STANDARD CHARTERED BANK ZIMBABWE LIMITED
versus
ZIMBABWE REVENUE AUTHORITY

HIGH COURT OF ZIMBABWE
KUDYA J
HARARE, 22 February and 25 April, 2007

Opposed Application

J C Andersen S.C., for the applicant

A B C Chinake, for the respondent

KUDYA J: On 12 July 2006, the applicant instituted proceedings in this Court seeking the following relief:

IT IS ORDERED THAT:-

1. That by way of a declaration of an existing and future right, that the income earned by a purchaser of a Treasury Bill only accrues for tax purposes on the maturity date of the Treasury Bill.
2. That the Respondent shall pay the Applicant's costs on the higher scale.

The *declaratur* in question was opposed by the respondent.

Counsels, for the parties, were agreed that the facts which gave rise to these proceedings were common cause, and that it was not necessary for me to canvas them. It was further agreed that in the event that the application fails, then the matter should be remitted to the respondent for further consideration, as there was insufficient information on the papers to deal with the issue of the applicable penalties and interest.

THE ISSUE FOR DETERMINATION

Both counsels were agreed that, as costs on the ordinary scale would follow the event, and as the respondent abandoned, in its heads of argument and confirmed at the hearing, the preliminary issue that it had raised which challenged the procedure used by the applicant in launching this matter in this Court, the only issue for determination was whether the face value of treasury bills and other similar financial instruments accrues to the holder on the date of issue or on the date of maturity.

THE NATURE OF TREASURY BILLS

These are freely negotiable financial instruments which fall into the same class as promissory notes, bankers' acceptances and bills of exchange. They are freely negotiable bearer debt instruments which are sold at a discount of their face value. They are used to finance commercial operations from their sale at a discount and payment is made at their face value on maturity. They may, of course, further be sold for less than their face value by any holder before maturity.

In the present matter, the applicant purchased and held onto the treasury bills, the subject of the dispute, beyond the tax year of assessment in which it purchased them during the period from 2000 to 2005. There is a plethora of legal literature on treasury bills from textbook writers and in court decisions. CHORLEY in **Law of Banking, 4th edition**, at page 98 states:

> "To discount a bill is in effect to buy it, and if the names on it be good and the price favorable, such purchases are a remunerative type of business which has been carried on by merchants and merchant bankers from very early times."

WILLIS in **Banking in South African Law: Juta 1981**, at page 143 also deals with the subject of discounting bills in these terms;

> "The discount of a bill is in fact a sale and not a loan agreement. This nature of a discount is very clearly set out in *Tucker v Ginsberg* 1962 (2) SA 58(W), approved in *Enger & Others v Omar Salem Esga Trust* 1970 (1) SA 82(N)." [At page 145 the learned author reminds us that] "it is clear then that a money lending transaction dressed up as a discount remains a money-lending transaction, but a discount remains a sale."

The American legal writer, J.T. Morse in volume 1 of his treatise published in 1888**, The Law of Banks and Banking** at page 133 treats a discount as a purchase. He wrote thus:

> "The word discount, by the usage of the commercial world and the common voice of all the dictionaries, means simply to buy at a reduction, and a loan is only one species of a discount."

For our purposes the nature of a bill is set out in *Tucker's* case, supra. In that case, Trollip J sought to determine whether the transaction before him was one of money lending or discounting a bill. He distinguished the two in the following way at 62A-:

> "The object of both discounting a bill and lending money on the strength of it is the same, namely, to provide the one party with ready money, but the nature of the two transactions is fundamentally different; according to the

> authorities such difference is “distinct and palpable”. See **de Villiers v Roux** 1916 CPD 295 where the English cases are collected, and **Maser v Meiring** 1931 OPD 74. In so far as they are relevant to the present dispute the points of difference are as follows: in the former transaction, the object is achieved by the party selling the bill before its due date for an amount in cash that is less than the amount of the bill (the difference being known as the “discount” or “discount charges)”, and on negotiation of the bill to the discounter, he becomes the owner of all the rights given by it against the various signatories thereto according to the relevant Bills of Exchange statute. The seller does not undertake to repay the amount of the bill on due date. His only obligation is to negotiate the bill to the discounter, and when he has done that, he is not under any further obligation **qua** seller to the discounter. He may, of course, be liable to the discounter as one of the signatories of the bill, if he too signed it, but that is on the bill **qua** signatory and not **qua** seller. The discounter is compensated for so laying out his money by the “discount” that he receives when the bill is finally paid. In the latter transaction, the object is achieved by the party borrowing the money from the lender and undertaking to repay an equal amount on due date, the bill being negotiated or delivered to the lender merely as security for the repayment of the loan. The borrower, whether or not he too has signed the bill, is principally liable to repay the amount borrowed, but the lender is secured by having his rights of recourse under the bill against the signatories in case the borrower defaults. The lender is compensated for so laying out his money by the “interest” that he charges the borrower. This interest can, of course, be paid in advance when the loan is made.
> As each party has given the transaction a different label, I think that it is appropriate to add here that the label used is not decisive. Despite the label, the Court must look to the nature of the transaction and not its object because, as stated above, the object is the same in both cases.”

The learned judge emphasized the need to have regard mainly to the substance and not the form of the nature of the transaction and to scrutinize the whole course of the parties conduct. I have not lost sight of the fact that the issue that confronts me and the one before Trollip J is different. His sentiments on discount and interest are in agreement with those expressed by the textbook writers and other judges. It seems to me that discount and interest are two sides of the same coin. While interest is often received before the capital is redeemed, that is, separately; discount is receipted on redemption, that is, indivisibly with the capital. Interest is often associated with a loan, while discount is concerned with the purchase by the holder of the treasury bill of a contingent right. Both the seller of the original Treasury bill and the borrower receive an immediate sum of money, while the holder of the bill and the lender receive an entitlement/ the right to the future fruits of the bill and the loan. In the words of Trollip J, the object of the holder of a bill and the lender is the same. Both desire to make a profit from their

respective capital transferred to the drawer and the borrower respectively. There remains the answer to the question whether the nature of a treasury bill and a loan, on close scrutiny, are in substance rather than form really different. That is the sub –question that I have to answer in determining whether a discount accrues on the date of issue of the Treasury bill or on its maturity.

