The Deductibility of Interest: A Controversial Field

by

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DECLARATION

This research has not been previously accepted for any degree and is not being currently submitted in candidature for any degree

Signed ....

Date 096565

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ABSTRACT

For any expenditure to qualify as a deduction against income, the Income Tax Act No 58 of 1962 as amended (the Act), requires that the expenditure fall within the ambit of section 11 (a) (the general deduction formula) read together with section 23 (g). What may be considered a prudent and proper deduction from an accounting point of view is of no consequence, unless, that deduction is permissible under the Act. Consequently, a deduction will only be allowed when it is incurred in the production of income.

The deductibility of interest has always been a vexing question. Although its deductibility is determined in terms of the general deduction formula, the courts have held widely differing views on the subject of its deductibility. The taxpayer's purpose in borrowing money is an important factor in determining the deductibility of interest. If the money was borrowed for the purposes of earning income, the interest will be deductible. It is immaterial that the borrowed money was not applied in a manner that produced income; as long as the taxpayer's purpose in borrowing the money was to use it in the production of income.

The courts have, however, failed to settle the issue. Similar cases have resulted in different judgements. It is therefore essential that taxpayer carefully applies sections 11 (a) and 23 (g) to determine the deductibility of interest before obtaining financing for business purposes.

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CHAPTER 1

INTRODUCTION

1.1 Introduction

Once a taxpayer's gross income has been established, exempt income is deducted and thereafter the calculation of taxable income is arrived at after the deduction of all amounts allowed in terms of the Income Tax Act 58 of 1962. These deductions are allowed in terms of the commonly known "general deduction formula" and "specific deductions". The general deduction formula is found in section 11(a) of the Act which needs to be read with section 23. The specific deductions are mainly found in sections 11 to 19 (Huxham, Haupt, 2003:61).

The category of deductions having the widest impact falls into the general deduction formula contained in section 11 (a). This is the section where the majority of the deductions are made. Huxham and Haupt (2003:61) believe that the general deduction formula may be analysed into several components:

- The preamble to section 11, which requires
  - a trade to be carried on
  - income to be derived from such trade

- Section 11 (a), which requires that there be
  - expenditure and losses
  - actually incurred
  - during the year of assessment

- in the production of income
- not of a capital nature

- Section 23 (g) which prohibits the deduction of
  - any moneys claimed as a deduction
  - to the extent to which
  - the monies are not laid out or expended for the purposes of trade

- Section 23 H which limits the deductions to a portion of the expenditure where the benefits resultant on the expenditure are for a period which extends beyond the year of assessment.

As a consequence , section 11 (a) may be seen as the positive test of deductibility while section 23 (g) may be seen as the negative test.

It is clear from the introductory paragraph of section 11 that an amount may only qualify as a deduction on fulfilment of two requirements, both of which must be satisfied. These are:

- the taxpayer must be carrying on a trade and
- that income must be derived from such trade

In the absence of these two conditions, the deduction should ordinarily not qualify for a deduction. However, the South African Revenue Services (SARS) has

recognized through its Practice note 31 that interest incurred in earning investment interest income may be deductible, but is limited to the actual interest that is earned (SARS, Practice Note 31).

Over the years, however, the question of when interest may be deducted, especially in cases where interest expenditure has a dual purpose, has become a thorny issue. This is more so as the courts have rendered inconsistent rulings on the question of unproductive interest.

1.2 Definition of Interest

The term interest has not been defined in section 1 of the Income Tax Act 58 of 1962 as amended (the Act). It is therefore necessary to look to court decisions as well as those offered by the authors of books on taxation.

The Oxford Dictionary defines interest as "money paid for the use of money borrowed". Silke (1998:7-82) on the other hand quotes Lord Wright who described interest as follows:

- "The essence of interest is that it is a payment which becomes due because the creditor has not had his money at the due date. It may be regarded either as representing the profit he might have made if he had the use of the money, or, conversely, the loss he suffered because he had not that use. The general idea is that he is entitled to compensation for that depravation".

Huxham and Haupt (2003:79) describe interest as a payment for the use of funds and is therefore of a revenue nature. They further believe that it is equivalent to rent paid for the use of a capital asset.

Section 24 J of the Act was introduced in 1995 and defines interest as follows:

(a) "the gross amount of any interest or related finance charges, discount or premium payable or receivable in terms of or in respect of a financial arrangement

(b) any amount (or portion thereof) payable by a borrower to the lender in terms of any lending arrangement as represents compensation for any amount to which the lender would, but for the lending arrangement, have been entitled

(c) the absolute value of the difference between all amounts receivable and payable by a person in terms of a sale and leaseback arrangement as contemplated in section 23G throughout the full term of such arrangement, to which such person is a party,

irrespective of whether such amount is—

(i) calculated with reference to a fixed rate of interest or a variable rate of interest; or

(ii) payable or receivable as a lump sum or in unequal instalments during the term of the financial arrangement."

Huxham and Haupt (2003:379) are of the opinion that section 24J was introduced

into the Act to address what was considered by SARS to be a serious problem concerning the treatment of interest and finance charges for income tax purposes. They believe that the problem related to the determination of the time of incurral and accrual of interest. They are also of the opinion that paragraph (b) in the definition of interest in section 24 J is not clear, as it refers to an amount to which the lender would have been entitled to, had the arrangement not been entered into. They go on to say that one would think that if there is no arrangement, then there is no amount to which the lender would be entitled.

Under the circumstances it is necessary to depend on the courts for the interpretation of interest.

In defining interest, a considerable amount of reliance has been placed on the judgement of Thompson AJ in the case of CIR vs Allied Building Society (25 SATC 343, 1963). In his judgement the learned judge at page 348 quoted the case of Farmer vs Scottish North American Trust 1912 A.C. 118 at 127 -

> " The interest is, in truth, money paid for the use or hire of an instrument of their trade, as much as is the rent paid for their office or the hire paid for a typewriting machine. It is an outgoing by means of which the company procures the use of the thing by which it makes a profit, and, like any similar outgoing, should be deducted from the receipts to ascertain the taxable profits and gains which the company earns".

Interest may therefore, be best described, as a "hiring fee" for money.

1.3 Exempt Interest

The Income Tax Act provides for the exemption of interest from normal tax in terms of section 10(1)(i)(xv). The exemption applies strictly to natural persons and is subject to certain limitations. (Arendse et al, 2003:80). The limitation are:
The first R1 000 in aggregate of any

- foreign dividend contemplated in section 9E (The repeal of section 9 E was promulgated in 2003, but does not affect the 2004 year of assessment) and
- interest received or accrued from a source outside the Republic not otherwise exempt from tax, is exempt from normal tax. In addition, the first R10 000 in aggregate of any interest received or accrued from a source in the Republic is exempt from normal tax. Taxpayers over the age of 65 enjoy an exemption of interest up to a maximum of R 15 000.

1.3.1 The Government exemption

In terms of section 10(1)(h) interest from stock or securities, including treasury bills issued by the government, including South African Transport Services, any local authority within the Republic, the Electricity Supply Commission or the South African Broadcasting Corporation is exempt from tax if it is received by or accrues to:

- a person other than a company who is not resident and does not carry on business in the republic, provided that if the recipient is a natural person, he is physically absent from the Republic for a period of at least 183 days in aggregate during the year of assessment in which the interest is received or accrued;
- a company which is not resident and does not carry on business in the Republic

Arendse et al (2003:82) are of the opinion that a non-resident investor may still enjoy this exemption even if he or it carries on business in the Republic, provided that the following conditions are fulfilled:

- The stock or securities have been issued in respect of a loan raised in a country outside the Republic
- The Treasury, with the approval of the Minister of Finance, has given an undertaking that the interest would be exempt from tax when derived by such a person or company
- The stock or securities have been acquired by the person or company outside the Republic and paid for by that person or company in the currency of any other country, other than the Republic.

However, the second proviso to section 10(1)(h), makes the interest exemption unavailable after 01 November 1987, to the following two categories of disqualified

investors:

- A person other than a company who is ordinarily resident in a neighbouring country if the stock or security was acquired by him on or after 01 November 1987
- A company that is incorporated, registered, managed or controlled in a neighbouring country.

Section 10(2)(b) precludes this exemption to a non resident who receives interest in the form of an annuity.

1.3.2 The General Exemption

In terms of section 10(1)(hA), interest received or accrued to a person who is not a resident is exempt from normal tax. However, the following limitations apply to the exemption:

- The exemption will not apply if the interest is received by a natural person who was at any time a resident, if during the year of assessment, he has carried on business in the Republic.
- For the exemption to be available to a natural person, he must also have been physically absent from the Republic for a period of at least 183 days in aggregate during the year of assessment in which the interest is received or accrued.
- The exemption is also withheld from a company which is not a

resident, if the interest is effectively connected with the business carried on by that company in the Republic. As a consequence, where a company which is not a resident carries on business through a branch in the Republic, any interest remitted by the branch will not exempt from normal tax.

1.4 The Deductibility of Expenditure in Terms of the Income Tax Act

It has been established in paragraph 1.1 that most deductions are allowed by virtue of the so-called general deduction formula. It is imperative to recognise that no deductions may be claimed unless the taxpayer is engaged in carrying on a trade. While section 11 (a) sets out what may be deducted, section 23 (g) stipulates what may not be deducted.

Section 23 (g) makes it absolutely clear that "any monies, claimed as a deduction from income derived from trade, to the extent to which such moneys were not laid or expended for the purposes of trade" may not be claimed as a deduction (SAICA Legislation Handbook, 2003:88). Section 23 (g) thus becomes the negative test. The dictates of accounting principles or sound business practice are irrelevant. This was established in Sub-Nigel vs CIR (15 SATC 381), where it was pointed out that the courts are not concerned with deductions which may be considered proper from an accountants point of view or from the point of view of a prudent trader, but merely with the deductions which are permissible according to the language of the Act.

Prior to its amendment in 1992, section 23 (g) prohibited the deduction of expenditure which was not laid out wholly and exclusively for the purpose of trade. No provision was made for the situation where expenditure was incurred partially for the purpose of trade and such expenditure was consequently disallowed (Huxham and Haupt, 2003:69). In the Appeal Court case of Solaglass Finance Company (Pty) Ltd vs CIR (53 SATC 1), the court held that a loss suffered as a result of a loan debt from a fellow subsidiary which went bad was not deductible as the loan had been granted with mixed intentions. As a consequence of the non-trade element, the loss suffered was not wholly and exclusively for the purpose of trade and was therefore not deductible. Arendse et al (2003:102) assert that the current form of section 23 (g) now explicitly envisages apportionment and allows deductions of trade portion.

1.5 Burden of Proof

Section 82 of the Act, places the onus of proof regarding the non taxability of an amount with the taxpayer (Huxham and Haupt, 2003:27). According to section 82:

"The burden of proof that any amount is—

(a) exempt from or not liable to any tax chargeable under this Act;

or

(b) subject to any deduction, abatement or set-off in terms of this Act; or

(c) to be disregarded or excluded in terms of the Eighth Schedule, shall be upon the person claiming such exemption,

non-liability, deduction, abatement or set-off, or that such amount must be disregarded or excluded, 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."

Section 82 is therefore an important factor, as the taxpayer has to prove that a deduction claimed meets the requirements of sections 11 (a) and 23 (g).

1.6 Application of Income Tax Law

Arendse et al (2003:108) believe that like any other expenditure, interest must be incurred in the production of income as defined in section 1 of the Act. If the interest constitutes expenditure in the production of income then it is necessary to determine the purpose of the expenditure and what it actually affects. This will in turn require an assessment of the closeness of the connection between the expenditure and the income generating operations. It is therefore imperative to ascertain the purpose of a particular transaction in order to determine the underlying cause that gave rise to that transaction. This allows for a distinction between purpose and cause, with causation being the subject of several High Court cases.

In the case of CIR vs Shell Southern Africa Pension Fund (46 SATC 1:), Nicholas JA, at page 2, said that:

- "A conditio sine qua non (condition that preceeds the event) is not

necessarily a causally relevant factor. As Denning J pointed out in the Minister of Pensions vs Chennell (1947) 1 KB 250 at 255 *in fine*, the latest event in a train of physical events is not necessarily 'caused by' the first event. An intervening event or extraneous event may be so powerful a cause as to reduce what has gone before to part of the circumstances in which the cause operates".

In Tuck vs CIR (50 SATC 98) Corbett JA in considering the causative factors behind a combined restraint of trade and remuneration agreement looked to the "quid pro quo" which gave rise to the receipt.

1.7 Summary

The current general deduction formula comprising of sections 11 (a) and 23 (g) of the Act may be broken down into the following elements:

- the expenditure and losses
- must be actually incurred
- during the year of assessment
- in the production of income
- if they are claimed as a deduction against income derived from trade, they must, either in part or full, constitute moneys that are laid out or expended for the purposes of trade (Arendse et al, 2003:93-94)

In the case of interest, there have been several court cases, where its deductibility has been challenged in terms of the above criteria. This is especially so in cases where money is borrowed for mixed purposes.

CHAPTER 2

THE DEDUCTIBILITY OF INTEREST

2.1 Introduction

If the purpose for which money is borrowed excludes the possibility of earning income, any interest incurred on the borrowed money may not be deducted. For example, should a director borrow money and lend it interest-free to his company, he will not be allowed to claim the interest he pays as a deduction, the money borrowed could not earn him any income (Arendse et al, 2003:109). The most important test to determine whether interest is deductible, therefore, is the purpose for which the loan was raised. If its purpose was for trade, it would be deductible. However, case law on the deductibility of interest is considerable and quite varied. Deneys Reitz (September 2001:4) in an effort to point out how varied the court judgements are, refer to the case of CIR vs Scribante Construction (Pty) Ltd (62 SATC 443), in which they are of the opinion that:

> "The defeat must have been galling for Revenue, because the facts were not dissimilar to those in Ticktin Timbers CC vs CIR (61 SATC 399) in which the Commissioner succeeded".

It is therefore imperative that the deductibility of interest must begin with the purpose of the transaction.

2.2 Financier vs COT (17 SATC 34)

In this case a taxpayer borrowed a sum of money which was used for the general purposes of his business. Certain of his investments produced no income. The portion of the interest that he paid on the loan and which related to the non-productive investments was disallowed as a deduction by the Commissioner. The test applied by the court was whether the money on which the liability for interest was incurred was in fact borrowed for the purposes of an investment, non-productive of income or productive of income.

Tredgold J, who delivered the judgement in the High Court of Southern Rhodesia in the above case, referred to the case of Producer vs COT (15 SATC 405). This case concerned a taxpayer who had borrowed money for the ordinary purposes of his business, but later invested the money in shares that did not produce taxable income. Tredgold J extracted the following principles from the case:

- "Where the taxpayer borrows a specific sum of money and applies that sum to a purpose unproductive of income and not directly connected with the income earning part of the business, then the interest paid on the borrowed money cannot be deducted as expenditure incurred in the production of income.
- Where a taxpayer has for good and sufficient reasons borrowed money for use in the business producing his income and in pursuit of that legitimate business purpose he subsequently invests such money in an investment which does not produce taxable income, the

interest is still deductible for income tax purposes".

Tredgold J therefore declared that, "It would seem that the test to be applied is the purpose for which the money was borrowed".

