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I hereby declare that I have read and understood the regulations governing the submission of LLM dissertations, including those relating to length and plagiarism, as contained in the rules of this University, and that this dissertation conforms to those regulations.

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# ***The Deductibility of Interest Expenditure under the Income Tax Act 58 of 1962***

## ***Introduction***

Many businesses rely on borrowed money to acquire assets or finance their trading activities. High gearing of this nature can be highly tax effective, provided the interest on the loan is tax-deductible. However, the deductibility of interest payments has given rise to much litigation. This is indicative of the many complexities which arise in the practical application of the legal principles. The purpose of this paper is to critically discuss these legal principles applicable to the deduction of interest expense, contained in the four components of the general deduction formulae in s11 (a) read together s 23(g) of the Income Tax Act 58 of 1962 (from hereon referred to as 'The Act'). Following this discussion of the relevant legal principles, the practical application thereof by the courts will be considered in four commercial contexts. It will become evident from this discussion, that most cases are decided on the basis of the 'in the production of income' requirement; which it is submitted, is partly attributable to the courts avoidance of the capital/revenue question which is particularly difficult to apply to interest expense. The essential difficulty encountered in the application of the 'in the production of income' requirement is an evidentiary one. The test requires that the true purpose of the borrowing must be ascertained through the use of objective criteria; and accordingly the onus of adducing such evidence becomes a crucial factor in determining the deductibility of the interest expense. In this regard, section 82 of The Act burdens the taxpayer who disagrees with SARS' refusal to allow an interest deduction with the onus of proving that he is entitled to such a deduction by virtue of the provisions of s11 (a). It follows thus that where uncertainty prevails such that the probabilities are equal, then the burden will not have been discharged. Given

the often awkward application of the of the established legal tests to interest expenditure, together with the 'murky evidentiary waters' in which many taxpayers wade when seeking to secure an interest deduction; the incidence of the onus will in many cases be the determinative factor.

## ***The General Deduction Formulae***

Since no special provision is made in 'The Act' for the treatment of interest expenditure, the deductibility thereof is determined by applying the general deduction formulae contained in s 11(a) and is subject to the expense not being specifically prohibited in terms of s23 (g) of the Act. Section 11(a) of 'The Act' reads as follows:

> 'For the purpose of determining the taxable income derived by any person from carrying on any trade within the Republic, there shall be allowed as deductions from the income of such person so derived-
>
> (a) expenditure and losses actually incurred in the Republic in the production of the income, provided that such expenditure and losses are not of a capital nature.'

Section 23(g) of 'The Act' provides-

> 'No deductions shall in any case be made in respect of any moneys, claimed as a deduction from income derived from trade, to the extent to which such moneys were not laid out or expended for the purposes of trade.'

Thus it is clear that s23 (g) is relevant to the requirement also contained in s11 (a), that a taxpayer can only deduct expenses incurred in the course of trading.

There are four aspects to the general formulae which give rise to litigation. These are as follows-

1) The taxpayer has to trade.
2) The interest must be actually incurred in the year of assessment
3) The expenditure must be incurred in the production of income
4) The expenditure must be of a non-capital nature.

The deduction of interest payments are frequently disallowed on the basis that one or more of these requirements of the general deduction formulae are not satisfied. These requirements will examined in turn, and it will become apparent that given the unique nature of interest expenditure, the general jurisprudential principles applicable to s11 (a) have often required further development and adaption by the courts in order to render these general tests appropriate for the specificity of interest expenditure.