During the month of June 2005, the respondent conducted a tax audit for the period 2001 to 2005 on the applicant. The result of the audit was the letter of 16 June 2006, in which the respondent sought audience with the applicant with a view to agree on the validity of income tax adjustments and settlement terms thereof which arose from its findings. The audit revealed a provisional non-declaration of taxable income and a liability for additional tax on treasury bills and other financial instruments of the same genre in the sum of $803 095 918 160.82(old currency), inclusive of interest and penalties. A flurry of correspondence between the parties failed to resolve the issue that now confronts me. The applicant took the firm view that "(treasury bills) do not bear interest. They are only payable on maturity and then to the bearer and the only income that is earned on Treasury bills is the income which one receives by way of a discount once the bills are paid out on maturity date. The bills are paid out to the person who is then the owner of those bills namely the bearer at maturity and no income accrues to holders of Treasury bills until the maturity date. The Applicant does not always hold (them) to maturity and often sells them prior to the maturity date."

The respondent's position was that "these instruments accrue interest on a daily basis and therefore Applicant also accrues the interest (income) on a daily basis for accounting purposes. When the Respondent undertook an audit it was discovered that at the end of each tax year, the Applicant reverses the interest accrued, but not yet received, in respect of non-matured financial instruments…… The way the Applicant computes the tax results in gross postponement of tax as the reversed amounts are only included in taxable income in the following year. However, in the case of profits being realized in each of the same financial years, the Applicant distributes dividends on the total profits, inclusive of the income accrued, but not received, on the non-matured financial instruments. This means that the reversal of income is only done for income tax purposes. However, from the information obtained in the banking sector during the audits conducted, Respondent established that the banks' computerized accounting system

automatically accrues interest on each investment as the year progresses. It is therefore possible for the Applicant to determine the interest due up to a certain point, for example, daily, weekly, monthly or yearly even before the full maturity of the financial instrument. Having realized that the Applicant was computing tax on various instruments in a way that postpones its payment, adjustments were made with the respective income being taxed on an accrual basis."

It is noteworthy that the Applicant accepted the factual aspects of the averments made by the Respondent on how it treated the discounts of treasury bills and identical financial instruments in its accounts. It however averred that the requirements of the Income Tax Act dictated the difference with its statutory accounts from which dividends were paid out after tax. The use of the emotionally charged expletives "extraordinary" and "actually dishonest" by the deponent to the Applicant's answering affidavit did not add any value to its averments. Reference to "accounting purposes" in contradistinction to income tax purposes was explained by that deponent in these terms:

> "The manner in which accounts are kept does not establish taxable income. It is return made in terms of the Income Tax Act which establishes taxable income, taking account of Court decisions on the said Act. For accounting purposes the discount on treasury bills and like instruments is required to be brought to account evenly over the period from purchase to maturity and the book value of immature instruments adjusted to fair value at financial period ends. From time to time the Applicant has to sell bills prior to maturity and the amount then recovered, is, less than the income brought to accounts and the estimated fair value. If the sale has to be done unexpectedly because of an urgent need for liquidity, the amount recovered is often very much reduced. The amount recoverable on a sale before maturity varies in accordance with the market conditions at the time and in our highly inflationary financial environment is not predictable. Certainly it cannot be said that the amount recoverable on a sale prior to maturity, will equal the amount of the total discount at a particular time reduced proportionately by the amount of unexpired time to maturity date, divided by the total time between the purchase and maturity date. In other words the discount which accrues on maturity does not accrue evenly on a day to day basis, in reality."

The Applicant's averments, as I will demonstrate in the course of this judgment, lean and rely heavily on the exposition of the law in this field by the English courts in the *Willingale* case commencing from the decision of the General Commissioners through the High Court and the majority decisions in the Court of Appeal and the House of Lords, respectively. These are conveniently located in the following law reports:

1. *Willingale (Inspector of Taxes) v International commercial Bank Limited* [1976] All ER 468 [Ch D] [the first Willingale case]
2. *Willingale (Inspector of Taxes) v International Commercial Bank Limited* [1977] 2 All E R 618 [CA] [the Court of Appeal decision]
3. *Willingale (inspector of Taxes) v International Commercial Bank Limited* [1978] I All 2455 ER 754 [HL] [the final decision of House of Lords decision]

THE ENGLISH APPROACH

The English courts where confronted with the same issue. The facts in the *Willingale* case were these: the taxpayer bank was incorporated in 1967 to provide medium term finance in world markets to commercial companies. At all relevant times its business included the discounting of or the purchase of discounted bills of exchange issued by borrowers all over the world. It usually held some of the bills to maturity but sold others prior to maturity. It drew up its annual accounts in the customary manner followed by clearing banks of including a portion of the profits the bank expected to make if its bills were held to maturity. It did not change the form of its accounts for assessment to tax. In assessing the bank for income tax for the periods ended 31 December 1967 to 31 December 1970, the inspector of taxes included a proportion expected from profits arising on maturity or sale of the bills.

The case before the General Commissioners for the City Division of London was whether in ascertaining the profits of the bank for corporation tax purposes under Case 1 of Sch D as set out in s 108 of the Income and Corporation Taxes Act 1970 and s 122 of the Income Tax Act 1952 , in the case of bills of exchange (including promissory notes) discounted or bought by the bank and held until maturity or sale, a proportionate part of the expected profit on maturity or sale referable to the accounting periods in question fell to be included in the computation of the assessable profit of the bank during the tax year in which they were discounted or purchased by the bank.

The General Commissioners, as reported in the first *Willingale* case at page 470f-h, scrutinized the nature of the discounted bills and notes and held that the inclusion by the bank in its accounts of the unrealized appreciation in the value of the bills and promissory notes was not in accordance with the principles of income tax law for the computation of profits and that these anticipated profits could not be assessed for corporation tax.

The taxman took the decision on appeal to the Chancery Division. WALTON J upheld the decision of the General Commissioners. At page 474e, the learned judge recognized that "over a period of time the whole of the profits on any particular bill must be caught in one way or the other for tax purposes; but by postponing liability (if they are in fact entitled to do so) the bank obviously improves very considerably its cash flow, and that is what this case is all about." The nub of the matter, in his view, lay in whether in law, in general accountancy practice or in bank accounting practice there was a distinction between earning interest throughout a period and earning discount throughout a period.

