H BANK ZIMBABWE LIMITED
versus
ZIMBABWE REVENUE AUHORITY

SPECIAL COURT FOR INCOME TAX APPEALS
KUDYA J
HARARE, 4 November 2014 and 25 June 2015

Income Tax Appeal

F Girach, for the appellant
T Magwaliba, for the respondent

KUDYA J: The appeal relates to the application of s 98 of the Income Tax Act *[Chapter 23:06]* to Nostro accounts.

The appellant is a registered commercial bank in Zimbabwe that provides retail, corporate and investment banking services. The respondent is a statutory body established in terms of the Zimbabwe Revenue Authority Act [*Chapter 23:11*].

On 16 November 2012 the respondent issued three amended assessments against the appellant for income tax for the tax years ending 31 December 2009, 2010 and 2011. The respondent invoked the provisions of s 98 of the Income Tax Act and deemed the Nostro accounts held in the name and to the credit of the appellant in the offshore banks as interest earning investments to which it imputed a rate of interest applicable to domestic lending on the ground that the Nostro account balances far exceeded the operational requirements to facilitate trade and foreign currency transactions for each month from 2009 to April 2012.

It levied tax shortfalls in the sum of US$1 485 353-47 for 2009, US$1 379 542-70 for 2010 and US$2 540 277-41 for 2011 [p(p)1-10 of rule 11 documents]. The three amended assessments issued in November 2012 thus brought to account income that had not accrued to the appellant. These amounts were not actually received but were deemed to have been received.

On 12 December 2012[p(p) 11-13 of r 11 documents] the appellant objected to the amended assessments. The objections were disallowed on 15 August 2013. The appellant

noted the present appeal on 3 September 2013. In both the objection and the appeal, the respondent acceded to the request of the appellant to freeze the imputed tax pending the conclusion of the appeal.

The appellant filed its 6 paged case on 6 November 2013. In response thereto, the Commissioner's 11 paged case was filed on 28 November 2013. In addition, the Commissioner filed the 140 paged rule 11 of the Twelfth Schedule of the Income Tax Act documents after the commencement of the appeal hearing. The appeal was heard on 4 November 2014.

The appellant called the sole evidence of its Finance Director who also doubles as its Chief Finance Officer and through him produced 1 documentary exhibit consisting of three schedules. The finance director qualified as a chartered accountant in 1998. He holds a Master's degree in Business Leadership from UNISA 2009 and is an associate member of the Institute of Bankers. He held senior managerial positions in finance and investment in four other companies before joining the appellant in 2007 as a financial controller. He has been a finance director of the appellant since 2008 and as such sits on the main board of directors of the appellant. The 2010 and 2011 annual reports encompassing p(p) 22 to 135 of the r 11 documents show that he is a member of the Loan Review Committee [p(p) 27 and 66], the Executive Committee, also known as the Country Management Committee, the Assets and Liability Committee (ALCO), the Risk Management Committee also known as the Risk and Control Committee [p(p) 28 and 67], which are sub-committees of the main board of directors.

The respondent did not call any evidence but relied on the averments made in the Commissioner's case and the information contained in the r 11 documents.

THE FACTS

The facts in this matter are derived from the evidence in chief of the Finance Director of the appellant who also doubles as its Chief Finance Officer, the r 11 documents filed of record by the respondent, the appellant's and the commissioner's respective cases. The facts are largely common cause.

In line with exchange control regulations and international banking practice the appellant maintains Nostro accounts with foreign banks outside Zimbabwe, in which are held funds denominated in the country currencies in which those foreign banks are domiciled. The finance director correctly defined a Nostro account as an account held by a domestic/local bank with an offshore /foreign bank in the currency of that foreign country. Nostro accounts

constitute current accounts that are used to facilitate international trade and foreign currency transactions. In addition they also constitute corresponding assets for foreign currency liabilities for the bank. The finance director for the appellant established in his evidence that in the absence of the conventional liquidity management instruments of operating a local currency such as an interbank market and lender of last resort and a viable primary and secondary money market, Nostro accounts were also used to carry the liquidity support for the banking industry in the imperfect multicurrency money market regime in Zimbabwe. The liquidity needs of the bank sustained depositors' confidence that payment would be met on demand. In setting Nostro balances, the bank was influenced by the composition of the deposits, established funding arrangements, market risks assessments and product and service strategies underpinned by the central bank's prescribed minimum ratio of liquidity to depositors' funds set out in the Exchange Control Directive of 23 February 2009 issued in terms of s 35 (1) of the Exchange Control Regulations 1996. Central banks normally prescribe a minimum rather than a maximum ratio of liquidity of depositors' funds. It was common cause that money in Nostro accounts is physically in the countries in which the account is domiciled and notes and coins are withdrawn by the bank such as the appellant in the offshore country and flown onshore to Zimbabwe.

The sole witness further established that the terms for Nostro accounts are negotiated and agreed between the local and foreign banks. Bank charges are levied and interest may be credited but the prevailing general international trade practice precludes Nostro accounts from earning interest subject to the discretion of the correspondent bank. Interest would ordinarily be earned on transfer of funds from the Nostro accounts to separate call accounts subject to the requirements of the Zimbabwean exchange control regulations.