## ***The General Deduction Formulae***

### ***(1) Trade Requirement***

The first step in determining whether a payment of interest is deductible must commence with an enquiry as to whether a trade is being carried on by the taxpayer. Previously, the deduction of money not wholly or exclusively laid out for the purpose of trade was prohibited, however s23(g) was amended with effect from 1993, and now an apportionment is permitted, and a deduction is prohibited only *to the extent to which* such moneys are not laid out or expended for the purposes of trade.[1] This amendment was effected to counter the harsh result of the Solarglass Finance Co (Pty) Ltd v CIR,[2] and has accordingly made the section 'less onerous insofar as it is no longer an all or nothing provision.'[3]

The trade requirement is contained not only in s23 (g) but also in s11 (a) read with the 'preamble' to s11:

'For the purpose of determining the taxable income derived by ant person *from carrying on any trade*, there shall be allowed as deductions from the income of such person *so derived-*

(a) expenditure and losses actually incurred in the production of *the income*, provided such expenditure and losses are not of a capital nature.

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[1] Emslie et al *Income Tax : Cases and Materials* 3rd ed (2001) at 405.
[2] 1991 (2) SA 257 (A).
[3] *Op cite* (note 1) at 406.

In accordance with the view of Emslie *et al*[4], it is submitted that the word 'the' in the expression 'the income' in s11 (a) signifies that expenditure and losses must be incurred in the production of income derived from the carrying on of a trade; since the word 'the' refers to the italicized words in the preamble to s11 (a) above.[5] Furthermore, the trade requirements of s23 (g) and s11(a) are for all practical purposes synonymous.[6] While the amendment to s23 (g) has made the section less onerous in terms of its former 'all-or-nothing' operation; it is nevertheless difficult to apply, since it is now necessary to 'identify trade and non-trade purposes, and where both are present, to attach weight to each in a precise manner so as to effect an apportionment, an expenditure or loss being deductible to the extent that it was incurred for the purposes of trade.' [7]

***Trading Generally***

In determining whether a person is carrying on a trade, some assistance can be derived from the definition of 'trade' in the Act, which 'includes every profession, trade, business, employment, calling, occupation or venture, including the letting of any property...'[8] However this definition is not exhaustive and regard must be had to the jurisprudence dealing with s23 (g) prior to its amendment which is highly instructive as to 'what constitutes a trade purpose and what constitutes a non-trade purpose.'[9] The hallmark of a trade purpose is a profit-making motive, and conversely the absence in certain circumstances of a profit motive may indicate a non-trade purpose.[10] In this regard the court in *De Beers Holdings (Pty) Ltd v CIR* held-

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[4] *Ibid.*
[5] *Ibid* at 406.
[6] *Ibid.*
[7] *Ibid.*
[8] Olivier 'The deductibility of Interest- A Problem Unresolved?' (1997) 44 *Stellenbosch Law Review* at 297.
[9] Op cite (note 1) at 405.
[10] Tager 'The deduction of interest payments for income tax purposes' (1976) 12 *SALJ* at 14.

> 'Where...a trader normally carries on business by buying goods and selling them at a profit, then as a general rule a transaction entered into with the purpose of not making a profit, or in fact registering a loss, must, in order to satisfy s23 (g), be shown to have been so connected with the pursuit of the taxpayer's trade, e.g. on the ground of commercial expediency or indirect facilitation of the trade, as to justify the conclusion that, despite the lack of profit motive, the moneys paid out under the transaction were wholly and exclusively expended for the purposes of trade...Generally, unless the facts speak for themselves, this will call for an explanation from the taxpayer.'[11]

Furthermore, in *ITC 1404*[12] the court affirmed that-

> '...the possibility or otherwise of earning a profit is simply a factor, perhaps the most important factor, and perhaps in the absence of anything else, a decisive factor, in considering whether or not, in particular, the requirement of s23 (g) has been met'[13]

***Trading as a Money- Lender***

The approach of Revenue to the question of when a trade is being carried on in regard to the earning of interest, is set out in Practice Note 31. The note makes provision for two different situations[14]-

I. Interest paid on funds borrowed for the purpose of lending them out as a higher rate will constitute a permissible deduction as the activities of the taxpayer constitute a trade; and

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[11] *De Beers Holdings (Pty) Ltd v CIR* 1986 (1) SA 8 (A) at 37.
[12] *ITC 1404* 48 SATC 1 at 2.
[13] *Ibid.*
[14] *Op cite* (note 8) at 298.