2.3 CIR vs Allied Building Society (25 SATC 343)

The ultimate use or destination of the money borrowed is not necessarily a decisive factor, but is relevant only in determining the purpose of the borrowing (Arendse et al, 2003:109).

In the case of CIR vs Allied Building Society (25 SATC 343), it was absolutely indispensable to the business of a building society to borrow money and a matter of commercial necessity that it accepted all monies tendered to it by the public. The court found that interest payable on borrowed monies were deductible in the circumstances and notwithstanding the fact that a portion of the funds may have been used to finance the acquisition of non-productive properties. The court further found that the acquisition of non-revenue producing properties was purely incidental to the business of borrowing money in order to earn income by investment. In addition, the Commissioner did not have sufficient grounds to reduce the interest deductible on borrowed funds if the taxpayer chose to let some of the money lie idle.

The court in this case accepted the view that the "true criterion of deductibility" was the purpose for which the Building Society borrowed the money (Arendse et al,

2003:109). This decision was confirmed in the case of CIR vs Standard Bank of SA Ltd (47 SATC 179).

2.4 CIR vs Standard Bank of SA Ltd (47 SATC 179)

This is a case that illustrates an inverted proposition to that contained in the Port Elizabeth Electric Tramway Company Ltd vs CIR (8 SATC 13). In that case, it was found that a close link must exist between the expenditure incurred and the production of income. In the Standard bank case (supra) it was found that an insufficiently close link existed between certain non-taxable income and the expenditure (Clegg,1991:244). However, the Standard Bank case (supra) confirmed that the purpose of borrowing was a "vital enquiry".

The Bank accepted all monies tendered to it by depositors and paid interest on the monies thus borrowed. These monies went into a common pool used for all purposes. The bank utilized a small portion of the funds in the pool to acquire redeemable preference shares. The preference shares, however, produced tax-free dividends.

The operations of the bank were such that it was required to borrow at a cheap interest rate and lend at a more expensive rate. Its immediate purpose was therefore to obtain floating capital. The court held that as the investment in preference shares was insignificant in relation to the main business of the bank, the general purpose of the funds borrowed had to be looked at (Huxham and Haupt, 2003:79).

The court held that the interest paid on all funds borrowed were deductible, as the bank generally raised the money to produce income. In deciding whether the expenditure was incurred in the production of income, the court had to look at the purpose of the expenditure. In addition, the court had to assess the closeness of the connection between expenditure and the income producing operations.

It was found that the connection between a certain proportion of the interest paid and the dividends received was not close enough to warrant the conclusion that the interest expenditure was incurred in the production of dividends or was an expense incurred in earning an amount not constituting income and so prohibited as a deduction. This principle was clearly illustrated in the case of CIR vs Drakensberg Garden Hotel (Pty) Ltd (23 SATC 251)

2.5 CIR vs Drakensberg Garden Hotel (Pty) Ltd (23 SATC 251)

This case is much loved by tax advisors. It deals with a situation in which the close and direct connection that is required in terms of the Port Elizabeth Electric Tramway's (8 SATC 13), between the expense and the production of income can be somewhere attenuated (Clegg, 1991:232).

In an attempt to gain absolute control of the hired premises from which it derived rent and business profits, the company borrowed funds in order to acquire shares in another company which owned the leased premises from which it conducted its business. The taxpayer was able to show a clear connection between interest paid on a loan to purchase shares and its business profits. The court was satisfied that

as a result of the purchase of the shares, profits (other than dividends) would increase. The interest paid was therefore deductible, notwithstanding the fact that dividends might not be received in respect of the shares or that such dividends , if they were received, would be exempt from tax in the taxpayer's hands.

The test for the purpose for which the money is borrowed was also stressed in the case of CIR vs Shapiro (4 SATC 29). In order to pay for shares in a company from which he derived salary and commission, a taxpayer borrowed monies on which he had to pay interest annually. He claimed that the interest should be allowed as a deduction against the salary and commission he received from the company. The court held that the salary and commission were not produced by his shareholding in the company but by the exercise of his duties as manager. Consequently, the interest paid on the money borrowed to buy the shares had not been in the production of income. The shares themselves produced exempt dividend income. The court found that the connection between the interest and the emoluments attaching to the position of managing director was not considered to be sufficiently close.

It follows from these cases that if the taxpayers purpose in buying shares is to ensure the continuance of the income from trading or business operations and so doing secure an increased income, the interest paid on the money borrowed to acquire the shares is properly deductible from that income.

2.6 Interest on Loans Raised to Acquire Capital Assets

Interest paid on money borrowed for the purpose of a business would appear to be expenditure actually incurred in the production of income. It is immaterial whether the loan was raised for the acquisition of fixed or floating capital. The interest expenditure cannot be regarded as being so closely identified or associated with capital assets that it must itself be regarded as being of a capital nature (Arendse et al, 2003:111).

The cost of finance is very similar to other payments made for the use of an asset. Where finance charges relate to stipulated assets, a deduction may be available in terms of section 11(bB). If the finance charges are not deductible in terms of section 11(bB), but all the requirements of section 11(a) are met, the deduction may be claimed in terms of section 11(a).

2.7 Interest on Loans Raised to Pay Dividends

Interest payable on money borrowed to enable a company to pay a dividend is not deductible. This was confirmed in ITC 678 (16 SATC 348). The question that the court raised in the case was:

- "Now what was the purpose of the expenditure in the present case, what did it do here? It enabled the appellant company to distribute its dividend. The distribution of a dividend is the distribution of its profits or of its accumulated profits. So this expenditure cannot be said to have produced the income of the company – that had already

been previously earned. It simply enabled the company to distribute its profits, and that is the purpose of this expenditure."

Since the purpose of the expenditure was to enable the company to distribute its profits and not to produce income, the expenditure was not permissible as a deduction.

2.8 Notional Interest

In certain circumstances an employee or the holder of an office will have included in his gross income the cash equivalent of the taxable benefit derived by him from a loan granted by his employer. Under specific conditions, Paragraph 11 (5) of the Seventh Schedule deems the cash equivalent to be interest actually incurred by a taxpayer for the purposes of section 11 (a).

Arendse et al (2003:111) quote a typical example of notional interest.

A borrows R200 000 from his employer. Interest on the loan is calculated at 8% pa. The official rate, however, is 13% pa throughout the year. A uses this loan to purchase a holiday cottage which is rented out for R50 000 per annum. Costs relating to the cottage for the year of assessment amounted to R6 500 for maintenance and R3 500 for water and electricity. The taxable rental income would be calculated as follows:

Taxable value of fringe benefit

Interest at the official rate of 13%	R26 000
Less: Interest paid by A	16 000
Taxable value of fringe benefit	R10 000

Taxable income derived from cottage

Rental Income	R50 000
Less: Maintenance Costs	(6 500)
Water and electricity	(3 500)
Interest paid on loan	(16 000)
Deemed interest (para 11 (5) of Seventh Schedule)	(10 000)
Taxable rental income	R14 000

2.9 Raising Fees

In CIR vs Genn & Co (Pty) Ltd (20 SATC 113) the court held that the raising fees were properly deductible from income. On the facts of the case it could not justify a difference in the treatment between the interest on the loan and the raising fees. The raising fees and the interest formed one consideration that the taxpayer had to pay for the use of the money during the period of the loan. The court considered the fees were sufficiently closely connected with the income-earning operations and therefore considered the expenditure to be in the production of income.

However, it does not necessarily follow from the above case that all raising fees are deductible from income. Each case has to be decided on its on merits. In ITC 882 (23 SATC 239), it was held that a fee for the raising of a mortgage loan for the purposes of acquiring a building at a time when the building was not lettable, constituted expenditure of a capital nature.

2.6 Summary

It is normal practice for a taxpayer to borrow money for business purposes on the security of his private assets. The fact that he has pledged or mortgaged private assets does not deprive him of the right to claim the interest paid as an allowable deduction. The sole test is the purpose for which the loan was raised. A typical example is where a taxpayer mortgages his private residence and invests the money in his business. The interest paid will be allowed as a deduction, since the purpose of the loan was for trade purposes (Arendse et al, 2003:109)

In practice the South African Revenue Services (SARS) accepts that if capital is borrowed specifically to reinvest, resulting in trade income, the associated expenditure is allowed as a deduction. On this basis SARS will allow a deduction of interest incurred in order to earn interest income (Arendse et al, 2003:110).

The Commissioner's practice is set out in Practice Note 31, the relevant portion of which reads as follows:

> "While it is evident that a person (not being a moneylender) earning interest on capital or surplus funds invested does not carry on a trade and that any expenditure incurred in the production of such interest cannot be allowed as a deduction, it is nevertheless the practice of Inland Revenue to allow expenditure incurred in the production of the interest to the extent that it does not exceed such income. This practice will also be applied in cases where funds are borrowed at a certain rate of interest and invested at a

lower rate. Although strictly in terms of the law, there is no justification for the deduction, this practice has developed over the years and will be followed by Inland Revenue".

CHAPTER 3

INTEREST ON DIVIDENDS DECLARED RETAINED AS A LOAN

3.1 Introduction

It has been a recent innovation where companies / close corporations declare a dividend / distribution and then credit these amounts to the shareholders / members loan accounts on which interest is payable. The incentive to do this is quite obvious. If the shareholder's / member's average rate of taxation is lower than the 37,5%, the total paid by companies for income tax and STC's (and the business is not a small business corporation), it may be in the interest of the business to credit such dividends / distributions to the loan account of the member in order to take advantage of a lower average rate in the hands of the shareholder/ member.

However, it may not be prudent to pursue such a course. The South African Revenue Services (SARS) may regard the interest on the loan account as having been incurred in order to enable the company or close corporation to pay a dividend. As will be shown in the cases that follow, the interest paid by the company or close corporation, in such cases, may not be deductible for the purposes of taxation. In addition, the added risk is that the interest received on such loan accounts may be taxable in the hands of the shareholder / member which would be an unfavourable outcome resulting in double taxation. This concept has been established clearly by the courts.

In ITC 792 (20 SATC 98) the court held that if the Commissioner disallows a portion of interest payable by a company to its shareholders as being excessive and not incurred in the production of income, he subjects the recipient to tax on the full amount received. It was further pointed out in WF Johnstone & Co Ltd vs CIR (17 SATC 235) that because any particular amount is not allowed as a deduction from the income of the payer it does not mean that it is not taxable in the hands of the recipient.

It has been generally accepted by the courts that interest on money borrowed by a company or a close corporation in order to pay a dividend / distribution cannot be said to have been incurred in production of income. The issue to be decided however, is whether the act of crediting dividends / distributions to a shareholder's / member's loan account results in the conclusion that the purpose of the loan is to enable the company to pay a dividend.

3.2 Dividends Credited to Loan Accounts Where Interest Declared Deductible

Several shareholders of companies and members of close corporations have built up substantial loan accounts resulting from the transfer of declared dividends and distributions to their respective loan accounts. These taxpayers have refrained from charging interest on these loan accounts for fear that the payment of interest on such loan accounts would be disallowed as a deduction to the company or close corporation, but would be taxable in the hands of the shareholder / member. However, an unreported judgement in the Cape Special Income Tax Court

delivered by Williamson J on 25 January 1994 gave some hope to shareholders and members faced with the above predicament.

3.2.1 The Williamson Judgement (Unreported Judgement - Cape Special Income Tax Court - 25 January 1994)

The taxpayer, a company, which had been converted to a close corporation in 1986, traded as the lessor of a block of flats. Interest had always been paid on the shareholder's loan account while it was a company and the interest continued to be paid on the member's loan account subsequent to its conversion. In its 1988 and 1989 years of assessment, the taxpayer claimed interest of R34 837 and R44 671 respectively, as a deduction. The interest arose as a consequence of dividends declared out of profits and credited to the members loan accounts. The Commissioner disallowed the deduction of the interest. The taxpayer objected on the basis that the interest was deductible under section 11 (a) read with Section 23 (g) of the Income Tax Act.

On appeal by the taxpayer, the court held the following:

- "If the company had actually paid the dividend and then subsequently borrowed the same money to finance its operations, the interest charged would have been tax deductible.
- The fact that there was no double remittance but merely a book entry did not change the substance of what had happened.
- The interest paid was an expense so closely linked to the business operation of the taxpayer that it qualified as an expenditure actually

incurred in the production of income.

- The interest was not an expense of a capital nature and it had been expended wholly and exclusively for the purpose of the taxpayer's trade.
- The interest was accordingly deductible and the Commissioner was directed to allow the deduction thereof in the 1988 and 1989 years of assessment". (The Taxpayer, 1994: 54)

It is however, doubtful whether the above judgement may be relied upon by the taxpayer, as the case was not reviewed on appeal. In addition, a plethora of cases disallow such interest deductions. Nonetheless there are other cases in which "purpose" has been looked at and has ultimately resulted in such interest being deductible.

3.2.2 CSARS vs Scribante Construction (Pty) Ltd (62 SATC 443)

This Judgement runs counter to a number of cases in which it was held that the purpose of the loan was to enable the company to declare a dividend. This was a case however, where the court had little difficulty in distinguishing it from others based on the facts established by the taxpayer.

The Appellant was a private company whose main trading operation was civil engineering and construction. It was a 'family type company' and the shareholding of the company vested in three family trusts. The shareholders, the company, the directors and the family trusts had all along been treated as one unit and decisions

were taken by the directors of the company on behalf of the family unit. The family financed the company and the company was considered to be the banker of the family.

Over the years and in accordance with family policy, bonuses payable to the directors were left with the company in a sort of 'banking fund' and were retained until they were required for further investment. The directors preferred to use the moneys in the operation of the company rather than operate on a bank overdraft. In some instances interest was paid to directors, while in other instances, the loans were interest-free. The interest credited to the director's loan accounts was treated as a company expense.

In the 1991 tax year the appellant declared a dividend of R6 573 076 out of the reserves available for distribution. However, during March 1990 the income tax regulations were changed to render declared dividends no longer taxable in the hands of the recipients. A portion of the dividend, namely R3 199 834, was credited to the interest-free shareholders' loan accounts while the balance of R3 373 242, was credited to shareholders' interest bearing loan accounts. The reason for the distinction was to be found in the fact that the company had on hand at the time surplus funds in the latter amount. These moneys were lying in the banker's call account and were available for the payment of the dividends.

The dividend distribution was done by way of book entry as the company did not physically pay the cash to the shareholders, but passed a journal entry debiting the

dividend account and crediting the shareholders' loan accounts. Over the relevant three year period, i.e. 1991 to1993, the appellant earned more in interest (R2 000 672) than the amount that was credited to the shareholders on the investment (R1 516 108).

In the tax years 1991 - 1993 the appellant deducted from its income the interest in the amount of R1 516 108 which it paid to the shareholders on loans arising from dividend distributions. The Commissioner for Inland Revenue disallowed the deductions on the grounds that the interest payments were 'non productive of income' and were therefore not deductible in terms of section 11 (a) read with section 23 (g) of the Income Tax Act No. 58 of 1962.