The finance director defined liquidity as the immediate availability of a customer's deposit on demand. He stated that the responsibility for the allocation of bank capital lies with the main board of directors. It delegates the allocation of funds to ALCO, a mandatory committee sanctioned by both local and international banking regulations and practice. The primary objective of ALCO is to enable the bank to earn sustainable profits in adherence to the risk management framework of the appellant. It manages liquidity guided by the nature of the deposits. Bank deposits consist of short term and fixed term deposits. Revenue streams for the bank also comprised equity investments, property investments, loans and advances and fees and commissions [p(p)44 and 107 of r 11 documents] which by nature do not immediately avail cash on demand and are not as liquid as Nostro account balances. It

surveys returns in the local market and the global market and projects/forecasts possible returns in those markets. It decides the amount to be invested and the amount to be retained for customer instructions. It must study the economic environment both locally and in the countries where the Nostro accounts are domiciled. Prudential banking practice demands that the appellant plans for the worst case scenario and utilise case studies such as spectacular collapse of sturdy banking houses such as the Royal Bank of Scotland, Baring Bank and Lehman Brothers that gripped the world financial markets in the global financial crisis of 2008 and 2009. It also studies political influence on the economy in the full knowledge that the loss of value of one currency may prompt demand for convertibility into more stable currencies. ALCO strives to strike a balance between income generation and the availability of money on demand and to honour obligations through prudent risk management policies. The bank uses Nostro accounts to maintain liquidity. The financial director's testimony that "under the foreign currency system, the Nostro balance is the main source or main investment for liquidity" went uncontroverted. He demonstrated by live examples of local distressed, failing and fallen banks that the failure to manage risk creates reduced confidence in banks. The tell-tale signs first manifest in limited cash withdrawals that graduate to unavailability of cash, placement on curatorship and end in the closure of the affected banks. The affected banks could not borrow when short from the RBZ because it had no resources to fulfil the role of the bank of last resort as it could not print any of the multi-currencies recognised as local legal tender. He made a compelling case for the use of the Nostro account to manage and control the appellant's liquidity.

That the appellant prioritised liquidity over profitability is apparent from the statements made in the annual reports. In 2009 the capital adequacy ratio of the Bank was 39%, in 2010 it was 24% and in 2011 it was 20% against the regulatory minimum of 10% [p(p) 54 and 128 of r 11 documents]. The liquidity ratio was 80% in 2009, 72% in 2010 and 69% against regulatory minimum of 10% in 2009, 20% in 2010 and 27.5 % in 2011[p(p)49 and 120 of the r 11 documents]. That the appellant's loan loss ratio remained within 1% in each of those three tax years was a sure sign of the existence of a very high quality loan book. It was on the basis of these ratios that the appellant could boast in the 2010 annual report [p(p) 24 and 25 of the r 11 documents] that its adherence to prudential lending practices over its very long existence in Zimbabwe had helped in unlocking value of the natural, artificial and intellectual resources of Zimbabwe commerce without exposing depositors to excessive risk by offering security of deposits.

The respondent charged notional interest on the ground that the Nostro account balances maintained by the appellant over the three years in question were far in excess of its international trade facilitation and foreign currency transactional needs. The Commissioner formed the opinion that the appellant moved huge sums from the high interest local market regime of between 13% and 35% to the offshore sub-zero interest market in a bid to avoid payment of income tax on the higher interest rate earnings**.** The commissioner proceeded to impute the interest rate at the lower end of the local lending rates of 14% per annum on the Nostro accounts rather than the call rates in the countries in which those accounts were domiciled.

The first schedule of exh 1 lists the 22 Nostro accounts and 1 call account, the average yearly balances in each account and the actual interest earned in each account in each year from 2009 to 2011. The call account was opened with a related party in 2010. It held an average balance of US$60 million in 2010 and earned interest of US$12 187-50. The average balance for the same account in 2011 was US$ 35 003 333-33 from which interest of US$ 93 298-60 was earned. In regards to the 22 Nostro accounts, 5 were denominated in United States dollars of which 4 were with related parties and 1 was with an unrelated party; 2 were in Japanese yen and were both held with unrelated parties; 3 were in Euros and were all held with related parties, 3 were in South African Rands and were all held with unrelated parties; 1 each was held in a related party in British Pounds, Zambian Kwacha, Botswana Pula, and Kenyan Shilling and 1 each with unrelated parties in Malawi Kwacha, Swedish Kroner, Canadian dollar, Australian dollar, and Swiss Franc.

In 2009 only 3 Nostro accounts earned interest. 2 of these in South African Rands were with unrelated parties and one in British Pounds was with a related party. The rand accounts held ZAR 4 012 543-25 and earned interest of ZAR 339 359-42 while the other Rand account had an average balance of ZAR 1 278 838-78 and earned interest of ZAR 38 006-51. The third account had GBP 1 084 015-23 and earned interest of GBP9 271-68. The same Nostro accounts in 2010 had average balances of ZAR 2 249 910 [earned interest of ZAR 167 217-43] ZAR 800 968.95 which earned interest of ZAR 14 264-80 and the third had GBP 745 600-44 and earned interest of GBP 3 683-92. Lastly in 2011 the same three accounts had average balances of ZAR 3 714 031-49 that earned interest of ZAR 127 195-42, ZAR286 505-24 that earned interest of ZAR 2 610-29 and GBP 538 116-60 that earned interest of GBP 2 773-29. In addition one of the USD Nostro accounts with a related party with an average balance of USD 58 134 452-23 earned interest of USD18 891-15. In 2009

and 2010 that Nostro account had average balances of USD 40 781 041-78 and USD63 858 456-64, respectively for which no interest was earned. All the interest earned was accounted for in the bank's books of account in each respective tax year.

The first schedule demonstrated that the appellant's Nostro accounts held by both related parties and unrelated parties did not actually earn interest except for the three that consistently earned interest income in all the three tax years under consideration and a fourth one in 2011. The schedule proved on a balance of probabilities that Nostro accounts whether held with related or unrelated parties do not generally earn interest income. In view of the wide geographic spread of the Nostro accounts, straddling as they do over North America, Europe, Asia, Australia and Africa, I am satisfied that this principle is of worldwide application.