I found his rendition of the differences between interest and discount illuminating. At page 474g-j he observed that:

> "A bill is the embodiment of an obligation on the part of X to pay a sum of £Y at a future date. I f, of course, the bill carries interest, then that interest will be dealt with in the normal manner, on an accrual basis, and so may for present purposes be left entirely out of account. That obligation is one which remains the same the whole time; it does not in any way change, nor have anything added thereto, nor produce any fruit. All that happens is that, as the years roll by, its value becomes closer and closer to the full amount of £Y. In the summary of the bank's balance sheets the Crown have labeled one section 'Bills included above (with accrued discount)'. But this appears to me to be a misconception. Discount does not in any way accrue. What happens is that the value of the bill increases by reason of the closer approach of the maturity date; the discount diminishes. If it is an accrual at all, it is a negative accrual."

He saw nothing untoward in the manner in which the bank had prepared its accounts as this was the conventional method used by clearing banks. Such a method was a better economic indicator which showed shareholders that the money that was disbursed in the purchase of the bill was not an idle expense but was steadily making a profit for them. **The most important question, which to him was a pure matter of fact, was to determine when the bank does make a profit out of the purchase of the bill. The only answer was that it does so when it sells or holds it to maturity. H**e held that from the nature of the discounted bills, no part of the anticipated profits on maturity were subject to corporation tax in the tax years of assessment in question and thus upheld the General Commissioners' decision.

The decision of Walton J was taken to the Court of Appeal by the taxman. The majority (ORMROD LJ and SIR JOHN PENNYCUICK) confirmed the decision of the lower court, while STAMP LJ dissented and found for the taxman.

Stamp LJ at 622e regarded the nature of the bank's discounts (or premiums at which they were made payable) as interest or the reward for capital lent. He saw no objection in the law relating to income tax treating the reward as being earned and accruing over the period (life of the bill-tenure) while the money advanced is outstanding. Having treated the discounts as interest, he came to the conclusion that the bank had earned a pro-rata share of the discounts and was therefore amenable to corporation tax for it in the year of assessment.

Ormrod LJ at 628e-g used the specimen transaction highlighted in argument where the bank bought for £1 000 a bill of the face value of £1 500 payable in five years. The bank's contention was that the profit would be realized when the bill is redeemed or sold and should be brought into account in the year of the sale or redemption while the taxman contended that on acquisition the taxpayer becomes entitled in law to the payment of its face value in five years time but is required to account for the pro-rata share of profit in each year of assessment over the five years.

He also recognized that the proposition advanced by the taxman was that "as money earns interest in the latter case, so in the former it earns discount." At page 628 h-j, he made short shrift of this contention in the following manner:

> "This is like saying that because two roads run from A to B, they are the same road. Money 'earns' interest the lender becomes entitled to it during the year of account; in the instant case the bill appreciates in value in the bank's safe, very much as stock- in-trade may increase in value in the trader's stores. The bank holds a single large debt, not a succession of five small ones. On this view the difference is ultimately one of fact, which may account for the difficulties in expressing it in terms of legal principles."

Sir John Pennycuick, with whom Ormrod LJ agreed, dealt with the distinction between interest and discount at 630e in this way:

> "It is worth while to make one or two observations with regard to interest. Plainly, interest has many features in common with discount, but it differs from discount in this critical respect that interest accrues from day to day and is usually paid at periodical intervals in each year, whereas nothing accrues or falls due for payment under a discount transaction before maturity."

The taxman took the matter to the House of Lords, where the majority (Lord Salmon, Lord Fraser of Tullybelton and Lord Keith of Kinkel) held that the taxpayer was not liable for corporation tax on the discounts in question. Lord DIPLOCK and Lord RUSSELL of Killowen dissented.

The dissenting Law Lords adopted the approach of STAMP LJ that the transaction entered into by the bank was a loan of money repayable by a larger sum at some future date and not an acquisition of an asset similar to any chattel. Their opinion was that the essential nature and content of the discount on the bills was no more than disguised deferred compound interest, which was conveniently reflected in the taxpayer's accounts in linear form.

Lord Fraser of Tullybelton provided at 758c the wording of the section in the relevant English statute that they were discussing. It reads:

> **"1. Tax under this Schedule shall be charged in respect of—(a) the annual profits or gains arising or accruing--…. (ii) to any person resided in the United Kingdom from any trade, profession or vocation….."**

Lord Salmon held that a bill may not be taxed until it was realized. In his opinion realized did not mean "received" but meant "ascertained and earned." The tax would be levied in the fiscal year of sale or maturity notwithstanding that the drawer defaults and the discounter does not receive any cash.

Lord KEITH of Kinkel, at page 766a-h, had regard to the nature of the transactions of the bank. He stated thus:

> "In each case a sum of money is paid out by the bank in a particular year and in return for it the bank receives a bill of exchange, a chose in action. The bill obliges the issuer to pay the bank a larger sum at the expiration of a number of years. The situation presents some analogy to the purchase by a trader of goods, which he expects later to sell at a profit, so that one might have expected to see the bank in the year of purchase enter the cost of the bill in its profit and loss accounts as a debit, in subsequent years to enter as a debit the cost or market value of the bill whichever was the less, and in the year of maturity to enter as a credit the face value of the bill, whether or not it was actually paid in that year. But here the cost of the bill does not enter the profit and loss account; it goes into the balance sheet. It is only the difference between the cost and the maturity value of the bill which ever finds its way in the profit and loss account in annual fractions over the period to maturity**. There can be no doubt from the beginning that the issuer of the bill is under a present obligation to pay the bank a sum certain on a particular future date. So there is attraction in the view that under the principles to which I have referred the bank, since it has by the transaction received in return for its payment the present right to receive a larger payment at a future date, should bring into its profit and loss account on the credit side the**

