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MoneyTalk

Writing off a Bad Loan ?

Made a loan and now it's gone bad?

MANY taxpayers who've experienced the loss of a loan gone bad have tried to claim the loss on the grounds that they were moneylenders. But what are their chances of being successful?

Unfortunately for them, says Professor Peter Surtees of Deneys Reitz Attorneys, the courts have established strict criteria for deciding whether or not a loan was lost in the course of a money-lending business, for it is only then that a loan is treated as trading stock rather than a capital amount. The taxpayer in ITC 1771 66 SATC 205 is the most recent victim of these strict tests.

Surtees says the taxpayer was a company in a group, and conducted the business of an investment and financing company. Over a period of years it had advanced various sums, ultimately totalling some R24 million, to a member of the group engaged in the manufacture of shipping containers. The taxpayer also held listed and unlisted investments valued at R167 million and R10 million respectively. In addition, it made loans to other companies both inside and outside the group. In April 1996, the manufacturing debtor company was closed down after suffering consistent losses for some years owing to competition from China. The taxpayer was unable to recover any of the R24 million debt, and claimed it as a revenue loss incurred in the course of a trade as a moneylender.

The Commissioner of SARS refused the deduction, and the taxpayer appealed to the tax court.

Surtees says the crisp question for decision was whether or not the loss had been suffered in the course of the trade of a moneylender. If this was the case, the loss would have been deductible according to Corbett AJA in Stone v SIR 36 SATC 117, where he said: *"It has been accepted in a number of cases, mainly in the Special Courts, 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".*

As to when a taxpayer may be said to be carrying on such a business, the court referred to *Solaglass Finance Co (Pty) Ltd v CIR* 53 SATC1, where the Appellate Division laid down guidelines for deciding this matter:

- There must be an intention to lend to all and sundry who are eligible from the point of view of the lender.
- The lending must be done on a system or plan with a degree of continuity of lending, recovery and lending again.
- The obtaining of security is usual, though not essential.
- Occasional lending at remunerative rates is not enough: there must be a certain degree of continuity and a system.
- The proportion of income from loans to total income: however, if the proportion is small, this need not be decisive provided the other essential elements are present.

Surtees says that, as the court noted, the Solaglass case was similar to the current matter in that both taxpayers operated as the lending entities in their respective groups.

The court accepted that the taxpayer had engaged in money-lending both inside and outside the group, but the issue was whether the loans under consideration had been part of that activity or not.

In deciding this issue, it quoted with approval Van Reenen J in ITC 1650 61 SATC 72: *"A long-term loan without any repayment terms, in my view, lacks the essential characteristics of floating capital which, if it becomes irrecoverable, constitutes a loss of a capital nature".*

In applying the Solaglass guidelines, the court drew particular attention to the following characteristics of the loans between the taxpayer and the debtor:

- There were no written agreements between the parties.
- Market-related interest was calculated monthly and capitalised.
- There was no provision for a fixed date for repayment – the loans were open-ended.
- Insofar as repayments might take place, there was no differentiation between payment of capital and of interest.
- Security was neither sought nor given.

Whatever the nature of the transaction between the taxpayer and the debtor was, it was not that of a commercially acceptable money-lending transaction as described in the case law. The point that seems to have weighed most heavily with the court was that the taxpayer had no means of ever recovering its loan save at the pleasure of the debtor, states Surtees.

He says the reader is left with the impression that there was insufficient attention within the group to the need for the taxpayer to behave as a money-lender even with internal transactions.

As stated earlier, many taxpayers have tried and failed to convince the courts that they are engaged in money-lending as a trade. Surtees says it is crucial for such a taxpayer to operate its business, both intragroup and outside, as a serious trade, treating all its borrowers on an arm's length basis.

This article is written by Kathy Thersby and extracted from Tax Breaks.

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