Schedule 2 of exh 1 represents the computation of possible interest income at call rates prevailing in each market in which the Nostro accounts were domiciled in each respective tax year. The lowest call rate at 0% were in respect of the Swiss franc, Malawi kwacha and Japanese yen Nostro accounts in each of the tax years 2009 to 2011 while the highest call rate was 9% in respect of the Zambian kwacha. The interest due on the Zambian kwacha would have been equivalent to US$333-00 in 2009, US$US$24-00 in 2010 and US$94-00 in 2011. The call rate in respect of each of the three South African Rand Nostro accounts was 6.9% in 2009, 6.2% in 2010 and 5.4% in 2011. The aggregate notional interest that would have been earned by the three accounts would have [USD38 894-00 + USD 11 759-00 + USD764-00] US$51 417-00 in 2009, US$ 27 978-00 [20 524-00 + 7 306-00 +148] in 2010 and US$ 26 082-00 [24 154-00 + 1928 (the third account had been closed). The call rate for each of the 5 USD accounts was 0.1% in 2009, 0.2% in 2010 and 0.1% in 2011. The total interest that would have been earned in 2009 would have been [USD45 661+ USD269 + USD160-00 + USD134-00 + USD28-00] US$46 252-00 and in 2010 [USD101 366-00+ USD118 + USD441 + USD741 + USD40] US$101 706-00 and in 2011 [USD67 880+ 957 (the other three had been closed) US$ 68 837-00. The call rates for the Euro accounts was 0.3% in 2009 and 2010 and 0.7% in 2011. The interest due would have been equivalent to US 1 157-00[USD1 104-00 + USD34 + USD19] in 2009, US$537-00 [USD516 + USD19 + USD2] in 2010 and for the one active Nostro account in 2011 the interest that would have been earned amounted to US$2 770-00. The call rates for the Botswana Pula Nostro account in 2009 was 6.1% with a possible interest income of US$4 646-00, in 2010 was 6.2% with notional interest income of US$10 549-00 and in 2011 was 5.5% with a notional income of

US$1 162-00. The call rates for the Australian dollar accounts were 2.8 % in 2009 with notional interest of US$1 412-00. In 2010 and 2011 the Australian dollar Nostro account had been closed. The call rate for the Kenyan shilling was 3% in 2009 and would have earned interest of US$3-00 while in 2010 it was 1.8% earning interest of US$5-00 and in 2011 it was 8.2% earning interest of US$50-00. The Canadian dollar call rate was 0.1% in 2009 earning interest income of US$10-00, 0.5% in 2010 earning income of US$111-00 and 0.9% in 2011 with a possible income of US$129-00. The respective call rates and possible interest income for the Swedish kroner were 0.1% and US$3-00 in 2009, 0.4% and US$3-00 in 2010 and 1.7% and US$29-00 in 2011. The respective call rates and notional interest income for the British Pound Sterling account were 0.4% and US$6 415-00 in 2009, 0.4% and US$ 4 487-00 in 2010 and 0.5% and US$3832-00 in 2011.

The total average amount of all the Nostro accounts in 2009 in the functional currency of the appellant were in the sum of US$44 369 931-00. The weighted average yield of the call rates in all the Nostro accounts markets was 0.25% in 2009. Had the amounts been placed in call accounts in their respective jurisdiction it would have earned interest of US$109 651-00. The total in 2010 was equivalent to US$ 71 723 463 with possible interest earning of US$ 154 348-00 and the weighted call rate yield was 0.22% in 2010 while in 2011 the total amount averaged US$ 93 706 692 with a possible return of US$ 145 317-00 where the weighted average call rate yield was 0.16%. The balance that would remain after deducting "marked and committed facilities" from the total balance in 2009 of US$11 780 493-00 would leave an average balance of US$ 32 589 438-00. The sum of US$29 113-00 would have been abated from the notional call interest leaving the interest at US$80 538-00 for the whole of 2009. In 2010 the adjusted average balances after deducting commitments would aggregate to US$ 41 241 008 and earn notional interest of US$ 88 750-00. The sums for 2011 would amount to US$ 54 162 838 and US$83 992 respectively.

Schedule 2 established that the interest rates in call placements were very low hovering between 0 % in the developed economies such as Japan and Switzerland and 9% in the developing economies such as Zambia. In the United States dollar denominated Nostro account markets, the call rates averaged between 0.1% and 0.2% per annum. The appellant proved beyond a balance of probabilities that the call rates in these markets were nowhere near the 13% to 35% per annum that prevailed in Zimbabwe at the time. Schedule 3 of exh 1, extracted from the Reuters financial service, listed the maximum possible interest rates applicable to each market on both call and term investments in South Africa, Stockholm,

London, Toronto, South Africa, New York, Zurich, Gaborone, Blantyre, Tokyo, Nairobi and Australia. The term investment rates were categorised in tenures of 30 days, 60 days and 1 year. The rates for all USD accounts were at 0.2% for the 30 and 60 day term investments in each of the three tax years under consideration. The yield for the 1 year term investments were 0.9% in 2009, 1.1% in 2010 and 0.9% in 2011. The financial director emphasised that such investments required approvals from the Reserve Bank of Zimbabwe and had to be weighed against the liquidity requirements of customers and the balances in each Nostro account. Again, the appellant established that the call and term investments in the relevant United States denominated Nostro accounts were extremely low hovering between 0.9% and 1.1%.