> **value of that right, suitably discounted, the payment out being likewise brought in on the debit side. But that again is not what was done, nor is it suggested that it should have been done. Nor has the amount of profit expected been brought at a valuation or at a discount.** **The reason why accounts prepared in the manner adopted by the bank show a true and fair view of its profits over the years is that, in order to have funds available for its bills at exchange transactions, the bank borrows money at interest. The interest payable each year goes into the debit side of the profit and loss account and it is with the object of showing what benefit there is to counterbalance these payments that a fractional part of the discount on the bills is taken into the account on the credit side in each year. But it is not accurate to say that the interest payments are earning these fractional parts of the discount. The borrowing transactions and the bill of exchange transactions are separate and distinct from each other. It is the bill of exchange transactions on which attention must for present purposes be concentrated. The substance as well as the form of these transactions are such, in my opinion, that the bank is by them acquiring assets which in the future it expects to realize at a profit. It is not reasonably to be regarded as rendering services to the issuers of the bills for which the latter there and then become liable to pay. The case stated speaks of the bank making a profit when the bills reach maturity, and I think that is in accordance with the plain common sense of the matter. What goes into the profit and loss account each year is a fractional part of what it is hoped the profit will ultimately be, although it is found in the case stated that the amount of the profit is not ascertainable, due to a number of circumstances, until the bill is sold or reaches maturity. So I am of the opinion that the** ***assessment of the bank to corporation tax on the basis of account made up in this way does contravene the rule that a profit may not be taxed until it is realized."(emphasis and underlining is my own)***

Lastly, Lord Fraser of Tullybelton also dealt with the nature of the bills of exchange in question. The bank used the terms 'accrued discount' and 'earned discount', which the learned law lord described as being "no more than convenient short hand descriptions….obviously not accurate, for discount, unlike interest, does not accrue and is not earned, and (such) expressions (were) apt to be misleading*.*" He saw the use of the epithet 'accrued discount' during the tenure of the bill as no more than the anticipation of profits awaiting realization.

After all, his view was that interest accrues from day to day or at fixed intervals, while discount does not. At page 760d-h, he provided two distinctions between interest and discount. These were that interest is realized from time to time and can be calculated in advance, discount is not realized until the bill is sold or matures leading to the postponement or roll up of profits and is neigh

impossible to calculate profit on any given date while the bill is still extant. He observed that the bank's discounts were in reality an acquisition of assets (not a rendering of service) and that so long as these were held; the bank could not realize any profit or loss.

THE SOUTH AFRICAN APPROACH

It all starts from *Lategan v Commissioner for Inland Revenue* 1926 CPD 202. A wine farmer sold wine in May 1920 for £5 924, of which £3 500 was payable in the year of assessment ended 30 June 1920 and the balance in the following year of assessment. The taxman claimed that the whole purchase price was part of his gross income for the existing year of assessment ended 30 June 1920. The taxpayer contended that the instalments payable in the following tax year should be excluded.

The matter was referred as a stated case by the Special Income Tax Court to the Cape Provincial Division. The relevant question being- that seeing that appellant, a farmer, during the year of assessment sold his harvest subject to conditions which stipulated payment should be effected in instalments, some of which fell due subsequent to the year of assessment, should the instalments which in terms of the agreement were not payable during the year of assessment be regarded as gross income within the meaning of section 6 of Act 41 of 1917? 'Gross income' was defined in s 6 as

> **'The total amount received by or accrued to or in favour of any person other than receipts or accruals of a capital nature...'**

Watermeyer J, with whom Benjamin and Louwrens JJ concurred, at page208 distinguished receipts from accruals. Receipts were not limited to the tax year in which the work was carried out or capital employed. The time of receipt was paramount. For earnings which were due but not received, the time when the work was done was looked to and not the time of receipt. He observed that the "same sum of money may accrue in one year and be received in another" but was categoric that "it could never have been intended that income tax should be paid twice over." He further noted that an amount may both accrue and be received in one year, even for work done in another year.

He held firstly that the taxpayer's taxable income included not only the cash which he has received or which has accrued to him but also the value of every

other form of property he has received or has accrued to him, including debts and rights of actions.

At page 209-211, he dealt with the treatment of a debt payable in the future in the following way:

> "It was argued, on behalf of the appellant, that a debt payable in the future was not an amount of money "accrued to" the taxpayer, and consequently it was not part of his "gross income," and a number of cases were cited on the meaning of the word "accrue."
>
> In my opinion, the words in the Act, "has accrued to or in favour of any person," merely mean "to which he has become entitled."
>
> So far as a debt is concerned which is payable in the future and not in the year of assessment, it might be difficult to hold that the **cash amount** of the debt has accrued to the taxpayer in the year of assessment. He has not become entitled to a right to claim payment of the debt in the year of assessment, but he has acquired the right to claim payment of the debt in future. This right has vested in him, has accrued to him in the year of assessment, and it is a valuable right which he could turn into money if he wished to do so.
>
> According to what has been stated above, the value of this right must, in my opinion, be included in the taxpayer's gross income for taxation purposes.
>
> There are, no doubt, difficulties in the way of this interpretation of the Act. There are, for example, many cases in which the Court has held that unpaid debts are not **"income**." See, for example, **St. Lucia Usines v St. Lucia (Colonial Treasurer**) (1924, A.C. 508) and certain Australian cases referred to by Rydge**, Commonwealth Income** Tax, p. 144, decided on the meaning of a section of the Commonwealth Act which is very similar to sec. 9 of Act 41 of 1917. But the Acts upon which those cases were decided were in terms different from the South African Act.
>
> The main difficulty which I feel in the way of the view which I have expressed is caused by the terms of sec. 21 (2) (e) of the Act. This section, while it supports the view that unpaid debts are "gross income," makes it appear that unpaid debts must be brought up in the return of "gross income" at their face value, and not at their actual value, but that a deduction can be made for bad and doubtful debts to arrive at the "taxable income."
>
> If this is so, then "debts owed to the taxpayer" from an apparent exception to the general principle that "gross income" consists of the "value" of the taxpayer's earnings, whatever their form may be.
>
> But the exception may be more apparent than real, if sec. 21(2) (e) is construed not as a section creating a new deduction in addition to those contained in section 17, but as a section merely providing a method for fixing the value of the debts to be brought up as "gross income" before any deduction is made to arrive at taxable income.
>
> In my opinion, therefore, the answer to the first question in the special case is that the instalments must be regarded as gross income, but something must

> be deducted from their face value to allow for the fact that they are not payable at the close of the year of assessment. Assuming that the right to receive the instalments was not converted into money by the sale or otherwise during the year of assessment, the value to be fixed (apart from any question whether the debt was good or bad) would be the present worth of the instalments at the end of the year, i.e., 30th June, 1920."(**Underlining my own for emphasis.)**

This case has been followed in many cases in South Africa. In *ITC 1488* (1991) 53 SATC 56, The Cape Special Court (per Howie J) was in large measure influenced by this case in equating accrual with entitlement, and held that where a taxpayer makes an election to exercise one of a number of benefits that arise on resignation of employment, that benefit accrues to him not on the date of resignation but on the date that his election is accepted.