II. 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. In this regard, Revenue follows a benevolent practice in that a deduction is allowed to the extent that it does not exceed income received from the investment.[15]

Thus a person who carries on the business of a moneylender will be entitled to deduct any moneys spent in connection with his trade. In this regard deductible expenditure includes interest expenditure incurred in acquiring his trading stock, which is money. In *ITC 957*[16], the taxpayer made loans to its shareholders at low interest or without interest. Based on the surrounding circumstances and transactions it was held, that since the taxpayer did not carry on the trade of money lending, it was not trading. This was notably a question of evidence. Though the point was not raised, arguably, such loans were made as part of the taxpayer's ordinary trade activities which included the trade of money-lending albeit as a subsidiary activity, since the objects of the company empowered it to 'invest and deal with the moneys of the company not immediately required in such a manner as may from time to time be determined; and to lend money...on such terms as may seem expedient.'[17] However it unlikely that the courts would countenance such an argument given the potential scope for abuse of the Practice Note thorough artificially utilizing the guise of a moneylender.

It is submitted however that the ambit of the Practice Note is arguably too narrow, for instance Olivier[18] argues that there is no justification for allowing expenditure incurred in the letting of property, which is specifically included in the definition of trade, but denying expenditure incurred in the making of

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[15] *Ibid* at 298.
[16] *ITC 957* 24 SATC 637 at 637.
[17] *Ibid* at 637.
[18] *Op cite* (note 8) at 298.

deposits.[19] The basis for her submission is that making deposits is analogous to renting property, in that it is the granting of the right to use the money deposited in return for the payment of a rental (interest) on that money.[20] She argues that 'if such investments are made regularly, with the purpose of producing income, there is no logic in denying an expenditure incurred in this way, on the basis that the taxpayer is not a money-lender.'[21] Thus arguably the preamble to section 11(a) should be amended to allow for deductions in respect of all income, as defined, and not only in respect of income from trade.[22] Nevertheless, the law remains unchanged, and the onus rests on the taxpayer to establish as reasonable basis of apportioning expenditure and losses incurred partly for trade purposes and partly for non-trade purposes, since no such method is provided in the Act.

***Commencement of trade***

Pre-production expenditure refers to preliminary expenditure incurred prior to the commencement of trade. It would encompass expenditure such as rental for the premises and machinery, salaries, and interest on borrowings, incurred before the taxpayer is in a position to open his doors for business. The courts have found that such interest incurred in respect of an asset before it is brought into use in the taxpayer's trade, is not deductible because it is regarded as being of a preliminary nature, incurred in the acquisition of equipment or a source of profits, and therefore of a capital nature.[23] In *CIR v Allied Building Society* the court held-

> 'The urban properties were of course being prepared for income earning operations in the future; but such operations would be conducted not on the bare land, but in the new buildings when erected.

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[19] *Ibid.*
[20] *Ibid.*
[21] *Ibid.*
[22] *Ibid* at 299.
[23] *Op cite* (note 1) at 450.

> The expenditure in issue...is more closely connected with the capital expenditure in creating a new source of income than with the income earning operations'[24]

In the case of *Borstlap v SBI*[25] the taxpayer purchased land on which there were old buildings. He financed the acquisition by means of loan capital secured by mortgage bonds over the property. The taxpayer's purpose was to demolish the buildings, and erect a new block of flats for letting. The taxpayer sought to deduct expenses incurred in connection with the property, including interest on the mortgage bonds. The court found that such expenses were capital in nature, being of a preliminary nature, incurred in the acquisition of a source of future profits.

Notably, certain pre-production interest is however deductible in terms of s11(*b*A) of the Act.