The evidence of the finance director in regards to these three schedules was uncontroverted. It demonstrated the depressed nature of markets in which the United States dollar denominated Nostro accounts were held. The effect of his evidence was that in weighing the various investment options with a paramount eye on profit generation against the possible market returns and the attendant risks involved ALCO adopted a conservative but prudent approach of safeguarding and growing deposits thereby ensuring liquidity to customers. The bank elected to hold the structure of the balance sheet to shore up customer confidence and sustain other sources of revenue such as fees and commissions. He testified that the bank was not in the business of making profits at any cost but would forego profits in order to protect both depositors and the financial system especially in times of financial upheavals. He was adamant that it would not have been prudent for the bank to move all the funds in Nostro accounts to Zimbabwe for on-lending as this would have compromised the very survival of the bank. In any event the bank retains 74.5% of the profits after tax of 24.5%. The issue of tax avoidance would not arise in these circumstances. ALCO assessed that it would have lost money in chasing higher returns. The appellant thus took a purely business decision based on the normal banking considerations in Zimbabwe and in the global environment to keep the amounts offshore and in Nostro accounts. The desire to secure depositors funds and the corresponding imperative to support prompt settlement of customer’s transactions constituted “legitimate and pure business choices in the normal remit of banking” that prompted the appellant to fore-go short term profits in order to contain the long run cost of funding and current and future default risk and loan write offs arising from non-performing loans in favour of a secure and stable bank for depositors and regulators. His

testimony in this regard resonated well with the sentiments of the Bank Chairman in the 2010 Annual report [p 24 of the r 11 documents] that:

> "The Bank's risk appetite continued to respond to progressive credit risk assessments benchmarked on both local economic conditions and international best practice to assure our depositors of a Bank that is highly secure and liquid. The Bank has thus continued a prudent approach to growing its loan book. Whilst this might be viewed as foregoing some short term benefits it remains the Bank's belief and commitment that the Bank keeps its focus on creating and preserving value over the long term. The Bank's long heritage is a product of such prudential risk processes and focus on long term sustainability."

This approach of the Bank is repeated on p 46 in note 24 of the same annual report where the appellant proclaims that it professionally manages targeted risk by identifying all key risks; measures them, and allocates cash in line with risk management policies, systems, changing markets and product and best market practices that achieve balance between risk and return. He reiterated that the operations of the bank over those three years satisfied the monetary authorities who never directed the appellant to transfer Nostro funds to the RBZ Nostro account in each of the countries that they were held to settle specific international transactions.

The bank has detailed written principles and policies that govern overall risk management. These are spelt out in detail in the 2010 Annual Report under note 24 [p(p)46-53] and replicated in the 2011 Annual Report in note 30 [p(p) 113-127]. It defines risk [at p(p)44 and 113] as the possibility of losses or profits foregone arising from internal or external forces. The specific financial risk areas covered by written policies include foreign exchange risk, interest rate risk, credit risks, liquidity risks, market risks, operational risks, legal, strategic and reputational risks. Some of these like credit risks are mitigated by taking security for funds advanced in the form mortgages over residential and commercial properties and charges over business assets like premises, inventory and accounts receivable, moveable assets and shares, credit scoring all customer borrowing applications and only lending to those who meet set criteria. The internal rating comprises 23 grades ranging from 1-14 who fall into the investment grade through 15-21 who require standard monitoring and 22-23 who fall into default grade. Credit risk for the Bank is concentrated in 10 industrial sectors under the rubrics of trade and services, energy and minerals, agriculture, construction and property, light and heavy industry, physical persons, transport and distribution, financial services, the State and generic others. It advanced loans in the sum of US$43 638 980-00 of which US$1 349 212 were impaired and only US$123-00 was written of in 2010. In 2011 the total amount

advanced was US$59 530 899-00 with no impairments or write offs. In both financial years the Bank did not advance loans to the energy and minerals, financial services, State and the generic other sectors [p(p)49 and 118].

The Bank defines liquidity risk as the possible failure repay deposits on demand and fulfil lending commitments. It manages through ALCO this risk through the use of advanced models that compare possible liquidity shortfalls against the maturity profiles of its assets and liabilities and closes the gap in advance. The models utilize balance sheet liquidity ratios and measure them against internal and regulatory benchmarks. On a practical plane ALCO monitors daily allocation and use of funds and maintains a high balance of cash for easy allocation to areas of need. To do so it requires a wide diversification source of funding.

THE ISSUES

The first issue referred to trial was whether it was open to the respondent on the facts of this matter to invoke s 98 of the Act and deem certain income to have accrued to appellant as and by way of interest on Nostro accounts and secondly, if so what percentage of interest should apply.

THE LAW

S 98 states that:

> "**98 Tax avoidance generally**
> Where any transaction, operation or scheme (including a transaction, operation or scheme involving the alienation of property) has been entered into or carried out, which has the effect of avoiding or postponing liability for any tax or of reducing the amount of such liability, and which in the opinion of the Commissioner, having regard to the circumstances under which the transaction, operation or scheme was entered into or carried out—
> (*a*) *was entered into or carried out by means or in a manner which would not normally be employed in the entering into or carrying out of a transaction, operation or scheme of the nature of the transaction, operation or scheme in question; or*
> (*b*) has created rights or obligations which would not normally be created between persons dealing at arm's length under a transaction, operation or scheme of the nature of the transaction, operation or scheme in question;
> and the Commissioner is of the opinion that the avoidance or postponement of such liability or the reduction of the amount of such liability was the *sole purpose or one of the main purposes* of the transaction, operation or scheme, the Commissioner shall determine the liability for any tax and the amount thereof as if the transaction, operation or scheme had not been entered into or carried out, or in such manner as in the circumstances of the case he considers appropriate for the prevention or diminution of such avoidance, postponement or reduction."

The onus

The section has been subject of judicial interpretation in this country, in South Africa and in other jurisdictions that have had a similar provision. I also had occasion to interpret the applicability of this section to Nostro accounts in *G Bank Zimbabwe Ltd* v *Zimra* HH 207/2015 from p(p) 11-17 of the cyclostyled judgment. In that case the parties were agreed that the onus was on the taxpayer to show on a balance of probabilities that the Commissioner wrongly exercised his s 98 opinion. In the present matter Mr *Girach* for the appellant, without citing any authority, submitted that the onus was on the Commissioner to justify his opinion. I suppose that he was relying on the common law principle that he who alleges must prove. Mr *Magwaliba*, for the respondent, made a contrary submission and relied on the provisions of s 63 of the Income Tax Act. The section reads:

> "**63 Burden of proof as to exemptions, deductions or abatements**
> In any objection or appeal under this Act, the burden of proof that any amount is exempt from or not liable to the tax or is subject to any deduction in terms of this Act or credit, shall be upon the person claiming such exemption, non-liability, deduction or credit and upon the hearing of any appeal the court shall not reverse or alter any decision of the Commissioner unless it is shown by the appellant that the decision is wrong."