In *Commissioner for Inland Revenue v Cactus Investments (Pty) Ltd* (1997) 59 SATC 1 (T), a case concerned with the issue of whether in a fixed period loan agreement (where the loan was paid over and interest was payable on due date at the end of the fixed period) interest accrued to the taxpayer on the date on which the loan agreement was transacted or on the due date. The taxpayer ceded the interest before the due date to various financial institutions that in turn ceded their rights to dividends in certain of their investments to it. The principles that were enumerated in the *Lategan* case were applied. At page 12-13 Southwood J, [(with the concurrence of Ginsburg AJ) and Wunsh J coming to the same conclusion but for different reasons] stated that:

> "In order to accrue in terms of the Act a right must be unconditional (**Ochberg v Commissioner for Inland Revenue 1933 CPD 256 at 264; Hersov's Estate v Commissioner for Inland Revenue** 1957 (1) SA 471 (A) at 481H-482A; **Mooi v Secretary for Inland Revenue** 1972 (1) SA 675 (A) at 684B-G). The words 'received by or accrued to or in favour of' in the definition of 'gross income' mean a receipt by or an accrual to or in favour of the taxpayer on his own behalf or for his own benefit."

It was held at page 17 that the taxpayer's right to claim interest was not subject to any further performance of any obligation by it but to a time provision, it vested in the taxpayer on the day each investment was made and therefore accrued to it on that date as gross income in terms of s 1 of the Act.(Wunsh J came to the conclusion at page 34, that the interest accrued on the maturity date during the same year of assessment that the loan agreements were transacted but as the

rights to the interest were ceded before they accrued, the interest due was not gross income in the respondent's hands.)

The last South African case that I will refer to is *Commissioner for Inland Revenue v People's Stores (Walvis Bay) (Pty) Ltd* 1990 (2) SA 353 (AD). It concerned the application of gross income as defined in section 1 of the Income Tax Act, 58 of 1962 which stated as follows:

> **"gross income" in relation to any year or period of assessment, means, in the case of any person the total amount, in cash or otherwise, received by or accrued to or in favour of such person during such year or period of assessment from a source within or deemed to be within the Republic, excluding receipts or accruals of a capital nature...'.**

The respondent taxpayer sold its wares to its customers for cash and on credit. The bulk of the credit sales were under a six-month –to-pay revolving credit scheme. At the 1983 tax year end there remained outstanding a sum of money which represented instalments whose payments dates fell in the succeeding tax year. The taxman assessed them to tax in the year of sale. The taxpayer appealed to the Special Court, in the main on the basis that these instalments were not an amount in cash or otherwise, received by or accrued to or in favour of itself and in the alternative that they ought not to have been included in its gross income at their face value but rather at the present market value of the right to receive them in future. The special court held that these instalments were properly assessed to tax as gross income and that these outstanding debts had to be valued at their market value. The taxman appealed against the alternative ruling while the taxpayer cross-appealed against the main ruling.

HEFER JA, who wrote the judgment of the full Court extensively quoted, approved and applied the *Lategan* case. He accepted that the word amount covered "every form of property earned by the taxpayer, whether corporeal or incorporeal, which has a money value….including debts and rights of action." He further accepted that "any right (of a non-capital nature) acquired by the taxpayer during the year of assessment and to which a money value can be attached forms part of the gross income irrespective of whether it is immediately enforceable or not, but that its value is affected if it is not immediately enforceable." He thus determined that "accrued to or in favour of" meant "to become entitled to" and not even the narrower "due and payable" ascribed to it in *Commissioner for Inland Revenue v Delfos* 1933 AD 242.

THE ZIMBABWEAN APPROACH

Mr. *Andersen* referred me to 3 local cases of *Building Contractors v Commissioner of Taxes* (1941) 12 SATC 182; *ITC 1068* (1965) 27 SATC 141; *Barclays Bank of Zimbabwe v Zimbabwe Revenue Authority* SC 31/06 (a limited appeal in *Barclays Bank of Zimbabwe* v *Zimbabwe Revenue Authority* HH 162/2004) while Mr. *Chinake* referred to 2 local cases of *Barclays Bank of Zimbabwe v Zimbabwe Revenue Authority* HH 162/2004); and *Barclays Bank of Zimbabwe v The Commissioner General- Zimbabwe Revenue Authority* HH 9/2006.

The *Building Contractors* case, *supra,* involved *inter alia* the determination of the stage at which retention money that was released on the strength of an engineer's certificate of no defects, in terms of the contract, three months after the completion of construction, accrued to the building contractors. That is, whether it accrued on the date when construction was completed or on the date the no defects certificate was issued. Construction was completed in a different tax year while the certificate which triggered the release and the payment were both done in the succeeding tax year. The taxman assessed the retention payment during the latter year. The building contractors appealed to this Court on the basis that the retention money had accrued to them during the tax year in which construction was completed.

Hudson J, dealt with the issue in the following manner:

> "It will thus be seen that the first ground of appeal depends on the application of the words "has accrued to or in favour of any person" appearing in sect. 9 (1) of the Income Tax Act. The meaning of the words has been considered in various cases decided in the Courts of South Africa. **In Lategan v Commissioner for Inland Revenue** (1926, C.P.D. 203) WATERMEYER, J., defined them as meaning "to which he has become entitled". While this meaning was adopted by WESSELS, C.J., in **Commissioner for Inland Revenue v Delfos** (1933, A.D. 242), DE VILLIERS and STRATFORD, JJ.A, in the course of their judgments in the latter case expressed the view that "accrued" means "due and payable". If the latter view is correct then, as Mr.**Greenfield** admitted, the appellants' first ground for appeal must fail. Though there is much to be said in favour of applying the meaning "due and payable" to "accrued"—particularly the use of the former expression in sec. 10 of the Act—I propose to adopt for the purpose of this case the meaning enunciated in **Lategan's case."**

The learned judge held that, as in terms of the contract there would be no final ascertainment of the amount of the final payment until the engineer had given his final quittance, the retention money accrued on the date on which the no defects certificate was issued. It was at that stage that the building contractors

became entitled to the retention money. [it is worth recoding that the interpretation that Hudson J rendered to the words “due and payable” in section 10 of the Act then in force latter found resonance with the reasoning of Hefer JA in the *People’s Stores (Walvis Bay*) case, *supra,* half a century latter].