The Special Court, at page 450, held:

- "That in a case concerning the deductibility of interest payable on money borrowed, the enquiry relates primarily to the purpose for which the money was borrowed. Where a taxpayer's purpose in borrowing money on which it pays interest, was to obtain the means of earning income, the interest paid on the money so borrowed is prima facie an expenditure incurred in the production of income. If, on the other hand, the purpose of the borrowing was for some purpose other than obtaining the means of earning income, the interest was not deductible.
- That in regard to the deductibility of interest on loans arising from

dividend distributions, the deductibility of interest depended on the purpose of the borrowing and what that borrowing actually affected in the company. The use to which borrowed moneys was put usually indicated the purpose of the borrowing.

- That it follows that where a company uses borrowings for the non-income producing purpose of paying dividends, the interest on the loan is not deductible in terms of section 11 (a). The converse, however, must also hold true, viz, that where the borrowing is used to produce income in the course of trade, the interest is deductible in terms of the said section read with section 23(g) of Income Tax Act No. 58 of 1962.
- That the aforesaid was the case, irrespective of whether the money was borrowed from a bank or from a shareholder. It was also immaterial where the bank or shareholders obtained the funds, the deductibility of interest depended on the purpose of the borrowing, not on the source of the borrowed moneys.
- That the evidence established the fact that the appellant actually distributed dividends to the shareholders who then lent back the receipts to the company. This meant that the appellant did not pay the dividends with the moneys borrowed back from its shareholders.
- That therefore, the money in this case was not borrowed for the purpose of paying the dividends and such purpose must therefore be determined with reference to the appellant's actual use of the borrowing.

- That the effect of the borrowing was that the money remained in the call account and the moneys on call were for the use of the appellant in obtaining bank guarantees. It also enabled the company to earn income to the extent of the difference between the interest received on the call account and the interest paid out to the shareholders.
- That in the present matter the acts of the appellant and its shareholders amounted to a payment of dividends which the shareholders then invested in the company in the form of loans. As the borrowings were used for the purposes of trade (section 23 (g)) and in fact produced income directly and indirectly (section 11 (a)), the interest paid on the borrowing was deductible in terms of the Income Tax Act".

The appeal was allowed. The Commissioner for Inland Revenue was ordered to uphold the appellant's objections to the assessments and allow the deductions claimed by the appellant in the tax years 1991, 1992 and 1993.

On referral to the Supreme Court of Appeal (64 SATC 379), the findings of the Special Court were upheld.

3.2.3 ITC 1764 (66 SATC 93)

In this case the taxpayer had declared a dividend to its parent company and simultaneously entered into a loan agreement with its parent company. Of the total dividend declared, a portion was paid in cash and the balance was credited to the

parent company's loan account. The loan was utilised to fund a capital expenditure programme. At the time of declaring the dividend, the taxpayer had significant cash reserves in excess of the dividend declared. The taxpayer sought to deduct the interest expenditure but this was disallowed by the Commissioner on the basis that the expense had not been incurred in the production of income as the loan was to fund the dividend. The court, however, held that the purpose of the loan was not to finance the dividend, which the taxpayer was more than able to do, but to ensure that funds were available for capital expansion and to secure liquidity. Accordingly, the court held that the interest was incurred in the production of income and was deductible.

The taxpayer had considerable undistributed profits. The directors of the taxpayer wanted to retain these profits to fund its capital expenditure programme, but its parent company, wanted a dividend to be declared in its favour. After intense negotiations, the taxpayer declared a dividend of R682 million to the parent company and simultaneously borrowed R348 million from it. The taxpayer made a cash payment of R300 million to the parent company and credited the outstanding balance of the dividend to the parent company's loan account. (It was not clear why there was a discrepancy between the amount paid and the amount borrowed and the dividend declared).

At the time of the declaration of the dividend, the taxpayer had a cash balance, over and above the loan amount, that exceeded the total dividend declared. This was an important factor when the court considered the case. The taxpayer claimed

a deduction in respect of the interest on this loan in terms of section 11 (a).

SARS disallowed the deduction, arguing that the interest had not been incurred in the production of income, because the purpose of the loan had been to fund the dividend. With regards to the fact that there had been enough cash available (excluding the loan amount) to fund the dividend, SARS argued that such cash funds had been earmarked for specific capital expenditure activities and consequently, the purpose of the loan had always remained to fund the dividend.

The taxpayer argued that the purpose of the loan had to be established and that the same test should apply, whether the loan agreement was entered into on the same day as the declaration of the dividend or a year later. The taxpayer argued that it had been its intention to utilise the loan amount with its parent company with this sole purpose in mind.

The court stated that the dominant test concerning the deductibility of interest payable on a loan is the purpose of borrowing the money.

Where the taxpayer's purpose in acquiring the loan is to obtain the means of earning income, the interest paid on the money so borrowed is prima facie expenditure incurred in the production of income. If the purpose is otherwise, e.g. to pay a dividend, then the interest on the loan is not deductible (CIR v G Brollo Properties (Pty) Ltd, 56 SATC 47). The declaration of a dividend and a simultaneous loan agreement does not per se result in the disallowance of the

interest on the loan (C:SARS v Scribante Construction (Pty) Ltd,64 SATC 379). Only when a company declares a dividend and simultaneously has to obtain external finance to continue to operate its business, will it appear that a scheme has been concluded to fund the dividend. In the present case, if the entire dividend had been paid in cash without any loan and without any reduction in actual expenditure, the taxpayer would still have had R79 million in cash at the end of the relevant financial year (Deloitte: 2004).

The court held that in order to determine the purpose of the loan, the intention of the company, as reflected in the intention of its directors in respect of the loan, must be established. The court found that the purpose of the loan was to ensure that funds were available for capital expansion. Its purpose was to secure liquidity for the company and it did so by way of a bona fide commercial transaction between itself and its shareholders.

Accordingly, the purpose of the loan was to earn income and, therefore, the interest paid on the loan was incurred in the production of income and could be deducted in terms of the Act.

3.3 Dividends Credited to Loan Accounts Where Interest Not Deductible

The facts in the Scribante case (supra) above were not dissimilar to those in the Ticktin Timbers CC vs CIR (61 SATC 399), in which the Commissioner succeeded.

3.3.1 Ticktin Timbers CC v CIR (61 SATC 399)

The appellant close corporation had declared dividends to its sole member, Dr Ticktin, but the dividends were not paid to the member. The dividends were instead credited to the loan account of that member in the books of the close corporation. Interest was charged on the loan and the appellant contended that the loan funds had been used in its business and that the interest on such funds had, therefore, been incurred in the production of income and was consequently deductible in terms of section 11 (a) of the Income Tax Act No. 58 of 1962.

The appellant close corporation came into being during 1985 when Dr Ticktin acquired the shares in a private company and converted the company into a close corporation. Among the company's assets was a substantial amount of distributable reserves which, in terms of section 40A of the Income Tax Act no. 58 of 1962 (as it was at the time) were deemed to have been distributed to the corporation. In the first entry in the loan account, the balance of the reserves after tax was credited to Dr Ticktin. Thereafter, the corporation's net income until 30 June 1985 was also credited to him and so was its net trading income for every ensuing year until 1989.

Dr Ticktin's explained that, as a sole member of the corporation, he was entitled to whatever dividends he wished to declare and that all the credits were passed in respect of dividends he had declared, but retained in the business as an interest bearing loan in order to finance the company's day to day operations.

In the previous court, a full bench of the Cape Provincial Division (CIR v Ticktin Timbers CC 59 SATC 260) upheld the Commissioner for Inland Revenue's refusal to allow the appellant to deduct interest on capital borrowed from its only member during the 1985 to 1989 years of assessment. The issue before the Supreme Court of Appeal was whether the previous court's findings that the interest did not constitute expenditure incurred in the production of income as envisaged in section 11 (a) of the Income Tax Act No. 58 of 1962, was correct.

The Cape Provincial Division had held that the money had not been borrowed by the close corporation in the production of its income. Deneys Reitz (September 2001:4) are of the opinion that in coming to this conclusion, the court held that the transactions were conceived with the intention of increasing the member's income and not the corporation's income. The aim had been accomplished 'by creating loans where none was needed for the taxpayer's income producing activities'. The court was of the view that with the creation of the loans, the appellant's expenses were increased and accordingly the loans were a burden to the appellant and not a benefit.

Section 11 (a) of the Act which allows the deduction of non-capital expenditure actually incurred in the production of income, is subject to section 23 (g) which (before its amendment during 1992) prohibited the deduction of moneys 'not wholly or exclusively laid out or expended for the purposes of trade.'

The Supreme Court of Appeal held, at page 400 :

- "That the enquiry in a case of this kind must proceed by an examination of the facts of the case. It was important to classify whether the expenditure was actually incurred in the production of income and whether its deduction was prohibited by section 23(g) of Act No. 58 of 1962.
- That there can be no objection in principle to the deduction of interest on loans in suitable cases, as loan capital is the life blood of many businesses. However, the mere frequency of its occurrence does not bring about the result that this type of expenditure requires different treatment.
- That the previous court was correct in its view that the loan in issue was not needed for the appellant's income producing activities and that the real intention was to increase its sole member's income and not that of appellant. The liability for the interest was accordingly not incurred in the production of the latter's income.
- That even if liability for the interest was incurred in the production of the appellant's income, the loan served a dual purpose; one of which had no bearing on the appellant's trade. Hence, the deduction of the interest was prohibited by section 23 (g) and the Commissioner for Inland Revenue had rightly refused to allow it.
- That it was quite clear that the relevant transactions, namely, the making of the distribution on the one hand, and the making of the loan, on the other, were not intended to be separate and unconnected transactions. They were interdependent and neither

was intended to exist without the other.

- That it was this link which was fatal for the appellant's case. It showed the true reason why the appellant had to borrow back at interest from Dr Ticktin. The appellant was under no obligation to part with the money. It was clear that the appellant wanted to make a distribution to Dr Ticktin and the interest was not deductible.
- That in the present case the purpose of the loan was to enable a distribution to be made to Dr Ticktin. Without the loan there would have been no distribution. Without the distribution there would have been no loan.
- That the conclusion of the previous court did not rest upon a wrong assumption that the money in question was borrowed in order to finance the making of the distribution. It rested upon a correct finding of fact on the evidence before the court that was indeed the purpose for which the appellant undertook to incur a liability to pay interest which would not otherwise have existed.
- The fact that the payment of the dividend was the historical cause of the company needing to borrow was irrelevant, as the purpose of the borrowing was to finance the company's trading operations after it had parted with its own resources while under the misapprehension that it could afford to do so".

The appeal was therefore dismissed with costs.

According to Deneys Reitz (September 2001:5) the court found that the interest was not deductible and arrived at this conclusion by looking at the situation in two ways. Firstly, the loan to the corporation was not required for its income producing activities but in order to increase the income of the member. The interest was therefore not incurred in the production of the income of the corporation and, even if it was, the loan served a dual purpose, one of which had no bearing on the corporations trade. The interest payment had thus been properly disallowed.

The second way of looking at the matter was that the corporation had enough funds for its operating needs. By declaring these funds as dividends to the member, it placed itself in a position where it was obliged to borrow working capital from the member. The dividend payments and the loans were therefore not intended to be separate and unconnected transactions. They were plainly interdependent and neither was intended to exist without the other. The court consequently found that 'the true reason why' the corporation had to borrow back from the member 'money which it had in its own coffers and was under no obligation to part with, was because it wanted to make a distribution' to the member (Deneys Reitz, September 2001:5).

In the Scribante case (supra) however, the position was different. The company was owned by members of a family; it had a good reputation in the construction industry and good relations with its bankers. The company found itself with funds of nearly R6,6 million. Of this amount, some R3,4 million was surplus to the commercial needs of the company. The company then declared the entire sum of

R6,6 million as a dividend, of which the R3,4 million was credited to interest bearing accounts and the rest to interest free loan accounts of the shareholders.

The court found that there were two reasons why the R3,4 million had been declared and then borrowed back. Firstly, as the funds were surplus to the requirements for working capital, the company had properly used them to declare a dividend. Secondly, the standing of the company with financial institutions was enhanced by the presence of a sound liquid position. In the nature of its business, the company regularly required guarantees from such institutions, and guarantees were more easily obtainable by a company with a sound cash profile. It therefore made sense for the shareholders to enhance this profile. The court found that the link between the loan and the dividend, which had proved fatal to the case of the taxpayer in the Ticktin case, did not apply to this portion of the loan. It would have applied to the interest free portion of R3,2 million had the taxpayer paid interest on it.

The crucial difference between the Scribante (supra) and Ticktin (supra) situations was the existence of surplus funds in the former and the consequent absence of a link between the loan and the dividend. In addition, the decision not to charge interest on the funds that would be required in the short term was clearly a wise one. It should, however, be noted that the court was not unanimous. Liebenberg J could find no distinction between the Scribante (supra) and Ticktin (supra) situations.

3.3.2 ITC 1466 (52 SATC 25)

In ITC 1466 the taxpayer, a close-corporation which had been converted from a company, distributed its after tax retained earnings to its sole member. No money was however paid to the member, and the distribution was effected by crediting the members loan account with the amount involved. The member charged interest on the loan and the Commissioner for Inland Revenue disallowed the deduction.

The Judge held that the taxpayer had not shown that the purpose of the loan was anything other than to enable it to make a distribution of its retained earnings to the members as a dividend. It had accordingly not been proved by the taxpayer that the interest on the loan had been expended wholly or exclusively for the purpose of trade.

ITC 1466 is not a general rule in regards to the deductibility of interest, where such interest is expensed as a result of a distribution being credited to a loan account.

In his judgement, Jennett. J found the following at page 27:

- "The argument on behalf of the Commissioner is that the purpose of the loan giving rise to the interest charged which the appellant seeks to deduct from its income was not that of the appellant's trade, but rather in order to enable the appellant to make a distribution to its member of its undistributed or undrawn income. If that is so, and

there is no evidence to the contrary as regards the purpose of the loan, then clearly the deduction claimed by the appellant was correctly disallowed by the Commissioner. The decision was in keeping with the decision arrived at in ITC 678 (52 SATC 25)".

During the course of his judgement, Jennett J also pointed out the following at page 27:

- "In the appellants notice of objection to the Commissioner's assessment, it contended that in the conversion of the appellant from a company to a close corporation, the revenue reserves of the company were effectively converted by operation of law into loan accounts".

The Taxpayer (1990: 187), believe that this latter argument is, however, not correct."

It is clear from the above that the taxpayer interpreted the law incorrectly. In terms of section 82 the burden of proof rests with the taxpayer to show that the Commissioner was incorrect. Yet, no evidence on the purpose of the loan was advanced by the taxpayer.

The decisions of the Special Income Tax Court do not, however, set a binding precedent. For the reasons mentioned above, ITC 1466 cannot be regarded as an

authority for the proposition that interest paid in such circumstances is never deductible. As Judge Galgut J. said in the case referred to as a Natal Case (supra), where the facts were similar to ITC 1466:

- "That while the payment of a dividend by means employed by the appellant is a common practice, there is insufficient evidence in the present matter to persuade us that the interest concerned does not fall foul of Section 23(g) of the Act." (The Taxpayer, 1990: 186)

3.3.3 "The Natal Case" (Judgement of the Natal Income Tax Special Court, delivered by Galgut J. 20 June 1990)

The difference between the Natal Case and ITC 1466 was the fact that in the Natal Case, the taxpayer's company operated on a break even basis and the increased interest expense resulted in an increased rental accruing to the taxpayer. This fact may have had some relevance "in the production of income" test for the deductibility of an expense. The court, however, correctly disregarded it as having had any bearing on whether or not the interest had been expended wholly or exclusively for the purpose of trade as required by Section 23 (g) of the Act.