In my view, the present case is an appeal under the Income Tax Act in which the appellant avers that it is not liable to income tax on notional interest income imputed by the respondent. S 63 squarely casts the burden of proof on the appellant and not on the Commissioner. That Mr *Magwaliba* is correct is buttressed by two cases, the South African Supreme Court of Appeals case of *Commissioner for the South African Revenue Services* v *Pretoria East Motors (Pty) Ltd* (291/12) [2014] ZASCA 91 and the local Appellate Division case of *Commissioner of Taxes* v *F* 1976 (1) RLR 106 (AD. In the Pretoria East Motors case in para [6] Ponnan JA stated dealt with the incidence of onus in thus:

> "In terms of s 82 of the IT Act:
>
> 'The burden of proof that any amount is-
>
> (a) exempt from or not liable to any tax chargeable under this Act;
> …….shall be upon the person claiming such exemption, non-liability, deduction, abatement or set-off,…..and upon the hearing of any appeal from any decision of the Commissioner, the decision shall not be reversed or altered unless it is shown by the appellant that the decision is wrong'
> A similar provision is to be found in s 37 of the VAT Act. The present appeal must therefore be approached on the basis that the onus was on the taxpayer to show on a preponderance of probability that the decisions of SARS against which it appealed were wrong (*CIR v SA Mutual Unit Trust Management Co Ltd* 1990 (4) SA 529 (A)at 538D). That, however, is not to suggest that SARS was free to simply adopt a supine attitude. It was bound before the appeal to set out the grounds

> for the disputed assessments and the taxpayer was obliged to respond with the grounds of appeal and these delineate the disputes between the parties."

In *Commissioner of Taxes* v *F* 1976 (1) RLR 106 (AD) at 115F-116A McDonald JP further underscored that:

> "The next point is that the Commissioner is obliged to exercise his powers under the section if the transaction, operation or scheme has the stipulated "effect", if he is of the "opinion" that the requisite abnormality is present and if he is further of the "opinion" that the taxpayer's purpose was as stated in that section. Here again there is a clear indication that it is the intention of the Legislature to cast the net in such a way as to block every possible avenue of escape. <u>This intention is also manifest by the further provision that when the stipulated effect is present and the requisite opinions are held, the onus rests on the taxpayer (under the Eleventh Schedule to the Act) to establish on a balance of probabilities that he did not have the purpose set out in the section.</u> Moreover, the section strikes not only at avoidance but also at mere postponement and reduction. This is a further indication of the Legislature's intention to make the section all-embracing. In short, the Legislature, by every conceivable means, has endeavoured to make it extremely difficult for a taxpayer to avoid the payment of tax which, in the normal course of his business and but for his desire to avoid, postpone or reduce such payment, would fall due."[Underlining my own for emphasis]

Ponnan JA stated beyond a peradventure that the onus rests on the taxpayer. All that is required of the Commissioner is to set out the grounds on which his opinion is based which grounds trigger the objection and grounds of appeal. McDonald JP held that the onus is on the taxpayer once the Commissioner forms the opinion that the transaction, operation or scheme has the effect of avoiding, postponing or reducing liability for income tax.

The opinion of the Commissioner is triggered by the tax returns made by the taxpayer. The Commissioner assesses the returns and may request for further information before he makes an opinion. Invariably, the opinion is grounded on "facts" provided by the taxpayer. These facts are often challenged verbally or in writing before formal objection is raised. By the time an appeal is noted the grounds for the opinion would have crystallised. In the present case, the "facts" on which the opinion was based were that the appellant held amounts in its Nostro accounts that were far in excess of its international transactional requirements in each of the three tax years in question. The money was kept offshore at zero interest rates. At the time onshore interest rates ranged between 13% and 35%. It was common cause that these facts were correct.

The appellant challenges the correctness of the conclusion reached by the appellant that it held Nostro accounts in order to avoid, postpone or reduce tax liability. The incidence of onus to prove the challenge rest on the appellant both as a matter of common sense and by virtue of s 63 of the Income Tax Act. Once the Commissioner forms an opinion based on

what appears to be reasonable and tangible grounds, the onus rests on the appellant to show that the decision made on the basis of the opinion and by implication the opinion was wrong. The onus, therefore, rests on the taxpayer to establish on a balance of probabilities that the opinion formed by the Commissioner was wrong. I therefore agree with Mr *Magwaliba* that the Commissioner bears no onus to establish on a balance of probabilities that his opinion was correct.

The essential elements of s 98 of the Income Tax Act

The various requisites which must co-exist to justify the Commissioner's invoking his powers under s 98 were enumerated by Smith J in *A* v *Commissioner of Taxes* 1985 (2) ZLR 223 (HC) at 232F-233B by reference to *Secretary for Inland Revenue* v *Geustyn, Forsyth & Joubert* 1971 (3) SA 567 (A) at 571E-H in these terms:

> "(a) a transaction, operation or scheme entered into or carried out;
> (b) which has the effect of avoiding or postponing liability for tax on income or reducing the amount thereof; and which
> (c) in the opinion of the Secretary, having regard to the circumstances under which the transaction, operation or scheme was entered into or carried out, -
> (i) was entered into or carried out by means or in a manner which would not normally be employed in the entering into or carrying out of a transaction, operation or scheme of the nature of the transaction, operation or scheme in question; or
> (ii) has created rights or obligations which would not normally be created between persons dealing at arm's length under a transaction, operation or scheme of the nature of the transaction, operation or scheme in question; and that
> (d) the avoidance, postponement or reduction of the amount of such liability was, in the opinion of the Secretary, the sole or one of the main purposes of the transaction, operation or scheme."