In ITC 1068, a consultant engineer gave his services in 1948 in the erection of thermal power stations to the then Electricity Supply Commission of Southern Rhodesia at a discount predicated on condition that all the contracts would be carried out and he would be the consultant engineer for all of them. A change in legislation in 1954 resulted in the breach of the condition and the termination of the consultancy by the ESC in 1956. The engineer sued ESC for the discount he had provided it over the 8 year period. An out of court settlement was reached and he was paid out a certain amount during the tax year ending 31 March 1963. The taxman included this amount in his gross income and assessed it to income tax in the year of receipt. He appealed to the Special Court on the basis that the amount paid had accrued to him in each of the 8 years in which he had given the discount and should not have been assessed in the year of receipt. The learned acting President equated “accrued” with “due and payable” and held that the engineer became entitled to the amount that was paid out to him “only when liability was determined in the settlement reached in the 1962-3 tax year.” In any event, he went on to find that as the amount had not been assessed to tax before, the taxman was entitled to assess it either on the basis of accrual or receipt. While the decision was correct as regards assessment premised on receipt, the definition favoured for accrual conflicts with the one given in the *Lategan* case. It would appear that the settled amount accrued on the date on which ESC breached the contract by making the decision to terminate his services.

The three *Barclays bank* cases, *supra,* raise interesting points which are apposite in the resolution of the issue before me. In the 2004 High Court determination, MAKONI J dealt with five main areas of contention of withholding taxes; management share option scheme; restraint of trade; non- residents tax on interest and excessive penalties on the amounts conceded by the taxpayer. The taxpayer appealed against the determination on the management share scheme only, thereby limiting the focus of the Supreme Court to that issue. Both counsel highlighted as forceful and valid reasoning the words of DENNING LJ in *Abbot v Philbin* [1960] 2 All E.R. 763 (HL) at p 777F-778C, quoted with approval by ZIYAMBI

JA in the Supreme Court *Barclays* case at p 8-9 of the cyclostyled judgment. They sought to extrapolate the poetic prose of the non- taxability of a bird in the bush as against the taxability of one in hand to the question whether a discount before maturity was a bird in the bush or in hand. As I understood both ZIYAMBI JA and DENNING LJ, the pith of their proposition was that a share option accrues to an employee when he or she accepts the offer (and receives the shares) and not before. No real guidance however emerges in resolving the issue before me, as no similar issue was before the Supreme Court and the House of Lords in the share option scheme cases.

MAKONI J, however, did deal with the issue of whether the discounted value received by the borrower and the face value of the bill of exchange was discount earned and not interest for the purposes of the 16th schedule of the Income Tax Act. On the basis of the facts before her the learned judge felt inhibited by the failure of the taxpayer to attach all the tobacco lines of credit loan agreements and all the general offshore lines of credit agreements, as the samples that were before her depicted different positions, to determine the true nature of the transaction, that is, whether the benefit that accrued therefrom was an interest yield or a discount yield. Notwithstanding this constraint, by reference to the definition of interest in the Oxford Concise Dictionary, she held that discount earned bore the same meaning as interest. This was because "in paying the face value of the bill, on the date agreed, the borrower pays an advantage or profit over and above the value he actually received in exchange of the bill." In arriving at that decision she differentiated the meaning of interest ascribed in the 21st schedule by the amendment as relating to that section and believed that she could interpret the same word which appears in different sections differently too.

In *Barclays Bank of Zimbabwe v The Commissioner General* HH 9/2006, sitting as the Special Court for Income Tax Appeals, HLATSHWAYO J, was confronted with the same issue of whether a discount accrues on date of issue or maturity. He was there dealing with a promissory note, and he made a specific finding that the documents that purported to be a promissory note was not "a true bearer promissory note". He did not specify what it actually was but implied that it was a loan agreement to which the taxpayer "had become entitled to the interest accruing from the instruments up to the end of each year of assessment" as demonstrated by the acknowledgement in its letter to the taxman of 19th July 2002

"that it raised interest accrual entries in compliance with International Accounting Standards." If I am correct that this is what was implied, then that implication would be based on weak ground as the taxpayer's commercial accounting procedures do not override the language of income tax legislation and decided cases on the point. See *Sub-Nigel Ltd v CIR* (1948) 15 SATC 381.

HLATSHWAYO J did however consider the meaning of sections 8 (1) and 10 (7) of the Act. At page 3 of his cyclostyled judgment he stated thus:

> "Section 8(1) requires to be included in the gross income any amount "received by or accrued to or in favour of a person or deemed to have been received by or accrued to or in favour of a person in any year of assessment…". In terms of section 10(7) an amount is deemed to have accrued in the year of assessment in which the taxpayer becomes entitled to it, despite its being only due and payable to him or her in a future year. Where, however, a taxpayer's entitlement to an amount remains conditional at year end, it has been suggested on the basis of the principle in **Mooi v SIR**(1971) 34 SATC 1, that there is no accrual in that year. See E.W. Hill, **Income Tax in Zimbabwe,** 5th ed. P5-6 and the cases discussed therein.
>
> Can it be said, therefore, that the facts of this case fall within the circumstances where the taxpayer's entitlement remains so conditional that there is no accrual in that year? The answer to this question depends on whether the instrument in issue is a true bearer promissory note with capital and interest redeemable only at maturity or some other evidence of indebtedness. **The taxability before the date of redemption of interest earned on a true bearer instrument would appear to be insupportable by the language of the Act and case law unless some element of discounting of such interest to its value at year end was undertaken."**

The learned judge concluded by stating that maturity was only a condition of payment and not a condition for accrual, thereby holding that a discount accrued on issue and not on maturity. I must confess that I was not able to find "the force and validity of the reasoning upon which the order is based" to use the formulation of RUMPFF JA in *Mooi's* case at p 686.