Before the declaration of the dividend, the capital employed by the appellant was represented by a loan account in favour of the holding company. The retained earnings amounted to R36 214. After the declaration of a R36 000 dividend, the position of the appellant did not in essence change. The capital employed was then represented by the loan account, which was increased by R36 000 and the retained earnings reduced by R36 000 to what was effectively, zero. While the

position of the appellant therefore remained unchanged, what was achieved by this exercise was a distribution of the dividend. The auditor, furthermore, admitted that the dividend could not have been distributed by any other means. The interest therefore fell foul of Section 23 (g) of the Act (The Taxpayer, 1990: 197).

3.4 Dividend Loan Created on Revaluation of Property in Company

It is important to bear in mind the general principles relating to the allowance of deduction of expenditure in terms of the provisions of the Income Tax Act. For an expense to be deductible it is not necessary that it actually generates income, but it must be incurred for the purpose of producing income (Temkin:2002).

3.4.1 Commissioner for SA Revenue Service v 121 Castle Street Cape Town CC (63 SATC 185)

The Cape High Court recently had occasion to consider whether interest paid by a taxpayer on mortgage bonds was deductible. The taxpayer, a close corporation, owned a property on the periphery of Cape Town's central business district.

An architectural practice wished to purchase the property. However, the close corporation members indicated they preferred to sell their interest in the close corporation rather than making the taxpayer sell the building. The ensuing transaction was funded by raising two bonds on the property. Five days after the loans were raised, the building was revalued. A dividend was declared and credited to the member's loan accounts. The effect of the transactions was to wipe out the loan obligations of the architectural practice.

The court had to determine whether the interest paid by the taxpayer on bonds in issue was deductible. The Commissioner argued that the loans were raised and advanced to the taxpayer's members to facilitate the acquisition of their interests in the close corporation. The expenditure thus incurred was not in the production of income.

The court held that in determining whether the relevant provisions of the Act were applicable, the objective of the transaction and the reasons why it was entered into was the dominant consideration. The objective with which the money was borrowed was of primary importance. For such expenditure to be deductible there should be a sufficiently close link between the expenditure incurred and income-earning operations.

Although the architectural practice had been secured as a tenant, there was no evidence that the transaction's purpose was to enable the taxpayer to secure a tenant as a result of which income would be produced. Had there been evidence that the taxpayer was unable to secure a tenant, except by financially assisting its new members to acquire "member" interests, it would have been open to contend that the purpose of the transaction was to secure a tenant and, accordingly, to produce income. Money was therefore not borrowed for use in the production of income and accordingly the taxpayer's capacity to produce income was not increased by the transaction.

The only result of the transaction was a liability to pay interest, with a consequent

reduction in its net income. The court held that the taxpayer was, therefore, not entitled to deduct from its taxable income the interest it paid on the bonds.

3.4.2 ITC 1595 (57 SATC 321)

The issue in ITC 1595 was whether or not interest paid by a company on its shareholders' loan accounts was deductible in terms of section 11 (a), read with section 23(g) of the Income Tax Act (Fisher, Hoffman, Sithole:1996).

The taxpayer was a private company which owned a commercial property. This was its only asset and the rental income derived from the property its only income. A group of investors wished to acquire the property and contemplated doing so by purchasing the shares in the company. A problem with this route was that the company was being taxed on its profits, and the shareholder would be taxed on the dividends distributed to them (the purchase of the shares occurred at a time when dividends were still taxable). To overcome this problem the investors arranged for a public company to acquire the shares in the taxpayer. This company then caused the taxpayer to revalue the property to its market value, transfer the increase in valuation to a distributable reserve, declare a dividend out of this revaluation and credit the loan account of the shareholder with the amount of the dividend. The crediting of the loan account was necessary as the company did not have the cash to pay the dividend. The public company (which owned the shares in the taxpayer) then sold the shares to the investors and ceded the loan account to them. The new shareholders then caused the taxpayer to pay interest on the loan accounts, ostensibly from the commencement of the next year of

assessment. The taxpayer sought to deduct the interest expense from its income, which resulted in little tax being payable by it. The interest income would obviously be taxable in the hands of the shareholders, but the taxation of the profits in the company and the taxation of the dividends in the hands of the shareholders was avoided.

The Commissioner for Inland Revenue disallowed the deduction on the grounds that the interest expense was unproductive of income, contending that the crediting of the loan accounts related to the payment of a dividend.

The taxpayer contended that the purpose of crediting the loan accounts was the retention of the money making up the dividend, for the furtherance of its trade. Without such money it would not have been able to continue trading. In addition, if it had to repay the loan accounts it would have had to sell its only income-producing asset.

The court decided the issue by answering the question of whether, on the facts, the purpose of the loan was the paying of a dividend. The Court found that the substance of the scheme was that by means of a mere book entry, the distributable reserves of the taxpayer had been moved to loan accounts and that the real motive behind this was to change its tax structure and not to serve its trade.

The Court made an interesting point in passing. It was prepared to assume that,

if a sufficient period is allowed to pass before interest is charged on the loan accounts, a stage would be reached when there would no longer be a connection between the payment of the dividend and the later interest expense. This later interest would then be sufficiently closely connected to the taxpayer's income-earning operation to conclude that it was being incurred for the purpose of its trade. Even on this assumption though, the Court felt that by the end of the year in question, insufficient time had elapsed to support such a contention.

This case serves to re-emphasise the fact that SARS examines the deductibility of an interest expense closely, to see whether it is productive of income.

3.4.3 CIR vs Guiseppe Brollo Properties (Pty) Ltd (56 SATC 47)

The facts in the Brollo case (supra) are somewhat complicated, but the central point is that the taxpayer claimed interest on a loan which resulted from a dividend declared but credited to the loan account. The taxpayer's property had been re-valued upward by R4 779 260. This surplus was transferred by the directors to non-distributable reserves. The sum was then transferred to distributable reserves which was then available for distribution as dividends.

The taxpayer did not have liquid resources with which to pay the amounts of the dividends. Its only assets of any significance were the land and buildings. Consequently, the dividend debt was simply credited to the interest bearing loan account of Hume Limited, its holding company. However, in terms of the company's articles of association, no interest could be charged on a such a loan.

The result of the transaction was that the dividend debt which was due and payable was converted into an interest bearing indebtedness. As a result, Hume Limited's loan account increased by some R6 million by 30 September 1984.

Hume Ltd was part of the Barlow Rand Group. The company adopted a group policy, in terms of which every operating subsidiary had to operate as a self-sufficient profit centre and to this end "the companies were structured on a one to one debt equity ratio." The loan value to each company was split as follows:

- 50% "equity loan" (which was treated as an interest free loan) and
- 50% as an interest-bearing loan.

Under Capital Employed in the Balance Sheet the following was reflected:

	Notes	1984	1983
Holding company	**6**	1 0 717 480	4 428 336

Note 6 to the financial statement reads -

	1984	1983
6. Holding company		
6.1 Equity loan	5 358 740	5 358 740

The loan is unsecured, interest free and no repayment terms have been arranged.

6.2 Long Term Loan	5 358 740	4 428 336

The loan is unsecured, bears interest at 14% (1983 - 12%) and no repayment terms have been arranged.		
Total Holding Company	10 717 480	4 428 336

Similar items appear in the financial statements for the 1985 and 1986 years, except that the rates of interest levied in those years increased to 15.3% and 17% respectively. The reason for this policy was to ensure that the companies paid market related interest rates and therefore receive market related rentals. The long term goal was to ensure that the rentals earned would eventually exceed the interest paid. The effect of this policy was to establish a direct connection between the receipt of rental at market related rates and the payment of interest to fund owning property.

In each of its returns for 1984, 1985 and 1986 the taxpayer claimed interest as a deduction which it paid to Hume Ltd. These deductions were initially allowed, but in a letter dated 25 May 1987 the Receiver of Revenue advised the taxpayer that adjustments had been made in the calculation of the taxpayer's taxable income. The taxpayer objected to the assessment, which was disallowed and resulted in an appeal to the Special Court. The judgement was reported as ITC.1500 (53 SATC 272)

The Commissioner thereupon noted an appeal against the decision to the appeal court on the grounds that:

- "The court should have found that the interest paid was on loan the account created for the purposes of enabling the appellant to distribute its profits through the declaration of a dividend and that accordingly the interest expenditure was not incurred in the production of income nor was it wholly or exclusively expended for the purpose of trade."

It was submitted on behalf of the taxpayer that the original purpose of borrowing the money did not govern its deductibility forever. Consideration had to be given to the purpose of the actual expenditure, as and when it was incurred, month by month, and if the interest on the loan debt was paid in the course of normal income earning operations, it should be deductible, whatever the original purpose of the borrowing may have been. The following cases were cited in support of this submission:

- Producer v Cot 1948 (4) SA 230 (S.R.)
- Financier v Cot 1950 (3) SA at 293 (S.R.)
- ITC 953 (1961) 24 SATC 552 at 554
- ITC 1171 (1972) 34 SATC 80 at 81-82

The court stated that the question in those cases related to the diversion of money borrowed, from one purpose (income producing operations) to another. They were not relevant to the present case, in which the taxpayer did not receive any money as a result of the transaction in issue, but incurred an indebtedness with a liability

for interest attached to it. The court held inter alia at page 50:

- "that the present case was not one in which money was borrowed to be used by the taxpayer for the production of income. The taxpayer's capacity to produce income was not increased by the transaction. On the contrary, the only result of the transaction was to burden the taxpayer with a liability to pay interest with a consequent reduction in its net income.

- that the special court view that there was no longer any identification between the determination of the amount of interest expenditure and the original dividend debt resulted from a misconception of the nature and effect of the Barlow Rand Group Policy and that the policy did not create any obligation to pay interest. It merely created a mechanism for computing the amounts of interest payable by and the rentals payable to the property companies in the division concerned.
- that the implementation of the Barlow Rand policy did not alter the fact that the loan account liability was incurred with the purpose of discharging the dividend debt and it was that purpose which was overriding".

The appeal was therefore allowed and the revised assessments were confirmed.

It was clear in this case that the company increased its loan from the holding company to finance the dividend paid in 1984. CIR vs Elma Investments CC (58 SATC 295) is also an authority that such interest is not deductible on the basis that it was not incurred in the production of income.

3.4.4 CIR vs Elma Investments CC (58 SATC 295)

On 29 August 1985 Elma Investments CC (supra), a close corporation, paid its members a distribution of approximately R70 000 from unappropriated past profits. The distribution had been made on the understanding that the amounts would be immediately lent back to the close corporation. The next day, the money was given back to the corporation in the form of an interest bearing loan from the members.

The corporation had sought a deduction in terms of section 11 (a) of the Act of the interest which it had paid to its member on their loan accounts for the1987, 1988 and 1989 years of assessment. The Commissioner for Inland Revenue disallowed a portion of the interest on the ground that the money on which the interest had been paid was used to finance a distribution of profit to the members.

The corporation contended, both to the Cape Special Court and on appeal to the full bench of the Cape Provincial Division, that the loan from the members was raised for the purpose of trade and not to finance the distribution of profits.

The Special Court had concluded in May 1994 that the money in question had been borrowed by the respondent in the production of its income and for the

purpose of its trade. The only issue to be determined by the Full Bench was the reason for borrowing.

The Special Court had correctly found that the repayment of the profit distribution to the corporation gave effect to a pre-arranged scheme. This meant that the members had decided, both between themselves and with the corporation, to distribute the profits long before they had passed the resolution for the distribution of profits to themselves.

The corporation contended that there had been two transactions; one in which the members made the corporation declare a distribution and then another in which the respondent, alarmed at having been made to payout essential working capital, did the best it could to repair the ravages caused by its members, by borrowing back from them the capital needed for the production of its income.

The Supreme Court held, upholding the Commissioners appeal, that on the facts, the loan was not raised by the taxpayer for the purpose of producing income but simply to create an interest bearing loan account in favour of its members.

Coopers & Lybrand (1996) were of the opinion that the scheme created an additional expenditure for the close corporation and not additional income.

The above judgement shows that this decision was in line with reasoning of the Appellate Division in the case of CIR v Guiseppe Brollo Properties (supra).

3.5 Quo Vadis?

It would appear that the taxpayers have met with little success in disputes with the Commissioner regarding the deductibility of interest on loans arising from dividend distributions. However, none of the decided cases give clear direction on whether such interest is invariably non-deductible. What is clear is that the deductibility of interest depends on the purpose of the borrowing and what the borrowing actually affects in the company.

Tsatsawane (2002) found two problems with the findings in ITC 1428 (50 SATC 34:1985), when compared to the Shapiro case.

- " It is not clear from the judgement why, on similar facts, it was decided, in the one case, that the main purpose of the taxpayer was to acquire the shares and, in the other case, that the main purpose was to be appointed director. It follows from the shareholding of a company, that one would be entitled to be become a director or appoint a director.

- The use of the money in the company in which the shares were acquired was irrelevant. The requirement was that the interest must be incurred in the production of the taxpayer's income, not that in which the shares were bought".

The use for which borrowed moneys are acquired usually indicate the purpose of

the borrowing , unless the moneys are borrowed for one purpose but used for another, as was the case in Commissioner for Inland Revenue v Allied Building Society (supra) and Commissioner for Inland Revenue v Standard Bank of SA Ltd (supra). It follows, therefore, that where a company uses borrowings for the non-income purpose of paying dividends, the interest on such loans is not deductible in terms of section 11 (a) of the Act. The converse must then also hold true, that where the borrowings are used to produce income in the course of trade, the interest is deductible in terms of section 11 (a), read with section 23 (g). This should be the case irrespective of whether the money is borrowed from a bank or from a shareholder. The deductibility of interest, therefore, depends on the purpose of the borrowings, not on the source of the borrowed funds. This reasoning, presupposes that an actual dividend was paid.

A serious problem arises when a company does not have funds to pay a dividend. If the distribution is effected by means of a book-entry ie a transfer of the balance on the accumulated profit to the shareholder's loan account. In these circumstances the courts have held that the purpose of the borrowing was to pay a dividend.

The Williamson Judgement's approval of allowing a deduction of interest where the company has sufficient funds, therefore goes against what appears to have been the principle in other cases, even though some of them appear to have been decided on the basis that the taxpayer had not discharged his onus in terms of Section 82.

The resolution of the shareholders declaring a dividend is the cause of a dividend. An agreement between the company and the shareholders wherein the company secures continued use of the funds in return for interest is the cause of the interest expense. The question then is whether the interest expense can stand up to the tests of deductibility.

It would appear from the transactions in some of cases already discussed, that the whole object of the transactions was to divest the company of its accumulated funds and lower its taxes by the interest charge. Had no dividend been declared, no loans would have appeared. It was solely for the purpose of declaring such a dividend that the loan debt came into existence. This supports the argument that the purpose of the loan may have been to pay a dividend. It follows therefore, that the interest paid on dividends credited to loan accounts cannot be deductible in terms of Section 11 (a) and Section 23 (g) as the purpose of the interest payment is quite obviously to pay the dividend at a future date.

