loss of US$1 004 833 was fortuitous expenditure, and not an outlay of a capital nature, incurred in the ordinary course of business. The Commissioner should have allowed the deduction. The appeal succeeds.

Mr *de Bourbon* sought, in the event of success, the deduction of the costs incurred by the appellant in respect of this appeal against its taxable income in the year it is incurred. The prayer was not opposed. I will therefore grant the prayer.

Accordingly, it is ordered that:

1. The appeal be and is hereby allowed.
2. The amended assessment of 26 July 2012 disallowing the sum of US$1 004 833 is set aside.

3. The respondent shall forthwith reimburse to the appellant the tax paid in the sum of US$200 966.20 together with interest paid in the sum of US$58 690.40.

4. The respondent is directed to issue a further amended assessment allowing the deduction of the sum of US$1 004 833 in terms of s 15(2) (a) of the Income Tax Act [*Chapter 23:06]* as a deduction against the gross income of the appellant for the year ending 31 December 2009.

5. The costs incurred by the appellant in respect of the objection and this appeal, as taxed by the Registrar, shall be allowed as a deduction in terms of section 15 (2) (aa) of the Income Tax Act [*Chapter 23:06*].

Gill, *Godlonton & Gerrans,* appellant's legal practitioners