The effect of the two subsections clarifies in our legislation that "accrued to" is at times not only distinct and separate from but may occur earlier in time than both "received by", and "due and payable". Section 10(7), in my view, underscores the correctness of the meaning ascribed to "accrued to" in *Lategan's* case as "to become entitled to".

THE COMPETING SUBMISSIONS

The applicant submitted that an amount only accrues in terms of section 8 of the Act when an entitlement to payment arises. Further that where payment is subject to conditions an entitlement to payment only arises when the conditions are fulfilled. Lastly, that those accounting procedures which may be followed by a taxpayer do not create a right which does not otherwise exist.

The respondent countered these submissions by contending that the maturity of the Treasury bill and other related financial instruments is only a condition of payment and not an accrual of interest and therefore the holder of the bill becomes entitled to income from it from the date of purchase. It argued that the fact that the applicant had in its commercial accounts credited earned but not yet received discount demonstrated that it had in truth and in fact calculated the income represented by the pro-rata amount of the discount received for each year of assessment despite the fact that actual maturity dates for the various investments would occur later.

THE RESOLUTION

It is not necessary for me to cite in full the provisions of section 8 (1) and 10 (7) of the Income Tax Act. The first defines gross income by the use of the words “received by or accrued to or in favour of a person or deemed to have been received by or accrued to or in favour of a person in any year of assessment…”, while the latter clarifies that where a taxpayer becomes entitled to an amount in the first year of assessment, which is due and payable in a future year, he is deemed to have accrued it in that first year.

The parties are agreed that a discount accrues. The dispute is centered on whether this occurs on the date of purchase or on the date of maturity. The applicant averred that a discount is not interest and should not therefore be treated in the way that interest is treated. The respondent says it is interest and should therefore be treated in the same manner as interest.

I am, of course, not bound by either English or South African case law. They, however, would be persuasive authority. I am also not bound by the decisions of MAKONI J, who has concurrent jurisdiction with me nor by that of HLATSHWAYO J, in the Special Court, but both carry persuasive authority too. There is no available Supreme Court decision on the point to guide me on which direction to take.

The English position, enunciated in the *Willingale* case, is that discount is not interest. This also appears to be the position in South African, regard being had

to the exposition in *Tucker v Ginsberg*. The local position as enunciated in the *Barclays Bank* cases is that the two are the same. MAKONI J arrived at this conclusion by reference to the definition of interest found in the Oxford Concise Dictionary.

The word discount neither appears nor is it defined in the Act. The Shorter Oxford Dictionary defines it in the following ways:

"**Discount, *sub* 1.** an abatement or deduction from the amount or from the gross reckoning of anything **2.**

Commerce a. a deduction made for the payment before it is due or prompt payment, of a bill or account; any deduction or abatement from the nominal value or price. **b. the interest charged for discounting a bill of exchange or promissory note; 3. the act of discounting a bill---at less than nominal value, below par;**
Bankers or merchantile discount: interest on the amount of a bill for the time it has to run; true discount: interest on the present worth of a bill.

Discount, *verb*--- to reckon as an abatement or deduction from a sum due; to deduct; **2.** to give or receive the present worth of (a bill or note) before it is due……….".(Emphasis my own).

The Concise Oxford Dictionary defines the word as follows "deduction from amount due or price of goods in consideration of its being paid promptly or in advance; deduction from amount of bill of exchange by one who gives value for it before it is due; …..Give or get present worth of (bill not yet due);"

It would appear that when regard is had to the definition in the Shorter Oxford Dictionary with reference to bills and promissory notes by bankers and merchants, the word discount carries a technical meaning which is synonymous with interest. It would appear therefore that MAKONI J's finding, in the context that confronted, may have been correct. She preferred interest to mean advantage or profit and ignored the other dimension in the definition of interest in the same dictionary of "money paid for use of money lent or for forbearance of debt;" This other dimension also reveals the similarities between interest and discount. A discount would also be money paid for use of money lent. It seems to me, with respect, that the distinctions made by Ormrod LJ at 628h-j and Sir John Pennycuick at 630e in the Court of Appeal; and Lord Fraser of Tullybelton at 760d-h in the House of Lords was of form rather than substance. A discount, from its definition, is

as a matter of hard fact in reality no more than disguised but deferred interest. That in my view is the true nature of all the freely negotiable bearer debt instruments such as treasury bills. It is on this basis that I find that the dissenting decisions in the English Court of Appeal and House of Lords on the point provide persuasive reasoning than the majority ones.

Mr. *Chinake's* submissions were tailored along the reasoning of Stamp LJ in the Court of Appeal at 622d-f. He regarded the discount or premium as a reward given by borrowers for the use of capital, earned and accruing over the period that the advanced money was outstanding. At 622f, the learned Lord Justice stated thus:

> "The principal and discount can be disentangled, because the principal is the amount paid for the bill, and the discount represents interest compounded annually at a fixed rate over the whole period of the bill. Similarly, the amount of discount attributable to each year over the period until maturity can be readily ascertained."

In his view the taxpayer had done all that was required of it to earn the money payable. It was this reasoning that both Lord DIPLOCK and Lord RUSSELL of Killowen found persuasive in their dissenting opinions in the House of Lords. Lord RUSSEL equated the payment on maturity with the payment of deferred interest in a straight forward loan agreement and thus held that it would have been earned on purchase and not on maturity.

In our law, as in both English and South African, the position is the same as regards the primacy of the language of the Act over the accounting preferences of the taxpayer in compiling its tax returns. See the *Sub-Nigel* case at page 389, referred to by HLASHWAYO J. in the Special Court case involving *Barclays* bank. I therefore accept Mr. *Andersen's* submission that the taxpayer's accounting procedures do not create a right which otherwise does not exist. The manner in which the taxpayer compiled its statutory accounts in order to demonstrate a true and fair view to its shareholders may not have been indicative of the discount that it in truth and in fact had earned. Walton J, in my opinion correctly recognized that banks often hold these instruments to augment their cash flow from the perceived tax savings shown in the commercial accounts as "discount accrued" which, in the matter *in casu*, were then reversed in each succeeding tax year. The other reason for posting such entries on the credit side of the profit and loss account was accurately explained by Lord Keith of Kinkel at page 766, which is, to show to the

shareholders that the money lent is not idle but is working towards the production of the discount payable on redemption.