There is clear difference between borrowing money from a bank to pay a dividend and borrowing the proceeds of a dividend itself to discharge the dividend debt. In the first case, money is paid by the company and received by the shareholders and in the latter case, no money is paid by the company to shareholders. The amount in question remains invested in the company as the shareholders elected to fund the company by debt instead of equity. Where no money is received by the shareholders, it is the dividend that is owed to the shareholders at interest and not the loan debt which arose as the result of dividends being credited to loan account.

The interest only came about because the dividend owing is used to fund the business.

If a company, on the other hand, borrows funds from a bank to pay a dividend to its shareholders and subsequently borrows the money back from those shareholders at interest in order to repay its indebtedness to the bank, the interest payable to those shareholders is not deductible. The purpose of the loan from the bank was to pay the dividend.

3.6 Summary

Meyerowitz et al (1998: 213-214) believe that the 'conventional' wisdom conveyed by the majority cases creates some curious and serious anomalies in logic and practice. They highlight the problem by presenting the following scenarios and questions:

- "A company buys trading stock on credit and pays interest on the debt due. No one would doubt that the interest paid is deductible, but why? Is the answer not that its purpose is to conserve its financial resources in order to earn income instead of depleting them by using available funds or selling assets to pay the debt? Similarly if it borrows the money to pay its debt, is its purpose not to finance its trading activities?

- Directors leave their salaries as debts due by th company on which

it will pay interest. In principle the deduction of the interest is allowable only if the debt owing to the directors is identifiable with the trading operations of the company. That identification is revealed by the fact that the debt is part of the method of financing the company's income-earning operations.

- Shareholders fund a company with interest-free loans. Thereafter they require the company to pay interest. The company is the worse off by paying interest but the interest is deductible because the loan is used in the production of its income.

- Shareholders convene a meeting of the company in order to pass a resolution reducing the company's share capital which has been used to produce its income. It has no funds with which to pay the shareholders. It therefore borrows money in order to do so or the shareholders convert the debt into an interest-bearing loan. Is the interest not deductible because the purpose is to return capital to the shareholders, or is the answer that it is not deductible because the borrowing or loan is required to finance its trading activities?

The authors submit that there is no difference in principle or in effect between a reduction of capital and the declaration of a dividend. In both cases it is the decision of the shareholders whose interests do not have to coincide with that of the company which is a separate

legal person. In both cases the resolution of shareholders creates a debt due by the company which, in the absence of an agreement to convert the debt into a loan, entitles each and every shareholder to enforce payment of the debt.

- A company has surplus of cash funds which it uses to pay a dividend declared, knowing that it would have to replenish its floating capital at some stage. Subsequently, it borrows from a bank or from the shareholders in order to finance its trading operations. Is the interest not deductible because, but for the dividend declaration, it would have had no need to borrow?

- A company is obliged to pay damages for, say, defamation. If it has a sufficient amount of floating capital to pay the damages, but has to replenish its floating capital, it has the choice of alternatives; one of using its own resources to pay the damages and borrowing funds to replace the loss of floating capital. Alternatively, it can in the first instance borrow the money to pay the damages and retain its floating capital.

Under the first alternative the interest it pays on the borrowed funds is undoubtedly deductible because the funds are to be employed in the production of income, but can the deduction under the second alternative be denied because the ostensible and direct use of the

borrowing is to pay the damages claimed?"

Meyerowitz et al (1998: 213-214) contend that these scenarios illustrate the proposition that whenever a company incurs a debt, however that debt arises, the enquiry should be: what is the taxpayer's purpose in substituting another debt in its place or accepting the conversion of the debt to an interest-bearing loan? If the answer is that the taxpayer uses the funds represented by the loan in the production of income then, in their view, the interest payable should qualify for a deduction under section 11 (a) read with section 23 (g) . They further believe that by saying, as some of the cases do, that, but for the dividend declaration, the taxpayer would not have incurred the liability and therefore the purpose of the borrowing or loan was to pay the dividend, is to stop short of the company's purpose in preferring to pay interest on the loan instead of utilising its own finances employed in the production of income to pay the dividend and consequently, reduce its financial ability to earn income.

CHAPTER 4

INTEREST CHARGED ON MONEY BORROWED TO REPLACE CAPITAL WITHDRAWN BY PARTNER

4.1 Introduction

The negative portion of the so-called general deduction formula, contained in section 23 (g), prohibits the deduction of any moneys which was not laid out or expended specifically for the purposes of trade (Arendse et al, 2003:102). This section is frequently relied upon by the Commissioner to either disallow the deduction of an expense or to limit such deduction (Huxham and Haupt, 2003:72). Without this provision it would have been very easy for a partner in a business to arrange his affairs in such a way that he could borrow capital for his trade and use his own capital to derive tax-free income. In this way, the taxpayer would lower his income by claiming the interest on the borrowed funds as a tax deduction. However, three cases with similar facts provide varied and different results.

4.2 ITC 1583 (57 SATC 58)

On 28 February 1985, the appellant's wife owed the Perm Building Society an amount of R24 615.36 in respect of money which she borrowed to help finance the purchase of the matrimonial home. At the same time the appellant, who carried on trade as an attorney in partnership under the name Thompson and Wood, had a credit balance of R32 037 standing to his capital account in his firm. On that date the balance of R24 615.36 owing to Perm was paid from the appellant's capital account from the business, effectively extinguishing his wife's debt to Perm

Building Society. On 30 January 1985, however, the appellant's wife had already applied to the Perm Building Society for a re-advance of R25 000. In her application she declared that she required the loan to finance her husband's attorneys practice.

The re-advance was granted on 1 March 1985 and thereafter paid by the Perm Building Society to the partnership. This in effect replaced the capital which had been withdrawn from the capital account the day before. The appellant's unchallenged evidence was that the money was lent to him by his wife and that he in turn on-lent it to his firm.

In his income tax return for the years of assessment ended the last day of February 1986 and 1987 the appellant claimed as deductions from his gross income amounts totaling R8 247 in respect of interest paid by him to the Perm Building Society. The Commissioner refused to allow the deductions on the grounds that the interest expenditure had not been incurred in the production of income and had not been wholly and exclusively laid out for the purposes of trade.

The Commissioner initially also relied on the provisions of Section 103(1) of the Act. At the appeal, however, he abandoned his reliance on this section.

The appellant stated that he had sought to reduce his liability for income tax by re-arranging his affairs in a more appropriate manner. From a tax planning point of view it was considered to be wasteful to be paying interest on the home loan

which, as domestic expenditure, did not qualify for a tax deduction. In addition, the appellant had a credit loan account with his firm which was used by the firm in the production of the income of its partners and on which he was being paid interest which was taxable.

With the partners approval, the appellant withdrew the amount from his capital account to discharge his wife's mortgage bond debt. However, the partners granted the approval on the strict understanding that the appellant would immediately replace the capital with an equivalent sum. The firm at the time needed its partners loan accounts as working capital and there was no question of the loan being repaid because it was no longer needed by the partnership. The appellant regarded the new loan to the partnership as an introduction of fresh capital.

The Commissioner argued that the expenditure was of a capital nature. The question to be determined by the court was whether the interest expenditure had been incurred in the production of the income and which was derived by the appellant in the form of emoluments from his firm and interest earned on his loan account.

The issue to be decided was whether the replacement of the old capital, with the new (borrowed) capital did not in any way impact upon the partnership's income earning capacity. The case law on this topic emphasizes that expenditure is deductible in the production of income if there is a sufficiently close link between

the expenditure and the income earning operations having regard to the purpose of the expenditure and what it actually affects. (CIR v Genn and Company, 20 SATC 113)

By emphasizing the closeness of the connection between expenditure and income, the courts have not said that only expenditure productive of income is deductible. On the contrary, expenditure which is wasteful or results in losses may also be deductible, provided that the expenditure be at least calculated to produce income. Only then would the connection be sufficiently close to regard the expenditure as forming part of the cost of the income producing operations. (Port Elizabeth Electric Tramway Company Ltd v CIR, 8 SATC 13)

In deciding the case the Judge took the following factors into consideration at page 59:

- "To form part of the cost of the income producing operations, the expenditure must be made having regard to the operational requirements of the income producer. When the operational requirements of the income producer is looked at in this case, it was noted that the partnership had all the capital it needed on 28 February 1985.
- The income of the partnership was being produced with the capital which was already in existence. The partnership could not afford to repay that portion of the capital contribution by the appellant.

However, in order to accommodate the appellant the partnership was prepared to let him replace his existing loan with another. This action could have had no impact on the firm's earning of income. Its position remained exactly as it had been before. The fact that the appellant was no longer funding his capital account from his own resources was irrelevant to the partnership's income producing activities.

- The situation would be have been quite different if an income producer repaid capital which was surplus to his requirements and later, for operational reasons, decided to borrow fresh capital. If that capital had to be borrowed by the lender, who then on-lent it to the income producer, the interest paid on the loan would, provided all other requirements were met, be deductible as having been incurred in the production of income (50 SATC 34).
- The Respondent referred the Judge to two cases. The first was ITC 241 (6 SATC 365). In this case, the appellant carried on business in partnership as an attorney and was required by the partnership agreement to maintain a certain sum invested as capital in the partnership business. He raised a loan from an outside source on which he was required to pay interest. He argued that the interest paid on this loan was deductible from his gross income on the grounds that, if he had not been compelled to leave his capital in the business he might have applied a portion of it to the purpose for which he had raised the loan. This argument, however, failed.

> The argument was again raised later in ITC 829 (21 SATC 199). In this case an attorney sought to deduct interest paid on a domestic mortgage bond from income derived from his professional practice. He claimed a deduction of interest on the amount that was equivalent to the money invested by him in the partnership practice".

The Judge was of the opinion that the above taxpayers did not even go to the trouble of re-arranging their affairs as the appellant had done. The payment of interest by them served, if that was possible, even less to maintain the stream of income from the partnership. If the loan in each case was to have been repaid, the income from the partnership would not have been in the least affected.

The Judge held that the appellant's re-arrangement of his affairs did not place him in a better position than that in which the taxpayers in ITC 241 and ITC 829 found themselves and that the rearrangement of the appellants affairs was designed to secure a fiscal advantage and not to maintain the flow of income from his practice.

The appeal was accordingly dismissed and the assessments for the tax years 1986 and 1987 were confirmed.

4.3 CIR vs Smith (60 SATC 397)

For the tax years which ended on the last day of February in 1989 and 1990 the taxpayer sought to deduct interest which he paid on a mortgage bond over the matrimonial home occupied by him and his wife. The Commissioner did not permit

the deduction, contending that it was not in the production of income that such interest had been paid.

The taxpayer's appeal to the board constituted in terms of Section 83A(2) of the Income Tax Act, No. 58 of 1962 was successful. On appeal by the Commissioner from the Board's decision to the Special Income Tax Court, the taxpayer's appeal was upheld (ITC 1603, 58 SATC 212). The Commissioner then appealed to the full bench of the Natal Provincial Division.

The taxpayer, a Mr Smith, had at all times been a land surveyor. Until 1987 he and a Mr Goosen had practised as junior partners with a senior partner who had imposed the condition that their capital contributions would always remain in the partnership. In December 1987 the partnership with the senior partner was dissolved. The taxpayer and Mr Goosen commenced a new partnership in which the taxpayer and Mr Goosen were equal partners. It was estimated that the new partnership would require capital in the sum of some R200 000 which would cover the working capital requirements of the business. It was therefore agreed that the taxpayer and Mr Goosen would each contribute R100 000 and this figure was paid by them from their shares of the profits of the old partnership. It was also agreed that their capital accounts would not be left permanently in the partnership but would be repaid if and when the partnership was able to do so.

The partnership progressed so well that by the end of February 1988 the partners devised a scheme which became the heart of the dispute. They had been to a

seminar at which the idea had been suggested, and because the partnership's financial circumstances were suitable they decided to implement the scheme.

The partnership's circumstances were suitable because, despite the fact that the practice was such that it was required to carry its debtors for a considerable period, by the end of February 1988, it was in a position to repay the capital accounts.

For some time its bank balance had been and still was in credit in the sum of over R90 000 and in addition, it had an overdraft facility of R60 000 to fall back on. Although the partnership was in a position to repay the capital accounts it did not mean, however, that if it were to do so it would not still require the capital. On the contrary, the taxpayer and his partner knew that the capital amounts would be required again within a few weeks.

On the 22 February 1988 the appellant had a capital account of R190 394. In accordance with the scheme, the partnership paid the appellant an amount of R89 835.50 which was paid into his wife's home loan account at First National Bank, representing a partial repayment of his capital account. Seven days later, on 4 March 1988 and the beginning of the new financial year, the partnership recalled the money that was repaid since it was needed to finance operations.

An amount of R90 000 was therefore re-advanced from his wife's home loan account and introduced back into his capital account in the partnership. This

transaction, in essence had the effect of neutralizing the initial repayment of R89 835.50 since clearly the partnership still required the R90 000 to fund its operations.

The question before the court was whether the interest paid on the wife's mortgage bond account in the amount of R13 894,00 (1989) and R15 391 (1990) against his taxable income had been incurred in the production of income.

4.3.1 Appellant's arguments against the disallowance of his claim

In the appellant's letter of objection, his accountants stated that the partnership made a profit from its operations. In addition, the partnership also paid the appellant interest on his capital account. The taxpayer therefore deducted the interest incurred on his personal bond as a deduction in terms of Section 11 (a), being expenditure in the production of income, wholly and exclusively laid out for the purposes of trade and not of a capital nature.

The accountants went on to explain the trade cycle in a professional practice and the elements that made up the capital account.

The first element was the funds introduced by a partner by agreement with his other partners. In the partnership of Mr Smith and Mr Goosen such funds were repayable on demand.

The second element was the net profit that is credited to the partner at the end of

the financial year, less any drawings that might have been taken. The net profit was regarded as having accrued to the partner for income tax purposes, even though he may not have received this amount as a cash payment. The meaning of accrue in tax law is to "become entitled to" or "being due and payable." The taxpayer was therefore entitled to his capital when it was "due and payable" and he could claim the payment at any time. There was therefore, no obligation on him to leave the capital in the partnership to finance future operations, particularly when the partnership had the ability to repay the capital account.

If a partnership repaid a partnership's capital account and thereafter continued to operate, it was up to the partners to decide how the operations would be financed. This could be through a loan or overdraft or creditors or requesting partners to introduce fresh capital. The new finance was an integral part of the new operation and the ability to operate depended on it. The cost of this new finance was therefore very closely linked to the new operations and the method of raising this capital had a very clear effect on the profit from the partnership operations.

The accountants then looked at the following:

On 22 February 1988 the taxpayer had a capital of R190 394 which was due and payable to him. The partnership had funds available and repaid a portion of the capital account. In the new financial year, ie 4 March 1998 the partnership requested an introduction of fresh capital to finance new operations as it ran into an overdraft. Had the partnership not requested the new capital it would have ran

further into overdraft and incurred further interest.

The Commissioner had officially conceded that he would have had no problems with the deduction of the overdraft interest in terms of Section 11 (a) of the Income Tax Act. The interest on the bond, however, was lower than the interest on the overdraft and therefore by obtaining the funds from the taxpayer through his bond and paying him interest thereon, the partnership was in a position to increase the profits it would have made.