***Cessation of trade***

Once trading has ceased, expenditure can no longer be deducted, in accordance with the provisions of s11 (a). However, it may be difficult to determine when trading has ceased. In *ITC 1627*,[26] the taxpayer was at all material times a professional person, and received income by way of salary. While so employed he developed a township, and borrowed money to do so. However, the loans were not fully paid off by the time the last stand in the township had been sold, and he thus continued to pay off the loans and interest thereon after such time. He contended that the interest should be set-off against his salary income. The court found that since the expenditure could be set off against the income derived from his professional trade, it was unnecessary to decide whether after closing down activities or 'active

[24] *CIR v Allied Building Society 1963* (4) SA 1 (A) at 12.
[25] *Borstlap v SBI* (4) SA 836 (A) at 844.
[26] *ITC 1627* 60 SATC 26 at 28.

trading', the collection of business debts constituted trading.[27] According to this reasoning the expenditure had to have been 'actually incurred' after active trading ceased, otherwise the issue would not have arisen; since provided an expense is 'actually incurred,' the fact that the trade ceases does not affect the deductibility thereof.[28] Thus while the obligation to repay the loan with interest was incurred before 'active trading' had ceased, the interest itself had to have been 'actually incurred' after 'active trading' had ceased.[29] Therefore, accepting that the expense was 'actually incurred' once active trading had ceased, it remained imperative in terms of s11(a) to establish that the taxpayer was trading when the expense was incurred.[30] Thus the conclusion reached by the court 'did require a finding that the continuing loan obligations flowing from the taxpayer's trade, *viz* the payment of interest on the loan, amounted to a continuation of that trade.'[31]

In this regard the court in *ITC 1627* cited a House of Lords case decided in 1950 in which it was held that 'trading does not cease when, the shutters are put up, but that it continues until all sums due are collected and all debts paid;' [32] and thus made an obiter remark that there was much to be said for the view that trading only cease when all the debts of a business have been paid and all the sums due to it have been collected.[33] However, in the case of *Timberfellers( Pty) Ltd v CIR*[34], the Natal Provincial Division found that the collection of trade debts per se was not the carrying on of trade. It is interesting to compare these findings with that in *Robin Consolidated Industries Ltd v CIR*[35] where the Supreme Court of Appeal found that the sale

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[27] *Ibid* at 28.
[28] *Op cite* (note 1) at 447.
[29] *Ibid.*
[30] *Op cite* (note 1) at 447.
[31] *Ibid.*
[32] *Theophile v Solicitor-General* (1950) 1 All ER 405 (HL) at 411.
[33] *Ibid.*
[34] *Timberfellers (Pty) Ltd v CIR* 59 SATC 153 at 163.
[35] *Robin Consolidated Industries Ltd v CIR* 1997 (3) SA 654 (SCA) at 659.

of stock in bulk by a liquidator in the course if liquidation of a company did not constitute the carrying on of a trade.[36] The court held-

> 'There was no venture into trading in the ordinary way-by the acquisition and holding of stock in the hope of reselling it at a profit...the taxpayer had merely realized assets; it had not traded in them.'[37]

Albeit easily distinguishable, the more narrow approach adopted by the court in *Robin Consolidated Industries Ltd* would seem to accord with the *Timberfellers* approach. A further question is raised regarding when a trade must be carried on, that is, at the time of the acquisition of a debt or at the time of payment of the interest. It is submitted, as illustrated in the cessation of trade cases, the taxpayer must carry on a trade when the obligation to pay interest is actually incurred; which may be different from the time when the debt is acquired. However, it is noteworthy that the pre-production cases appear to look to the time of acquisition of the debt.