The application of the facts to the law

I apply the above factors to the facts of this case.

(a) any transaction, operation or scheme entered into or carried out;

The words "any transaction, operation or scheme entered into or carried out" have in this jurisdiction been given a wide and all-embracing meaning which encompasses all spheres of a taxpayer's endeavours. McDonald JP, as he then was, put it with customary clarity in *Commissioner of Taxes* v *F* at 115E thus:

> "Each of these words is of wide and general import and there are few activities of a taxpayer which will not be appropriately described by one or other of them."

I did not hear Mr *Girach* make a contrary submission. I am satisfied that the opening and operations of Nostro accounts by the appellant constituted "any transaction, operation or

scheme". The Commissioner was correct to treat the Nostro accounts in question as constituting a transaction, operation or scheme.

b) which has the effect of avoiding or postponing liability for tax on income or reducing the amount thereof; and which

It seems to me that Nostro accounts being in nature non-interest bearing current accounts do not produce any income. They are not designed to earn any income. It was common cause that the Nostro account in question did not earn any interest. Interest could only accrue on transfer to call accounts in those jurisdictions that they were held or on transfer onshore. They, for that reason, do not in the normal scheme of things attract any tax liability. In these circumstances, it is not possible to find that they therefore have the effect of avoiding or postponing or even reducing the amount of tax liability. The second requisite factor does not apply to the Nostro accounts held by the appellant.

(c) in the opinion of the Secretary, having regard to the circumstances under which the transaction, operation or scheme was entered into or carried out,

(i) was entered into or carried out by means or in a manner which would not normally be employed in the entering into or carrying out of a transaction, operation or scheme of the nature of the transaction, operation or scheme in question; or

(ii) has created rights or obligations which would not normally be created between persons dealing at arm's length under a transaction, operation or scheme of the nature of the transaction, operation or scheme in question; and that

Mr *Girach* submitted that the appellant through the evidence of the financial director established on a balance of probabilities that the Nostro accounts were neither opened nor operated in an unusual manner not associated with such accounts. The annual reports of the appellant revealed that the appellant treated all deposits made by customers in one of three ways. A portion was held in cash and of the remainder one portion was deposited with the central bank and the balance was deposited in Nostro accounts. It was common cause that Nostro accounts are a matter of international banking necessity. They are held by all onshore and offshore banks including central banks. Our very own Reserve Bank of Zimbabwe holds such Nostro accounts. A bank cannot possibly transact in a currency other than the one printed in its country of domicile without a Nostro account. The means and ways the appellant entered into and carried out its Nostro accounts were in line with what banks of its

remit were wont to do. It was common cause that as at the date forming the subject matter of the dispute there were no guidelines from the Reserve Bank of Zimbabwe specifying the percentage of depositor's funds that could be held offshore. Banks were at liberty to hold as much as they wanted in Nostro accounts. In 2009 and 2010 before the introduction of the RTGS platform in multicurrency Zimbabwe, all funds were transacted through Nostro accounts which in the uncontroverted testimony of the financial director were the main source for liquidity. The appellant made legitimate and pure business decisions on the amount to retain in the Nostro accounts against the amount for investment in interest bearing financial instruments. The decisions were guided by liquidity considerations, which entailed forecasting the spending patterns and requirements of its in excess of 130 000 customers. These were juxtaposed against projections of the future behaviour of the Zimbabwe economy and the economies of all the countries in which the Nostro accounts were held. This delicate balancing act was carried out by a specialist committee, ALCO, constituted by highly qualified and skilled experts who understood the economic environment and all the nuances that affect both their customers' and the countries that hold the Nostro accounts, especially in the wake of the 2008 world financial crisis that witnessed the spectacular collapse of outwardly solid banks such as Lehman Brothers in the US and the Royal Bank of Scotland in the United Kingdom.

The Commissioner did not attack the means of entering into these accounts. Rather, he attacked the manner in which these accounts were operated. It was common cause that the average amounts held in the Nostro accounts at the end of each tax year were far in excess of the trade and liquidity requirements of the bank's customers. It was common cause that interest rates on call accounts in the countries in which the Nostro accounts were domiciled were very depressed hovering between 0.9% and 1.1% in the developed capital markets and running up to 9% in the developing countries such as Malawi and Zambia while those prevailing in Zimbabwe were very high and attractive in the 13% to 35% band. Mr *Magwaliba* forcefully contended that the excess amounts should have been remitted to Zimbabwe for on lending at the higher interest rates obtaining in Zimbabwe at the time in line with the profit motive that drives the very essence of banking. He submitted that the appellant deliberately avoided earning income in Zimbabwe on these excess funds in order to avoid, postpone or reduce its tax liability.

The evidence of the financial director that the appellant had a low risk appetite was reinforced by the policies, practices and procedures on risk management found in the two

annual reports produced under the rule 11 documents. The Annual reports demonstrate that the appellant was a cautious conservative institution that was familiar with the operating economic environment in Zimbabwe. It was deeply involved in lending to various industrial sectors in Zimbabwe. It did not lend blindly but did so after carrying out various assessments dictated by its policies, procedures and practices. These policies were fomented in the cauldron of the appellant's longstanding presence in this country. It appreciated that high returns come with high risks. It is equally true that high risks may result in even greater losses. The appellant followed the strategic course of preserving liquidity. "The strategy paid off for the bank. Both deposits and corresponding liquid assets of the bank progressively increased from 2009 to 2011."[p(p) 49 and 120]. Its brand became demonstrably solid and its reputation increased. Deposits and customers increased as did profits from non-funded income. It also increased lending. It could boast in the financial reports of 2010 at p 51 and 2011 at p 124 " that the Bank is satisfied with its risk management processes and systems in place which have enabled the Bank to minimise losses" and remained true to the Chairman's word on p61 on the 2011 Annual report that it has followed a "safe bank model that ensures utmost security of depositor's funds and enjoyable transactions for big and small customers" which has seen the growth of the high credit quality loan book underpinned by disciplined risk processes adhering to rigorous credit processes and prudent lending guidelines in safeguarding depositor funds hence loan loss ratio remained under 1%.