The accountants argued the above facts established that the expenditure was closely linked to the income of the partnership. As the funds borrowed by the taxpayer were loaned completely to the partnership to provide working capital, the increased expenses were wholly and exclusively laid out for the purposes of trade and was not of a capital nature.

On this basis the accountants argued that they believed that the appellant had discharged his onus providing the bona fides of the deduction. In the notice of appeal the appellant's accountants advanced no additional reasons against the disallowance of his claim.

4.3.2 The Commissioner's Arguments

The Commissioner accepted that the appellant was entitled to his capital account. However, the Commissioner contended that the appellant's actions clearly illustrated that the purpose of the money borrowed was the replacement of old

capital with new borrowed capital, with an end result of rendering the interest on the bond over his residence, tax deductible. He had merely made it appear that the bond related to his practice capital account and not to the private property. The partnership had not truly raised fresh new capital so as to increase its capital base. It remained exactly as it always had been.

The Commissioner relied on the decision in ITC 1583 (57 SATC 58), emphasizing, Judge IH. Conradie's finding that the replacement of old capital with new (borrowed) capital did not in any way impact upon the partnership's income earning capacity and that the re-arrangement of the appellant's affairs was designed to secure a fiscal advantage and not to maintain the flow of income from his practice.

The Commissioner also emphasized other case law on this topic viz, CIR v Genn and Company (Pty) Ltd (supra), CIR v Nemojim (Pty) Ltd (supra), that expenditure was deductible in the production of income if there was a sufficiently close link between the expenditure and the income earning operations having regard to the purpose of the expenditure and what it actually affected.

"By emphasizing the closeness of the connection between expenditure and income, the courts have not, of course said that only expenditure productive of income is deductible. Expenditure which is wasteful or produces losses may also be deductible. But to be deductible, the expenditure should at least be calculated to produce income. Only then would the connection be sufficiently close to regard

the expenditure as forming part of the cost of income producing operations." (Port Elizabeth Electric Tramway Company Ltd vs CIR, 8 SATC 13 at page 17)

The Commissioner's representative argued that to form part of the cost of the income producing operations, the expenditure must be made having regard to the operational requirements of the income producer.

The Commissioner included the following in his heads of argument:

"When one looks at the operational requirements of the income producer in the present case one sees that the partnership had all the capital it needed. The income which the partnership was producing was being produced with the capital which was already there. It could not afford to repay that portion of the capital contributed by the appellant, which is evidenced by recalling the R90 000 after only 7 days, but in order to accommodate the appellant. It was prepared to let him replace his existing capital loan with another. This manouevre had, and could have had no impact on the partnership's earning of income. Its position remained exactly as it had been before. The fact that the appellant was no longer funding his capital account from his own resources, was irrelevant to the partnership's income producing operations."

The Natal Provincial Division responded by quoting the following from the judgement passed by the Natal Special Court:

Although the facts in ITC 1583 (supra) were somewhat similar to those in this appeal, that case is nevertheless distinguishable. The partnership in ITC 1583 (supra) had been in no position to continue without the loan capital, and the partners had agreed to the arrangement purely to accommodate the appellant. It was for this reason that the partners had laid down the condition that the money was to be repaid immediately. Throughout the two days concerned, and at all relevant times, the partnership required the loan capital, and it was not a case of the partnership being in a financial position to repay the loan.

In this case, however, the agreement between the taxpayer and his partner provided that the capital accounts of the partners would not permanently remain in the partnership. The arrangement was, on the contrary, that the partners would be repaid their capital accounts as soon as the partnership was able to do so. At the relevant time the partnership found itself in a position to continue its income earning operations without the capital and without having to borrow from other sources. Although the capital was repaid within a few days, the evidence shows that, by utilizing its overdraft facility, the partnership would in fact have been able to continue for at least some weeks. The taxpayer would also have been free to borrow from any other source of his choice. It was for obvious reasons, to his advantage, to obtain the re-advance from his wife's bondholder.

It was emphasized in cases such as CIR v R.B. Saner 1927 TPP 162 at 172, that it was the substance and not the form that must be looked at. In this regard it might well have been said that the scheme resorted to by the appellant in ITC 1583 had

been artificial. To say in this case however, that there was essentially no difference between the position before the scheme had been embarked upon and the position after it had been implemented, ignores two relevant matters relating to the taxpayers partnership. It ignores firstly, that it had been agreed that the partner's capital contributions would not remain in the partnership permanently but would be repaid if and when the partnership was able to make repayment. It ignored the fact that, at the relevant time, the partnership could in fact have continued operating for some weeks without the partners first repaying their capital contributions. The Judge agreed that it was true that the taxpayer in this case had planned the whole scheme in advance, that he had arranged in advance for the Bank to make a further loan available under the same bond, that without repayment of the capital the partnership would have been able to operate and that the capital was in fact repaid within a few days.

Despite all these facts, the case was distinguished from the facts in ITC 1583 and the scheme was not artificial. Indeed, they showed that it was not just in form but also in substance that the loan on 1 March had been raised and therefore that it was in the production of income that the interest thereon was paid. (The Taxpayer, 1999: 118)

The above statement delivered by Galgut J, President on 13 December 1995, in ITC 1603, (58 SATC 212), which was ratified by Natal Provincial Division.

The Commissioner referred the court to three further cases:

- ITC 241 (6 SATC 365:1932).
- ITC 829 (21 SATC 199:1956).
- CIR v Ticktin Timbers CC 1997 (3) SA 625 (C).

The Court found the decisions of the above cases was of no assistance to the appellant in this matter. The court stated also that if the situation had continued either with or without an extension of the overdraft facility, the interest paid by the partnership on any overdraft, would have been a legitimate expenditure incurred in the production of income. Any other conclusion involves the proposition that once partners have started to finance the business operations of a partnership out of retained profits, they are obliged at all times thereafter to continue to do so; a proposition which could not be correct. If the partnership had continued to fund its activities by way of an overdraft and the bank had required security, that could have been provided by way of surety mortgage bonds over the partners' properties.

The fact that the partners chose to use a cheap form of finance cannot alter that situation, nor can the mere fact that the motive of the taxpayer in this instance, was to gain a tax advantage. The Commissioner also contended that the loan of 1 March 1988 had been raised solely for the purpose of facilitating a tax benefit for the taxpayer and that although the proceeds were used in the partnership, that was only the incidental result and not the purpose for which it was raised.

In rejecting the Commissioner's argument, the court quoted Galgut J in the

following manner:

"There is no doubt that the essential, if not the sole, motive of the taxpayer was to gain a tax advantage. The submissions of the representative of the Commissioner elevate beyond its true relevance [of] the taxpayer's motive, however, because the test is not limited or dominated by a taxpayer's motive. It need hardly be stressed that, despite the fact that his motive may be to gain some tax advantage, a taxpayer's intention may nevertheless be to earn income." (58 SATC 216)

Conceding that in many cases, a taxpayer's motive may be relevant, the court stressed that the real question was whether it was in the production of the income that the expenditure had been laid out and the answer to that question was a matter of fact. If it was shown, as a fact, that the purpose and effect of a loan were to produce the income, and if the loan and income-earning operations were sufficiently closely connected, in the absence of something more, the taxpayer's motive to secure a tax benefit, will not affect the conclusion that it was in the production of the income that the interest was incurred.

In dismissing the appeal, the court held:

- that although the taxpayer had the motive, in having part of his capital account in the partnership re-paid and of obtaining a tax advantage, the money thereafter borrowed and put to his capital account in the partnership had the purpose of producing income and

therefore the interest payable by him was deductible.

4.4 ITC 1690 (62 SATC 497)

In this case the taxpayer was a partner in a firm of attorneys. As in the Smith case above, he had a bond over his private residence and sought to arrange his affairs in such a way that the interest on his bond could be deducted from his professional income. He did so by withdrawing a sum of R140 000 from his capital account and paying it into his bond account, having arranged with his bank to receive an advance of an identical amount on the same day against his bond account. He used this advance to replenish his capital account to what it had been before the initial withdrawal (Deneys Reitz, September2001:2).

At the time of this series of transactions, the bank account of the partnership was overdrawn, and there was no question of there being surplus funds available for refund to the partners. The Commissioner refused to treat the interest on the new loan as expenditure incurred in the production of income, and the taxpayer went to court. He argued that he was not obliged to finance his contribution to the partnership from his own resources and, if he chose to do so by means of a loan, the interest on the loan was deductible.

The court agreed with this submission in principle, and reaffirmed the dictum that every man is entitled to order his affairs in such a way as to minimize his tax burden. However, the court added the caveat that schemes aimed at achieving this objective had to satisfy two criteria:

- firstly, they should not fall foul of section I03 (1) of the Income Tax Act (the general anti-avoidance provision) and
- secondly, they should be what they purported to be.

The judgment began by describing the scheme as "this financial sleight of hand". The Judge expressed his surprise that the Commissioner had not relied on section 103 (1), from which may be inferred that in his opinion the scheme was both abnormal and had a purely tax-saving purpose.

The court then confirmed the principles stated in the English case of WT Ramsay Ltd v IRC 1982 AC 300 and has been referred to in our courts several times since then as the so-called "Ramsay" principle. In terms of this principle it was:

- "the task of this court to determine the legal nature of a transaction to which it is sought to attach a tax consequence and if that transaction is part of a series of transactions the whole combination of transactions has to be considered. The court is not limited to consider the genuineness or import of a single transaction in isolation, but may consider the scheme as a whole.... In doing this the court seeks to ascertain the substance of the transaction and will not be blinkered by the form thereof"

In establishing the substance of the transaction, the court found that it had to answer the question as to whether a new or second loan had indeed come into

existence, or whether the pertaining legal relationships remained the same. In doing so, it identified the three parties to the matter: the bank, the taxpayer and the partnership. Having examined the respective relationships between the parties, the court found that the transactions had not changed these. In short, the form - the debit and credit entries had not altered the substance at all. By contrast, the scheme in CIR v Smith had been one in substance as well as in form.

In the result, the court found that the taxpayer's "manouevre was a mere paper exercise which effected no change"; and the interest expense was disallowed.

This would appear to support the fact that "the fine line between success and failure in any tax case" (Deneys Reitz, September 2001:2)

4.5 Summary

The Income Tax Act does not prohibit a taxpayer from arranging his finances in any manner that would be of best advantage to him. He is free to borrow from whatever source he chooses and this will not prevent him from deducting the interest payable on the loan. The only proviso is that the money must be used in the production of income and it will be in the production of that income that the interest thereon will deductible.

In each of the above cases, it is a question of fact, whether the parties intended their agreement to mean what it said. If the agreement did not say so, the law must give effect to the parties' real intention. A transaction is not necessarily simulated

or disguised simply because it is devised for gaining a tax benefit. If the parties honestly intend an agreement to mean what it says, the contract must be interpreted accordingly, and in that event, the question will be whether the benefit does accrue to the partnership.

The withdrawal by the partner of his capital and his replacement of capital with borrowed funds did not impact on the partnership income. The real issue to be decided was not whether the re-arrangement impacted upon the partnership income, but whether the interest paid by the taxpayer on the money borrowed by him to replace his own capital in the partnership was incurred in the production of income, namely a share of the partnership profits.

The Court and the Special Court attempted to distinguish ITC 1583 on the facts. The reasoning in that case and the reasoning in the Judgements of both the Special Court in ITC 1603 and the full bench on appeal are incompatible and that distinguishing the facts was more a convention employed by the courts than a reality. (Meyerowitz et al, 1999: 115)

Silke (1998: 7-90-2) queried the decision in the ITC 1583 on the grounds that it was neither supported by the provisions of the Act nor the established legal principles governing the deductibility of interest. He believes that the real issues involve a determination of whether the interest paid by the taxpayer was incurred in the production of income, namely, a share of the partnership profits including income in the form of interest on his capital account. The purpose of the act (the

raising of the loan) entailing the expenditure (the interest incurred) was sufficiently closely connected to his income-earning operations to be regarded as part of the cost of performing that activity.

Deneys Reitz (September 2001:2) believe that the crucial element in the success of the Smith case was the fact that at the time he withdrew the sum from the partnership, the funds concerned were surplus to requirements. They contrasted this decision with that in ITC 1583 where the taxpayer lost on a similar set of circumstances. The grounds for dismissal here was that the loan had no impact on the firms earning of income and it was considered to be a manouevre with form but no substance. They go on to describe ITC 1690 as a case in which the form had not altered the substance at all. By contrast, they say, the scheme in the Smith case had been one in substance as well as form. They further point out an interesting comment at the conclusion of the judgement:

- "It matters not that the appellant, better advised, might have structured his scheme differently and possibly achieved the same result. We have to deal with the facts as they are, not what they might have been"

Under the circumstances it is necessary to take careful note of the following when attempting to deduct interest in these circumstances:

- The re-arrangement of a taxpayer's affairs which is designed solely

to obtain a tax advantage will not entitle the taxpayer to a deduction.

- To be deductible interest must be incurred in the production of the income and the closeness of the connection between the expenditure and the income producing operation must be assessed.
- The fact that a taxpayer is no longer funding his capital account from his own resources is irrelevant to the partnerships' income producing operations.
- A court will always look to the substance and not the form of a transaction where a loan is raised in circumstances where the partnership is not in a position to continue without the loan and the partners agree to an arrangement purely to accommodate the taxpayer. The scheme in terms of present case law, would be deemed artificial.
- Where, however, there is agreement among partners that their loan capital would not remain permanently in the partnership and the partnership is able to continue its income-earning operations without the capital, then a loan raised by a partner to repay the capital thereafter, is legitimately raised in the production of the income and interest incurred thereon would be deductible.
- Despite the fact that a taxpayer's motive may be to gain some tax advantage, his intention may nevertheless be to earn income and, although his motive may be relevant, the real question is whether it was in the production of the income that the expenditure was incurred.

CHAPTER 5

INTEREST ON LOAN RAISED TO BUY MEMBERS INTEREST IN A CLOSE CORPORATION OR SHARES IN A COMPANY

5.1 Introduction

If interest is paid on an amount borrowed to acquire shares, the deduction of interest will not be allowed. The purpose of the expense is to obtain shares which produce exempt dividend income (Arendse et al, 2003:110). A similar situation exists with close corporations. Where money is borrowed to buy an interest in a close corporation, the deduction of interest will also not be allowed as the purpose will be earn exempt distributions.

CIR vs Shapiro (4 SATC 29) and CIR vs Drakensberg Garden Hotel (Pty) Ltd (23 SATC 251), established that there must be a "closeness of connection" between the interest deduction claimed and the income generated. However, it does not necessarily follow that interest paid by a company on moneys borrowed to acquire shares may not be deducted. If it can be shown that the sole or main purpose of the acquisition of the shares is the production of income and that any dividends received is incidental to the main purpose, interest paid on the money so borrowed to acquire shares would be properly deductible. It is however, very rare for a taxpayer to succeed in deducting an interest expense when applying the Drakensberg Garden Hotel case (supra), as the following cases will demonstrate.

5.2 Natal Laeveld Boerdery CC vs CIR (60 SATC 81)

The taxpayer, Natal Laeveld Boerdery CC carried on farming operations on its farm, Roosmaryn, near Komatipoort. Van Dyk and Van Veyeren, the only members of the corporation, had equal interests in the taxpayer until September 1987. Van Dyk managed the farming activities while Van Veyeren acted in an advisory capacity. Van Veyeren later became less involved in the management of the affairs of the corporation.