Notably, where trading ceases in a particular business in respect of which money has been borrowed, it will be a question of fact as to whether there has been a change of the original purpose for which the money was borrowed. Thus, where a person borrows money at interest to finance a particular trade, if when trade ceases, he employs that money in a new or different trade, deductibility of the interest on the original loan must be assessed in relation to the new trade. Provided all the requirements for deductibility are satisfied, it is entirely feasible that while the original purpose of raising the loan has ceased, that purpose has now been replaced by a new, and equally acceptable trading purpose.[38] A change of purpose would be evident, for example, where the

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[36] *Ibid.*
[37] *Ibid.*
[38] *Op cite* (note 10) at 20.

business in respect of which the money was borrowed is realized and the proceeds are not used to repay the loan.

In conclusion it is noteworthy that the onus would rest on the taxpayer to establish that the funds continued to be used for a trading purpose, or at least to provided a reasonable basis of apportioning such expenditure; and this might prove to be a difficult burden to discharge in circumstances where there is a purported change of purpose. Thus, while the subsection has been made less onerous by the amendment to section 23(g) in the sense of no longer operating on an all-or-nothing basis; it has simultaneously increased the onus on the taxpayer to attach weight to trade and non-trade purposes in a precise manner so as to effect an apportionment.[39] In certain circumstances this burden, sourced in the complex construction of the section, may prove an insurmountable burden even for the taxpayer with a *bona fide* case to make.

[39] *Op cite* (note 1) at 406.

***Actually incurred***

The expression "expenditure actually incurred" refers to all expenditure in respect of which the taxpayer has incurred an unconditional legal obligation during the year of assessment, irrespective of whether or not that liability has been discharged during the year.[40] 'Actually incurred' does not mean 'actually paid', and in the case of *Edgar's Stores Ltd v CIR*[41] the court said a distinction must be drawn between-

(a) 'the case where the existence of the liability itself is conditional and dependent upon the happening of an event after the tax year in question, in which event the liability is not incurred in the tax year in question; and

(b) the case where the existence of the liability is certain and established within the tax year in question, but the amount of the liability cannot be accurately be determined at the tax year-end, in which event the liability is nevertheless regarded as having been incurred in the tax year in question.'[42]

On the basis of this principle, it is possible for a taxpayer to manipulate the date accrual and deduction of interest, through altering the facts so that in terms of the law the date of accrual is no longer what it would have been has the facts not been rearranged( for example by the insertion of a suspensive

[40] *Edgar's Stores Ltd v CIR* 1988 (3) SA 876 (A) at 883.
[41] *Ibid.*
[42] *Ibid* at 885.

condition.)[43] Thus, if interest is made payable at a fluctuating rate (such as fixed in relation to the prime rate of interest), this would amount to a condition and the interest could then not be said to have accrued up front because the amount thereof would be subject to fluctuation from time to time.[44] Many tax-planning schemes were devised around this, in order to defer accrual of the interest income, and accelerate incurral.[45]

This uncertainty regarding the timing of interest expense incurral was made manifest in diametrically opposed decisions of the Special Court. In *ITC 1485,*[46] it was held that because it is inherent in the nature of interest that it accrues from day to day, that there can be no liability incurred at the end of the tax year in respect of interest payable in respect of a time which has not yet elapsed.[47] Thus in this case a bank claimed the deduction of the total interest payable in the tax year in which it had issued negotiable certificates of deposit, although the interest payable thereon extended beyond the tax year in which the NCD's were issued. The court found that interest for any period beyond the year of assessment had not been incurred for the purpose of s11 (a).[48] This decision was dissented from in *ITC 1587*[49] and *ITC 1588*,[50] where the court held that where a taxpayer has contractually bound himself to pay interest on a loan for a period, there is an absolute and unconditional liability for the whole amount, which is thus deductible in the tax year in which it is incurred notwithstanding that it relates to a period extending beyond the end of the year.[51] This uncertainty involving a fundamental issue was potentially highly prejudicial to taxpayers. For example, taxpayers who acted on the authority of *ITC 1485* and accordingly failed to claim a deduction of interest