In hindsight, these policies boarded well for the appellant. It had a high liquidity ratio which progressively decreased from 80% in 2009 through 72% in 2010 to 69% in 2011. It survived the upheavals that afflicted banks that looked to high interest rates without making prudent assessments on the quality of their loan books. In essence the appellant did not view the local high interest rates as sustainable. It appears that most of the potential local borrowers were not creditworthy. It realised that local lending in the face of declining capacity was likely to result in interest reversals, debt write-offs and downward revision of interest that characterised the Zimbabwe bank market after 2012. The 2010 Chairman's statement [p24] demonstrated that the appellant was alive to the short term nature of banking deposits in Zimbabwe and the structural deficiencies of the absence of an interbank market to support liability and asset products and the absence of an independent credit ranking agency to vet borrowers who often were multi-borrowed in bank and non-banking credit. The appellant also used the market risk tools of Value risk (VaR) and daily value at risk (DVaR), Stress tests and annual earning at risk (AEaR) to measure the estimated loss in its investment

portfolios against the projected changes in the fair value of its financial instruments dictated by up and downward movement of interest rates, exchange rates, and share prices. The projected volatility of market interest rates militated in favour of holding non-interest bearing amounts in 2010 of US$ 80 043 734 comprising of cash and bank balances of US$38 584 852 [p51] and US$77 449 936 and US$34 051 513 respectively in 2011 [p124].

I am satisfied that the appellant established on a balance of probabilities that the way it operated its Nostro accounts, which resulted in high liquidity ratios of 80% in 2009, 72% in 2010 and 69% in 2011 adjudged against the economic environment subsisting both in the countries where the Nostro accounts were domiciled and Zimbabwe was normal. It was, like any bank, driven by liquidity concerns and the desire to satisfy unpredictable customer instructions. I am satisfied that it made pure banking decisions that appear to have been beyond the comprehension of the Commissioner.

The appellant has discharged the onus on it to show that the way and means it operated its Nostro accounts were normal and in tandem with those associated with the operation of such accounts by prudent Nostro account holders.

In regards to the arm's length principle, the appellant established that it actually earned nominal interest with related parties. It further established that zero interest was the prevailing banking practice and that it did not earn interest from unrelated parties and thus discounted any transfer pricing differentials in its operation of these accounts against unrelated parties such as the Reserve Bank of Zimbabwe to the advantage of related parties. The FD wrote to the case manager of the respondent on 22 November 2012[p(p) 15-16 of r 11 documents] thus:

> "Nostro accounts, like current accounts that they are, do not create entitlement to interest regardless of whether they are held with related or unrelated entities. Thus, other Nostro balances outside related parties, including the balances held through the RBZ RTGS NOSTRO account, referred to above, and which is now the major account pays nil or negligible interest. It is not possible for any holder of the NOSTRO account to force interest rates to be paid that are outside the normal offering that defines a NOSTRO account and outside the market conditions prevailing where the Nostro accounts are domiciled. It should also be noted that Nostro accounts cannot be held locally, by nature. Interest rates applying to other products of different markets can therefore not be imputed to a Nostro account balance held in a specific domicile."

I am also satisfied that the appellant did not create abnormal rights and obligations with any of its Nostro banks. It did not earn interest on Nostro accounts held with unrelated parties just as it did not do so from related parties. In fact the little interest it earned was from some three Nostro accounts it held with related parties.

"(d) the avoidance, postponement or reduction of the amount of such liability was, in the opinion of the Secretary, the sole or one of the main purposes of the transaction, operation or scheme."

Mr *Magwaliba* relied on the authority of *CSARS* v *NWK Ltd* 2011 (2) SA 67 (SCA) para [55] for the submission that the holding of excess funds in the Nostro accounts constituted simulated transactions. Lewis JA stated:

> "[55] In my view the test to determine simulation cannot simply be whether there is an intention to give effect to a contract in accordance with its terms. Invariably where parties' structure a transaction to achieve an objective other than the one ostensibly achieved they will intend to give effect to the transaction on the terms agreed. The test should thus go further, and require an examination of the commercial sense of the transaction: of its real substance and purpose. If the purpose of the transaction is only to achieve an object that allows the evasion of tax, or of a peremptory law, then it will be regarded as simulated. And the mere fact that parties do perform in terms of the contract does not show that it is not simulated: the charade of performance is generally meant to give credence to their simulation."

The meaning and effect of the above paragraph was explained at length by both Shongwe and Wallis JJA in *Roshcon (Pty) Ltd* v *Anchor Auto Body Builders CC and Others* 2014 (4) SA 319 (SCA) in para(s) 15, 27, 32, 33, 35 and 37. In determining whether a transaction is disguised the court looks at all the circumstances surrounding it. If the circumstances disclose a secret understanding that is covered up in the purported transaction then it will strip it off the false veneer and give effect to the real but hidden transaction. Some of the terms that have been used to describe a simulated transaction are "disguise true nature, "pretence" "in fraud of legislation", "fraudulent pretence". In para(s) 27, 33 and 37 Wallis JA noted that:

> "Whether a particular transaction is a simulated transaction is therefore a question of its genuineness. If it is genuine the court will give effect to it and, if not, the court will give effect to the underlying transaction that it conceals. And whether it is genuine will depend on a consideration of all the facts and circumstances surrounding the transaction."