Mr. *Andersen* further contended that the discount did not accrue on purchase but would do so when the applicant became entitled to payment at the latest on maturity or on any earlier date of disposal. He forcibly argued that the condition precedent to entitlement was the agreed date of payment. Mr. *Chinake* was in agreement that the date of accrual was dependent on entitlement, not of payment but of the discount itself. He appeared to concede that the suggestion proffered by *Hill* in *Income Tax in Zimbabwe* that "where, however, a taxpayer's entitlement to an amount remains at a year end……on the basis of *Mooi v SIR……* there will still be no accrual in that year." HLASHWAYO J. agreed with *Hill* and held that the taxability before the date of redemption of interest earned on a true bearer instrument would appear to be insupportable by the language of the Act and case law unless some element of discounting of such interest to its value at year end was undertaken.

I read the phrase "entitlement to an amount" to mean accrual of the amount. I do not understand it to mean entitlement to payment. The *Building Contractors* case and *ITC 1557* (1993) 55 SATC 218(a South African case) demonstrate the meaning of entitlement to an amount as a condition precedent. The *Building Contractors* case sets out the meaning of a condition precedent in relation to the accrual of gross income. It clearly demonstrates that the fact that the taxpayer has carried out all his obligations in terms of an agreement is not the decisive factor in determining his entitlement to the fruits of the contract. Where he has carried out all the obligations expected of him, his entitlement to the fruits may often be triggered by the agreed commissions or omissions of the other party to the agreement. In the *Building Contractors* case the entitlement took place on a date three months after the taxpayer had perfectly carried out all his obligations only because until a certificate of no defect was issued the amount due to it would not be ascertainable. That certificate was the condition precedent. The same position is also evident in *ITC 1557*, supra where the issue revolved on when the conveyor of passengers became entitled to claim the payment of a subsidy. In that case the Department of Transport (the subsidor) had rules which obliged it to pay only after it had carried out and received an audit certificate. It carried out and thus had the audit certificate in the tax year following the one the taxpayer had conveyed the

passengers. Melamet J held that the taxpayer was entitled to the subsidy in the year the subsidor issued the audit certificate.

It seems to me that notwithstanding my agreement with Stamp LJ and Lord Russell on the congruency between discount and interest, I do not share the view that entitlement to the discount would occur at the date of purchase. I take cognizant of the views of Watermeyer J, in *Lategan's* case which where approved in the *People's Stores* case. These views have been adopted by Mr. *Chinake* in his submissions. These are that "*so far as a debt is concerned which is payable in the future and not in the year of assessment, it might be difficult to hold that the* ***cash amount of*** *the debt has accrued to the taxpayer in the year of assessment. He has not become entitled to a right to claim payment of the debt in the year of assessment, but he has acquired the right to claim payment of the debt in future. This right has vested in him, has accrued to him in the year of assessment, and it is a valuable right which he could turn into money if he wished to do so.*

According to what has been stated above, the value of this right must, in my opinion, be included in the taxpayer's gross income for taxation purposes."

It is noteworthy that Watermeyer J was alive to the difficulties posed by his formulation above. He went on to discuss the decisions that held that unpaid debts were not part of the gross income, and disagreed with their conclusions. He accepted that the cash amount of the debt would not accrue in the year of assessment as the taxpayer would not be entitled to a right to claim payment of the debt in the year of assessment. He held that all he was entitled to was the **value** of the acquisition of the right to sue on the debt in future, a valuable right which vested in and accrued to him in the year of assessment. It was the **value** to the right to sue for a debt in the future that had to be included in the gross income as opposed to the right to the cash payment of the debt due in the future.

I must confess that at first I was unable to discern the distinction in that formulation. I then had regard to Lord Keith of Kinkel's words at 766 that: "***There can be no doubt from the beginning that the issuer of the bill is under a present obligation to pay the bank a sum certain on a particular future date. So there is attraction in the view that under the principles to which I have referred the bank, since it has by the transaction received in***

return for its payment <u>the present right to receive a larger payment at a future date</u>, <u>should</u> bring into its profit and loss account on the <u>credit</u> side <u>the value of that right</u>, suitably discounted, the payment out being likewise brought in on the debit side. But that again is not what was done, nor is it suggested that it should have been done. Nor has the amount of profit expected been brought at a valuation or at a discount."

The meaning of the Watermeyer J formulation became crystal clear. He was in agreement with Mr. *Andersen* that payment does not accrue on purchase but on prior sale or on maturity. The learned judge had earlier in his judgment defined amount with reference to value. He therefore found that what accrued to the wine farmer was not the payment due for the wine that had been sold, but was the present worth of the debt due to him in future. That in my view is what Lord Keith of Kinkel observed might have been what the Inspector of Taxes' argument might have been, but was not. The correctness of this finding is borne out by the other meaning of discount which is common to both the Shorter Oxford Dictionary and the Concise Oxford Dictionary of giving or getting the present worth of a bill not yet due.

In essence, therefore, the value of the right appears earlier in time to the redemption of the discount. In my estimation it takes place, where the taxpayer still holds the bill, at the end of the first and at the end of all subsequent tax years in which the tax payer holds the bill. It seems to me that the formula that is used to calculate the discount could be useful as a starting point to calculate the bill's present worth, also known as its present market value, at the time of disposal (which takes place before the end of the tax year) or at the end of the tax year. It does not have to be pro- rata to the value of the discount.

In these circumstances, the question of a condition precedent does not therefore arise. Entitlement occurs before maturity, on the date of each tax year end. The respondent is therefore operating within the proper terms of its legal mandate to assess as to income tax on all treasury bills and all kindred freely negotiable bearer debt instruments on the basis that they "accrued to or were in favour of" the applicant.

The parties were agreed that that if I dismissed the applicant's claim, I should remit the matter to the respondent for reconsideration of the issue of the penalties and interest.

In the result, it is ordered that:-

1. The application be and is hereby dismissed with costs.
2. By consent of both parties, the matter be and is hereby remitted to the respondent for the reconsideration of the issue of penalties and interest.

Messrs Atherstone and Cook, applicant's legal practitioners.
Messrs Kantor and Immerman, respondent's legal practitioners.