Van Dyk then began planting bananas on Roosmaryn. He also caused the taxpayer to transport sugar cane for other farmers for a fee in order to increase the corporation's income. These activities led to dissatisfaction on the part of Van Veyeren, mainly on the ground that banana farming was too risky and that the transport business would make inroads into the taxpayer's farming activity. This led to disputes and eventually an agreement was concluded wherein the taxpayer bought Van Veyeren' s interest for R1,8 million. This resulted in Van Dyk becoming the only member of the taxpayer. The taxpayer, however, did not have the funds to pay the purchase price to Van Veyeren. The corporation therefore borrowed R2,3 million from a Syfrets and registered a bond over Roosmaryn as security. The proceeds of this loan were used to payoff its debt of R442 500 to First National Bank and the balance was utilized to pay Van Veyeren.

In its returns of income for the 1988, 1989 and 1990 years of assessment, the taxpayer claimed interest payments paid to Syfrets as a deduction against its income.

The Commissioner refused to allow the interest deductions on the grounds that it had not been incurred in the production of the taxpayer's income. The taxpayer then appealed to the Special Income Tax Court. This appeal was unsuccessful. It thereafter made an unsuccessful appeal to the Supreme Court of the Transvaal Provincial Division resulting in an appeal to the Appellate Division of the Supreme Court.

The taxpayer contended that the previous courts had erred in not distinguishing between the purpose for which the Syfrets loan was concluded and the how that purpose was achieved. The purpose was to place it in a position to expand its farming operations and consequently to increase its income. The method had been the elimination of Van Veyeren's interest, who was a stumbling block in the achievement of that purpose.

Van Heerden DCJ, who delivered the judgement in the Appellate Division, noted that the primary criterion in the determination of the question was whether section 11 (a) did apply and at the same time whether section 23 (g) did not apply.

If the deductibility of interest payable on a loan was in question, regard must be had primarily to the purpose for which the money was borrowed and that purpose, according to section 23 (g), had to be to produce income for the taxpayer.

This case was decided on the 'negative test' which required the purpose of the expenditure to be 'wholly or exclusively' laid out for the purposes of trade. Any

attempt to draw a distinction between Van Dyk's purpose and the method of its attainment was untenable. Van Dyk had a primary and secondary aim for the taxpayer. The primary aim was to remove Van Veyeren and in so doing to become the sole member of the taxpayer. The secondary aim was, as sole member, to proceed with farming activities of the taxpayer without any hindrance.

The court was also of the view, that in order to determine the taxpayer's aims, attention had to be paid to the dispositions of both Van Dyk and Van Veyeren. Van Dyk wanted to get rid of Van Veyeren in order to plan the taxpayer's farming. A loan in order to buy Van Veyeren out was the means to achieve this. The welfare of the taxpayer after his interest had been purchased could obviously not have been of any importance to Van Veyeren as his co-operation in securing the loan was attributable to one aim only, that is, to receive payment for his interest in the taxpayer. Van Veyeren's aim was not to place the taxpayer in the position to increase its income potential.

In so far as there was a joint purpose of the two members, it was only to reach the position where, by concluding the loan, Van Veyeren would disappear from the scene and Van Dyk would become the only member of the taxpayer. Accordingly, the interest expenditure was not deductible in terms of section 11 (a) read with section 23 (g) of the Income Tax Act. The appeal was therefore dismissed.

The taxpayer's reliance on CIR v Drakensberg Garden Hotel (Pty) Ltd (supra) was misplaced. Not only were the facts totally different from those in this appeal but the

Special Court in that case had made a factual finding regarding the purpose for which the relevant transaction was concluded. It was held that the interest on the purchase price of the shares was correctly deducted on the basis that the purpose in buying the shares was to ensure a continuance of the taxpayer's income from subletting and trading. The acquisition of the shares was the only realistic way in which the taxpayer could adequately protect its interests and there was therefore a sufficiently close connection between the purchase of the shares and the production of income.

This case was decided on the 'negative test' which required the purpose of the expenditure to be 'wholly or exclusively' for trade. The 'negative test' no longer applies and the expenditure is now not deductible 'to the extent to which such monies were not laid out or expended for the purposes of trade.' It follows therefore, that on the same set of facts a court might now come to a different conclusion (Tsatsawane, 2002:3).

Williams (1999: 230) is of the opinion that this case involved a straightforward situation of a close corporation borrowing money for the purpose of removing an obstacle to become more profitable and the interest, therefore, should have been allowed as a deduction. He pointed out that recent English decisions have recognized the deductibility of expenditure incurred for such a purpose and quoted as an example, Lawson v Johnson Matthey Plc [1992] 2 AC 324 (HC); [1992] 2 All ER 647 (HL). He therefore, considered the decision of the Supreme Court of Appeal surprising, and that it was unlikely to have any adverse impact on our tax

jurisprudence, as it rested on a "quirky" finding of fact, in relation to the taxpayer's purpose in taking out the loan.

Meyerowitz et al (1998:58) are of the opinion that an interesting aspect of the judgement was its reference to the intention of the members of a close corporation. In so far as the intention of its members was to be imputed to the close corporation, the judgement pointed out that at the time of the decision to borrow, both Van Veyeren and Van Dyk were members of the taxpayer and Van Veyeren's purpose in agreeing to the loan was simply to be paid for his interest. It was not to put the taxpayer in a position to increase its income.

Haupt and Huxham (1998:24) expressed surprise that the appellant was prepared to go to the expense of an appeal through the courts on a matter which had only the slimmest chance of success. They believe that the Judge had little difficulty in agreeing with the decisions of the lower courts. However, they noted that the aim of the member was regarded as being the aim of the appellant and this they believe may not necessarily be correct. A typical case in this regard is ITC 1602 (supra).

5.3 ITC 1602 (58 SATC 205)

The appellant taxpayer was a close corporation whose sole assets were a cane farm and a sugar quota. It let the farm and quota to *W*, one of five members of the appellant, for a period of six years. Each of the five members held a 20% interest in the taxpayer. The farm was in a neglected state and *W* wished to bring about

fixed improvements to the farm. The the other members, however, were not prepared to consent to the improvements unless the lease provided that the improvements be effected by *W* at his own expense and without any compensation by the taxpayer at the end of the lease. *W* initially agreed to the amendments, but on learning that the costs of the improvements would be substantially in excess of his original concept when agreeing to the amendment, he decided to acquire control over the farm. He could have done so by one of two means: purchasing the farm from the taxpayer, or he could, on the other hand, gain control of the taxpayer by buying out the other members. Because he believed that getting the sugar quota transferred to himself would not be easily achieved, *W* decided to follow the latter course.

Section 39 of the Close Corporations Act allows a corporation to acquire all but one of its members interest. In addition, section 40 allows a close corporation to give financial assistance to the remaining member or members to buy the interests of the other members. In either case the remaining member or members will hold 100% of the members interest.

The close corporation in this case therefore, followed the first course ie section 39. It borrowed money from the Land Bank to buy out the four retiring members. *W* was then in a position to make the intended improvements. He not only caused the improvements to be effected, but he caused the close corporation itself to carry on the farming operations. As a result the close corporation was able to derive a substantially greater income than was previously the case. The interest which the

taxpayer had to pay on the Land Bank loan was the sum of R23 438,00 for the tax year which ended on 30 June 1988, and it is the deductibility of this interest that was the issue the case.

The Commissioner disallowed the interest on the loan used to buy out the retiring members. On appeal by the taxpayer, it was held that:

- The loan was raised to buy out the interest of the retiring partners.
- The subsequent carrying on by the close corporation of the farming activities arose because *W* relinquished his lease.
- The two steps were not so closely linked that it could be said that the first step, the loan, was taken in order to increase the Close Corporation's income. Accordingly, the interest on the loan had not been incurred in the production of income.

The appeal was therefore dismissed.

If the loan raised by the taxpayer was used for the purposes covered by section 40 of the Close Corporations Act, that is, if the proceeds were in turn lent by the taxpayer to *W* in order that *W* could buy out the four retiring members, then it would not be fair to say that the income earned by the farming operations conducted by the taxpayer was sufficiently closely linked to the interest expenditure. However, in this case, section 39 of the Close Corporations Act was applied as the taxpayer itself acquired the interest of the four retiring members.

The court came to the conclusion that what the loan achieved was at most , only the first of at least two steps that had to be taken; one of two links that had to be in place before the chain was completed. What the loan achieved was simply to enable *W* to acquire control over the taxpayer. That was the first step. Had nothing further been done thereafter there would have been no change in the taxpayer's income earning activities.

The second step was that *W* had to cause the taxpayer to cease its activity of letting the farm and the quota, and instead, itself undertake the farming activities. This was done by *W* and in order to do so, further loans had inter alia, to be raised in order to enable the taxpayer to acquire equipment and implements with some of them being purchased on credit. The further loans and the credit transactions were not in dispute as they were directly linked to the income earned by the taxpayer's farming activities.

It was this second step that resulted in the farming activities and the generation of income. The Land Bank loan did not increase the income producing capacity of the taxpayer. All that it achieved was that the taxpayer's management was changed. Apart from that purpose, what was actually effected by the interest expenditure went no further than helping *W* acquire control of the taxpayer.

There may, however be cases where the taxpayer is able to defend the deduction of interest where it can be shown that the dominant purpose is to earn income. One such case is ITC 1604 (supra).

5.4 ITC 1604 (58 SATC 263)

The taxpayer, a professional person, was employed in 1985 by a company in terms of an agreement which provided for a monthly salary escalating annually at 25% of the net profits. He also had an option of acquiring 10% of the company's shares, subject to a maximum shareholding of 50%.

During 1987

- the company was converted into a close corporation;
- the taxpayer acquired a 49% interest in the close corporation by buying a portion of the interest of the other member;
- an association agreement between the taxpayer and *D* was entered into; D being the other member who held 51%; and
- a management agreement was concluded in terms of which the taxpayer was employed by the close corporation at a remuneration to be agreed upon between the interest holders and another from time to time.

The taxpayer and *D* agreed that the close corporation's profits would be shared pro-rata between them according to their respective percentage interests. The taxpayer borrowed money which he used to pay for this interest in the close corporation. He claimed that the interest he paid as expenditure was incurred in the production of his income.

The claim was disallowed by the Commissioner, but the taxpayer's appeal was

upheld by the Special Board. The Commissioner referred the matter to the Special Court in terms of section 83A (13)(b).

The Special Court held, upholding the taxpayer's appeal, that on the evidence, the taxpayer's dominant purpose was to enable him to secure his position as managing director, to run the close corporation on a permanent basis and to secure his employment at an increased salary and to further enhance his income by sharing 49% of the close corporation's profits as an executive bonus.

The issue in this matter was whether the taxpayer was entitled to deduct the interest which he paid to the bank from his gross income. This depended upon whether the deductions should have been allowed in terms of the general deduction formula, section 11 (a) and whether the deduction was prohibited by the 'negative counterparts', sections 23 (f) and (g).

Meyerowitz et al (1997:238) believe that an unusual argument was advanced by the Commissioner's representative in support of the disallowance of the interest. This argument was in essence, that the interest constituted capital expenditure because of its association with the financing of the interest in the close corporation. The Judge referred to CIR v Genn & Co. (Pty) Ltd (supra) where the possibility of interest paid, being of a capital nature, was raised. The Judge was of the opinion that "In the present case the interest paid was the recurrent or periodical charge or "rental" payable for the continued use by the appellant company of the money lent to it. Such interest was not intended or calculated to, nor did [it] in fact,

improve, augment or preserve those aforementioned capital assets, or form part of or add to the costs of acquiring them or enhance their value. Consequently, we do not think that in the circumstances of this case the interest was closely identified or associated with those capital assets that it must itself be regarded as being of a capital nature."

Meyerowitz et al (1997:238) also quote Silke on the matter, who was of the opinion that "As long as the interest is not intended or calculated to, nor does it in fact improve or augment the capital assets of the business or form part of or add to the costs of acquiring them or enhance their value, it cannot be regarded as being so closely identified or associated with capital assets that it must itself be regarded as being of a capital nature."

When applying these principles to the facts of the case, it is clear that a loan liability incurred by the taxpayer for acquiring the interest was of a capital nature but the interest paid did not improve, augment or preserve the value of the corporation, nor did it form part of or add to the costs of acquiring the asset or enhance its value. It therefore follows, that in the circumstances of the present case, the interest was not so closely identified or associated with the capital asset that it must itself be regarded as being of a capital nature.

The court found that the taxpayer did not contemplate earning dividends or obtaining a capital distribution. His purpose was to secure his income and to increase it. This is precisely what he achieved. The acquisition of the interest in the

corporation, therefore, was closely connected to the earning of income by way of an increased salary and a substantial effective bonus.

The taxpayer declared in his returns as part of his income, the executive bonuses which the Commissioner accepted and taxed in his hands and there was no suggestion in argument that the bonus amounted to a dividend. It followed, therefore, that the interest incurred on the loan to acquire the interest in the close corporation was expenditure initially incurred in the production of income.

The Court found with reference to section 23 (g), that the taxpayer, at all relevant times, was employed by the corporation and was carrying on his profession as a pharmacist. He was therefore carrying on a 'trade' as defined in the Act. The expenditure was incurred in connection with his employment and was therefore wholly and exclusively for the purpose of trade.

However, there are times when the court will consider the *ipse dixit* of a taxpayer. If it is found that a taxpayer's seeks, at all relevant times, to increase his income, the court may find in favour of the taxpayer, as happened in the ITC 1620 (supra).

5.5 ITC 1620 (59 SATC 316)

This case involved a taxpayer who incurred interest on a loan raised to enable him to buy shares in his employer company. The taxpayer had been told by his employer that he would be given a salary increase if he committed himself to the company by acquiring 10% of the shares. The taxpayer raised a loan of R50 000

in order to acquire the shares. The appellant's salary was then increased as agreed.

The appellant paid interest in the amounts of R8 587 and R12 231during the1990 and 1991 years of assessment respectively and sought to deduct these amounts from his income. The Commissioner refused to allow the deduction in terms of section 11 (a) read with section 23 (f) and (g). The taxpayer successfully appealed to the Special Board. The Commissioner, not satisfied with this decision, referred the matter on appeal to the Transvaal Special Court.

The Special Court held:

- That the enquiry needed to be directed to determining both the purpose of the payment of the interest by the appellant and whether a clear and close casual connection could be found between the payment of the interest and the production of the appellant's income as a working director of the company.
- That the surrounding circumstances indicated that the appellant did not purchase the shares in question as an investment, i.e. he had not taken any steps to secure his position, no written agreement of employment had been concluded, he had not insisted on attending directors meetings or on seeing the books of the company or on being given signing powers on the company's bank account.
- That the appellant's testimony was accepted to the effect that he had

purchased the shares for the purpose of increasing his income and the said acquisition had the desired effect and the fact that the value of the shares had increased over the years did not detract from that fact.

- That although the facts in this case were not the same as the facts in ITC 1428 (50 SATC 34) and ITC 1504 (53 SATC 349), the general effect was the same. It was also considered that the Shapiro vs Commissioner for Inland Revenue (4 SATC 29) was not authority against the deduction of interest by the appellant.
- That the matter should be referred back to the Commissioner for Inland Revenue for re-assessment on the basis that the appellant was entitled to deduct the amounts of interest in the years of assessment under consideration.