> "[33] In the income tax cases, the parties seek to take advantage of the complexities of income tax legislation in order to obtain a reduction in their overall liability for income tax. There are various mechanisms for doing this, but they all involve taking straightforward commercial transactions and adding complex additional elements designed solely for the purpose of claiming increased or additional deductions from taxable income, or allowances provided for in the legislation. The feature of those that have been treated as simulated transactions by the courts is that the additional elements add nothing of value to the underlying transaction and are very often self-cancelling. Thus in *Erf 1383/1* Hefer JA said that 'there is a distinct air of unreality about the agreements'. In *Relier* Harms JA referred to the 'unusual and unreal aspects' of the transactions. The analysis by Lewis JA of the transactions in *NWK* clearly demonstrated that a range of unrealistic and self-cancelling features had been added to a straightforward loan. They served no commercial purpose, were

> based on no realistic valuation of the different elements of the transaction and were included solely to disguise the nature of the loan and inflate the deductions that *NWK* could make against its taxable income. In those circumstances the courts stripped away the unrealistic elements in order to disclose the true underlying transaction."
>
> "[37] For those reasons the notion that *NWK* transforms our law in relation to simulated transactions, or requires more of a court faced with a contention that a transaction is simulated than a careful analysis of all matters surrounding the transaction, including its commercial purpose, if any, is incorrect. The position remains that the court examines the transaction as a whole, including all surrounding circumstances, any unusual features of the transaction and the manner in which the parties intend to implement it, before determining in any particular case whether a transaction is simulated."

The evidence of the financial director established that one of the main purposes of the transaction, operation or scheme was to maintain liquidity for customers. The Nostro accounts with the highest amounts were held with related parties who had between them a credit rating of A+. This is apparent from the information on p 119 where the appellant disclosed that in 2011 bank balances of US$113.8m (2010 US$110m) except for US$23,2m in RBZ was held with banks with A+ credit ratings. The Bank gives the assurance to its stakeholders at p(p 53 and 128 "that total capital for the bank is assessed to be sufficient to support current business and planned capital projects and that growth in advances will continue to be pursued cautiously and in such a way as to achieve economic asset yields". It promises at p 90 that:

> "The bank will continue to grow the loan book in 2012 in line with risk management policies while at the same time maintain a balanced liquidity position after considering the resources available to do more business in the future."

It seems to me that the appellant's sole purpose is to continue to serve generations and leave its footprint in the development of Zimbabwe as it has done in the past. The appellant entered into and carried out genuine commercial transactions, much like in the *G Bank* case, *supra.* The sentiments in *NWK*, *supra* are inapplicable in the present case. The facts of the present matter do not disclose that the purpose of the transaction was only to achieve an object that allows the evasion of tax, or of a peremptory law. They also do not disclose that the avoidance, postponement or reduction of tax liability were some of the purposes for keeping the excess amounts in Nostro.

Like in the *G Bank* case, *supra,* the appellant attacked the misapplication of s 98 by the respondent. It contended that the respondent had no business making pure banking decisions on prudential banking considerations. In doing so he compromised the remit of banking regulators and the high profile of the bank. The profile of the appellant was what

drew customers with high balances looking for a safe haven for their funds to the bank. It was improper for the Commissioner to make investment choices for both the bank and its customers. The customer with high deposit in the Nostro held account risked being taxed for not placing his money in an interest earning account; a tomato vendor who sells his or merchandise down town risked being taxed on notional income on uptown sales. See *Commissioner for Inland Revenue* v *IHB and AH King* 1947 (2) SA 196 (A) at 207-208. The balances were not excessive for the bank requirements to serve actual and possible transactions commensurate with the profile of its deposits. The right of choice of placement of funds was a fundamental strategic function that drove the product and service strategies of the bank. The Commissioner was ill equipped to make such choices for the bank. He could not usurp the role of the central bank, which eventually flexed its muscles through the Exchange Control Directive of 21 February 2012[p(p)17-21 of rule 11 documents] that directed banks to maintain a maximum threshold of 25% of their foreign account balances in their Nostro accounts to meet their day to day international payment obligations. The maximum balance in Nostro accounts was increased to 30 % from 30 June 2012. The ledger balances of foreign currency accounts deposits held with the central bank and Statutory Reserve liabilities did not form part of that maximum threshold. The reason behind the directive was to enhance market liquidity. The effect of directive was to transfer balances in excess of 25% to RBZ Nostro held with the Federal Reserve Bank in NY earning zero per cent interest and which, in any event, did not come to Zimbabwe for on lending.

Like Beadle CJ in *Commissioner of Taxes* v *Rendle* 1965 (1) SA 59 (RAD) at 61B I would remind the respondent once again that:

> "It is not for the Commissioner to direct how a taxpayer should run its business."

Like in *G Bank*, based on the authority of the *King* case, (*supra)*, I am satisfied that the Commissioner cannot invoke s 98 against a tax payer who abstains from earning income and to whom no income accrued or was received or is deemed to have accrued or received.

I am satisfied that the appellant has established on a balance of probabilities that the respondent wrongly invoked s 98 to the Income Tax Act to bring to account notional interest to its taxable income in each of the three years in issue.

In the light of this conclusion, it is unnecessary to determine the second issue that was referred to trial.

COSTS

Mr *Girach* 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 terms of s 15 (2) (aa) of the Income Tax Act. The prayer was not opposed. It will therefore be granted.

DISPOSITION

It is accordingly ordered that:

1. The appeal be and is hereby allowed.
2. The respondent is directed to withdraw and amend the three assessments in respect of the tax years ended 31 December 2009, 31 December 2010 and 31 December 2011 issued against the appellant on 16 November 2012.
3. 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*].

Scanlen & Holderness, appellant's legal practitioners