This case does not add anything extra to the existing case law. The decision was based solely on the facts and the *ipse dixit* of the appellant.

It was, however, interesting to note the contention of the Commissioner. His representative contended that the shares were capital in the appellant's hands and that the expenditure incurred in respect of the purchase of the shares was expenditure of a capital nature. This argument suggested a complete lack of understanding on the part of the Commissioner's representative. It was undoubtedly true that the shares were held as capital. It was however, equally true that the appellant was not attempting to claim a deduction in respect of the cost of

the shares. If he had attempted to do this, he would surely have failed. What the Commissioner's representative failed to see was the fact that only the interest expense was in question.

It was incorrect for an interest expense to be regarded as a capital expense because the principal loan was used to acquire fixed capital. If this were true, interest paid on loans to acquire plant and machinery or buildings would never qualify as a deductible expense. Interest is a recurring expense which arises as a result of the use of someone else's money, in a way similar to rent, and it certainly does not take on the capital or revenue nature of the loan.

The Commissioner's representative submitted that the facts in the case were closer to those in the Shapiro case and urged the court to follow that case. In the Shapiro case the taxpayer was involved in the acquisition of shares. Arising from the purchase of such shares followed the appointment as managing director. This was in terms of the agreement for share acquisition. In the present case, the appellant had to acquire the shares to improve his salary and his position. He was appointed a director of the company.

The difference between the two cases therefore, lie in the fact that in the Shapiro case the taxpayer did not have to acquire shares to become managing director. His appointment as the latter arose from the acquisition of the shares, which was the taxpayer's primary objective. In this case the appellant could not earn his salary unless he purchased the shares in question. He had to purchase them to earn his

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increased salary. Without the shares he could not earn the latter. The incurring of an interest liability to enable him to buy the shares was therefore an expenditure directly linked with the earning of his income.

The Commissioner's representative failed to point out however, where the court erred in its analysis of the facts in the Shapiro case. The important distinguishing feature was that the taxpayer acquired the shares to increase his income and not to earn tax free dividends.

Thus, it can be said that interest on money borrowed to deal in shares is deductible. However, dividends are exempt from tax and as a consequence, interest on money borrowed to acquire shares or an interest in a close corporation as an investment is not deductible. However, where shares are acquired primarily for the purpose of producing taxable income in the course of trade, for example, in order to obtain security of tenure or to ensure services, then the interest is expenditure incurred in the production of income and is fully deductible, whether the taxpayer is an individual or a company. This was the situation in ITC 1641 (supra).

5.6 ITC 1641 (60 SATC 493)

The taxpayer, a close corporation, carried on business as a lessor of immovable property, which was sought after by a firm of architects. The corporation borrowed money which was advanced to the new members in order to facilitate their acquisition of the interest of the former members. The corporation then effected

repairs and improvements to the building resulting in the architects, in the form of another close corporation, becoming tenants of the taxpayer at substantially increased rentals. The rentals derived by the taxpayer from the building prior to the change over of members had been R30 000, whereas after the change over, the rentals increased to R91 845 in1992 and to R99 073 in1993.

The corporation had a dual purpose when it incurred the interest expenditure. Firstly, it enhanced its income-producing capacity by securing accommodation in its property for the close corporation owning the architectural practice. Secondly, it assisted the new members with their purchase of the existing members' interest.

The court held that the interest expenditure had to be apportioned as section 23 (g) in its form at the time implicitly allowed apportionment and that the taxpayer had not shown that either purpose was more dominant than the other.

Since the decision in Solaglass Finance Co. (Pty) Ltd v CIR (53 SATC 1) prohibited apportionment prior to the amendment to section 23 (g), which was effective from January 1993, it followed that the appeal should fail in respect of the 1992 year of assessment since the purpose of the borrowing in that year of assessment was not wholly for the purposes of trade. As for the 1993 year of assessment, 50% of the deduction claimed was allowed as section 23(g) in its present form catered for such apportionment.

5.7 Summary

The above cases demonstrate that interest may be partly deductible on a loan acquired to buy members interest. However, there must, at least, be two steps that should be taken before the interest could be deemed to be deductible. Quite apart from the change in the control of the close-corporation, the change in the members interest must enhance the income-producing capacity of the close-corporation in order that the deduction of interest does not fall foul of section 23(g).

The purchase of shares however, must follow the principle established in the Drakensberg Garden Hotel case. If the taxpayer's purpose in buying shares is to ensure the continuance of the income from trading or business operations and in so doing secures an increased income, the interest paid on the money borrowed to acquire the shares is properly deductible from that income.

If interest paid on money borrowed by a company to acquire shares in another company is linked with the actual or prospective receipt by the company of dividends, it cannot be allowed as a deduction, since dividends constitute exempt income.

However, it does not always follow that interest paid by a company on moneys borrowed to acquire shares may not be deducted from its income. If it can be shown that the sole or main purpose of the acquisition of the shares is the production of income and that any receipt or accrual of dividends on these shares is purely incidental to the main purpose, interest paid on money borrowed to

acquire the shares would properly be allowable as a deduction. There must also be a sufficiently close link between the payment of interest and the earning of income to permit the deduction of the interest as an expenditure incurred in the production of the income.

CHAPTER 6

CONCLUSION

6.1 Introduction

The deductibility of interest is a controversial field. Often different interpretations are sought from the wording of the Act. The Income Tax Act itself fails to define the term interest and has led consequently to litigation in the courts. However, in Sub-Nigel Ltd vs CIR (15 SATC 381) the court indicated that in deciding what deductions are permissible, regard must be given only to the language of the Act. The court is not concerned with deductions that may be considered proper from the point of view of an accountant or a prudent trader, but only with deductions permissible under the Act (Tsatsawane 2002:1).

To qualify for deduction, any expenditure or loss must be an expenditure or loss actually incurred in the production of income and such expenditure must not be of capital nature.

6.2 Purpose

The deductibility of interest is determined by means of the general deduction formula. Expenditure on interest qualifies for deduction if it is incurred in the production of income. Interest incurred in the production of exempt income is not deductible; nor is interest incurred for domestic or private purposes deductible (ITC 829, 21 SATC 199).

The taxpayer's purpose in borrowing money is an important factor in determining the deductibility of the interest on the loan. If the money was borrowed for the purposes of earning income, the interest is deductible. It is immaterial that the borrowed money was not in fact applied in a manner that produced income. As long as the taxpayer's purpose in borrowing the money was to use it in the production of income. This fact was clearly established in CIR vs Allied Building Society 1963 (4) SA 1 (A).

In Producer v Commissioner of Taxes 1948 (4) SA 230 (SR) the taxpayer borrowed money for use in business but later invested it in shares that did not produce any taxable income. The court held that the interest was incurred with the purpose of producing income. The fact that the money did not actually produce income was irrelevant. In effect, the court held that the deductibility of interest expenditure is covered by the original purpose for which it was borrowed. This decision was followed in Financier vs Commissioner of Taxes 1950 (3) SA 293 (SR), where it was held that the decisive test was the purpose for which the money was borrowed.

In determining whether money is borrowed for the purpose of producing income and whether interest payable on it is deductible, the following guidelines were established in Financier vs COT 1950 (3) SA 293 (SR) at 295:

- "Where a taxpayer borrows a specific sum of money and applies that sum to a purpose unproductive of income, and not directly

connected with the income-earning part of his business, then the interest paid on the borrowed money cannot be deducted as expenditure incurred in the production of income.

- Where a taxpayer has for good and sufficient reasons borrowed money for use in the business producing his income, despite the fact that he subsequently, in pursuit of a legitimate business purpose, invested such money in an investment which does not produce taxable income, the interest is still deductible for income tax purposes".

However, the ultimate use or destination of the borrowed money is not necessarily decisive. It is relevant only in determining the purpose of the borrowing, usually the chief factor in the examination of the true nature of the transaction. It is immaterial whether the borrowed money actually produced any part of the income; the issue is whether the expenditure was incurred for the purpose of earning income.

6.3 In the Production of Income

In Commissioner for Inland Revenue v Standard Bank of SA Ltd 1985 (4) SA 485 (A) at 500-501, the court suggested that

- "Generally, in deciding whether money outlaid by a taxpayer constitutes expenditure incurred in the production of the income (in terms of the general deduction formula), important and sometimes overriding factors, are the purpose of the expenditure and what the

expenditure actually effects; and in this regard the closeness of the connection between the expenditure and the income-earning operations must be assessed.

- More specifically, in determining whether interest (or other like expenditure) incurred by a taxpayer in respect of moneys borrowed for use in his business is deductible in terms of the general deduction formula and its negative counterparts in the Act, a distinction may in certain instances have to be drawn between the case where the taxpayer borrows a specific sum of money and applies it to an identifiable purpose, and the case where, as in the instance of the Society in the Allied Building Society case (supra) and the Bank in the present case, the taxpayer borrows money generally upon a large scale in order to raise floating capital for the use in his (or its) business."

In the former case, both the purpose of the expenditure and what it actually effects can readily be determined and identified; a clear and close causal connection can be traced. Both these factors are important considerations in determining the deductibility of the expenditure. In the latter case, and more particularly in the case of institutions such as the society in the Allied Building Society case (supra), and the bank in Standard Bank of SA Ltd. (supra), there are certain factors that prevent the identification of such a causal connection and one cannot say that the expenditure was incurred in order to achieve a particular effect.

In a general sense, the expenditure is incurred in order to provide the institution with the capital with which to run its business, but it is not possible to link particular expenditure with the various ways in which the capital is then used. There might be a change of purpose in respect of the borrowed money, which will affect the deduction of the interest. If a taxpayer borrows money at interest to finance a particular trade, and the trade ceases and he then decides to employ that money in a new trade, he should be allowed to deduct the interest paid on the loan from the new trade. This is because the purpose of borrowing the money has now been replaced by a new, equally acceptable trading purpose. However, interest payable takes and retains its character from the purpose for which the money is borrowed and this character persists unless and until, that purpose ceases or the borrowed money can be identified or associated with a different purpose (Tsatsawane,2002:2).

In terms of SARS Practice Note 31, interest expenditure paid on funds borrowed for the purpose of lending them out at a higher rate will constitute a permissible deduction. Furthermore, a taxpayer who is not a moneylender but earns interest on capital or surplus funds invested is not regarded as carrying on a trade. Expenditure incurred in the production of such interest is thus not deductible. This means that interest expenditure is deductible only if the taxpayer has carried on the trade of moneylending. In ITC 957 (24 SATC 637) the taxpayer made loans to its shareholders without interest or at low interest rates. The court held that as the taxpayer did not carry on the trade of moneylending, it was not trading.

What is clear from the Act is that the expenditure must have been incurred in the production of income. This requirement, however, has to be read in conjunction with section 23 (g), which states that any expense that is incurred in respect of any amounts received or accrued that do not constitute income as defined are not deductible. The tests for this requirement were laid down in the Port Elizabeth Electric Tramway Co vs Commissioner for Inland Revenue 1936 CPD 241. The first test is whether the act to which the expenditure is attached is performed in the production of income. This entails looking at the purpose of the act entailing the expenditure. The second test is whether the expenditure is linked to it closely enough.

6.4 The Acquisition of Shares

Interest on money borrowed to acquire shares will seldom be deductible as the shares produce exempt income and the expenditure is thus not incurred in the production of income. But there are conflicting decisions in respect of this issue.

In Commissioner for Inland Revenue v Drakensberg Garden Hotel (Pty) Ltd 1960 (2) SA 475 (A), a company sought to gain absolute control of the hotel premises and store which it leased and from which it derived income. It therefore acquired the shares in the company that owned the premises. The court found that the connection between the interest payable and the production of the income was sufficiently close to allow the deduction of the interest.

By contrast, however, the Natal Laeveld Boerdery CC vs CIR (60 SATC 81), the

interest on a loan taken by a close corporation in order to acquire a 50 per cent interest of a departing member was held to be not tax-deductible. The primary purpose of borrowing the money was not to produce income but to enable the other member to get rid of the departing member and assume sole control of the close corporation. As has been pointed out earlier, many authors believe that the court should have found the interest expenditure to be deductible in this case. It is not clear why, when the facts were similar to those in the Drakensberg Gardens Hotel case (supra), the court came to a different conclusion. It is Tsatsawane's (2002:3) opinion that the court in Natal Laeveld Boerdery (supra) erred in not distinguishing between the purpose of the loan (to enable the close corporation to expand its farming activities and thereby increase its income) and the method by which that purpose was achieved (the removal of the other member as the obstacle in the achievement of that purpose). In addition, the decision in Natal Laeveld Boerdery (supra) is not in accordance with the reasoning of the English Courts. In Lawson (Inspector of Taxes) v Johnson Matthey Plc [1992] 2 A 11 ER 647 (HL), the taxpayer (Johnson Matthey plc) carried on the business of refining and marketing precious metals. John Matthey Bankers (JMB) was one of the taxpayer's subsidiaries and carried on the business of banking. JMB became insolvent, and the taxpayer had to inject 50 million pounds into JMB on agreement with the Bank of England to purchase the issued share capital of JMB. The taxpayer had not paid the amount in order to divest itself of a burdensome asset (its shares in JMB), but in the justified expectation that only if it did so would the Bank of England rescue JMB and so enable the taxpayer to continue in business. The question for the court was whether the taxpayer made the payment to dispose

of the shares in JMB or whether to enable the taxpayer to continue to trade (and thereby produce income) by removing the danger of JMB's insolvency. The court held that the payment was of a revenue nature and qualified for deduction.

The Natal Laeveld Boerdery case (supra) had more or less the same facts: removal of an obstacle in order to continue its business. The court therefore, should have allowed the deduction.

The position on the deductibility of interest paid on a loan for the acquisition of shares has not been authoritatively dealt with by the legislature. Tsatsawane (2002:4) believes that Port Elizabeth Electric Tramway Company Ltd (supra) lays down the correct approach.

6.5 Summary

The Income Tax Act does not contain specific provisions that deal with the deduction of interest. Interest expenditure can therefore only be deducted if such expenditure meets the requirements of sections 11 (a) and 23 (g). In this regard, the purpose of the expenditure is an extremely important consideration on whether the interest is deductible. The courts are concerned with the expenditure incurred for the purposes of earning income. If the expenditure was incurred for the purposes of earning income, the interest incurred will be deductible. It is irrelevant whether income was produced or not.

The Act also does not contain definitions of what is meant by expenditure of a

capital nature. As a consequence, guidance has always been sought from the courts. In determining the nature of the expenditure, the ruling of the Appellate Division in the case of New State Areas Ltd vs CIR (14 SATC 155) at 627 has always been helpful:

- "The conclusion to be drawn from all the cases, seems to be that the true nature of each transaction must be enquired into in order to determine whether the expenditure attached to it is capital or revenue expenditure. Its true nature is a matter of fact and the purpose of the expenditure is an important factor; if it is incurred for the purpose of acquiring a capital asset for the business, it is capital expenditure. . .; if, on the other hand, it is in truth no more than part of the cost incidental to the performance of the income-producing operations, as distinguished from the equipment of the income-producing machine, then it is revenue expenditure. . . . '.

It therefore important that a taxpayer apply these tests in determining whether the interest is deductible.

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