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[43] Emslie et al *Income Tax: Cases and Materials* 3rd ed (2001) at 491.
[44] *Ibid.*
[45] Olivier 'The deductibility of Interest- A Problem Unresolved?' (1997) 44 *Stellenbosch Law Review* at 299.
[46] 1991 *Taxpayer* 176.
[47] 'Deduction of Interest: The Time Factor' April 1995 *The Taxpayer* 61
[48] *Ibid.*
[49] *ITC 1587* 57 SATC 97.
[50] *ITC 1588* 57 SATC 148.
[51] *Op cite* (note 47) at 61.

payable beyond the end of the tax year, might lose the right to claim such amounts in the following year; on the basis that liabilities actually incurred are only deductible in the tax year in which they are incurred.[52] In this regard the court in *Concentra (Pty) Ltd v CIR*[53] stated-

> 'The reference in s11 (2) (a) to 'expenditure and losses incurred' are expenditure and losses incurred in the year of assessment. Accordingly, expenditure has to be deducted in the year in which liability therefore arises, irrespective of when payment is made.'

Furthermore, accepting the latter decisions, Revenue could be prejudiced on the basis that 'the deduction in one year of a taxpayer's total interest liability would seriously erode the amount of Revenue to be collected.'[54] Fortunately, a decision of the Supreme Court of Appeal has settled this prevailing uncertainly.

In *Cactus Investments (Pty) Ltd v CIR*[55] the question in issue was whether, after making funds available to the borrower, the lender had an unconditional right to receive the interest on due date. The court thus affirmed that under the common law interest accrues upfront when the lender lends money to the borrower and becomes entitled to receive interest in the future. This judgment obviously has implications for the claiming of interest expenditure by the borrower, since contrary to *ITC 1485*, the court asserted that the fact that the time for repayment of interest expenditure has not yet arrived, does not amount to a condition, but is a mere time provision.[56] Thus just as lender becomes entitled to the total amount of interest in the tax year in which the loan is granted, so the borrower's liability for the total interest is incurred in the year in which the loan is advanced.

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[52] *Op cite* (note 47) at 61.
[53] *Concentra (Pty) Ltd v CIR* 1942 CPD 509 at 512.
[54] *Op cite* (note 52).
[55] *Cactus Investments (Pty) Ltd v CIR* 1999 (1) SA 315(SCA) at 319.
[56] Ibid at 319.

Furthermore, for purposes of tax planning the following dicta of Hefer JA must be observed-

> 'Although a taxpayer is entitled to arrange his affairs in such a manner that the fruits of his labour or money will attract no (or less) or later tax, a stipulation that interest will accrue on a date after the date on which it accrues *ex lege*, avails him not'[57]

Thus, it is meaningless to attempt to vary the date of accrual by agreement (for example, through inserting time clauses), when in terms of the law as applied to the facts the date of accrual is otherwise. Rather, the facts must be altered so that in terms of the law, the accrual is no longer what it would have been had the facts not been rearranged (for example, by the insertion of a suspensive condition.) [58] The court thus qualified the scope for manipulating the timing of the recognition of interest which taxpayers previously enjoyed. Furthermore, SARS, no doubt wary of the potential prejudice to its coffers caused by *ITC 1587* and *ITC 1588* providing that interest expense is incurred upfront; responded accordingly.

***Section 24J***

Invariably in response to the conflicting judgments of the Special Court, the legislature introduced section 24J to the Act. The section regulates the timing of accruals and deductions of expenditure in regard to various types of interest bearing instruments.[59] The object of the section is to tax interest payable on a day-to-day basis and to permit the deduction to the person liable on the instrument on a similar basis.[60] The section does not cover all interest-bearing instruments, and in respect of the accrual of interest, the section is only applicable to an "income instrument" as defined; and in respect of the incurral

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[57] *Ibid* at 322.
[58] *Op cite* (note 1) at 491.
[59] 'Incurral and Accrual of Interest' June 1995 *The Taxpayer* 108
[60] *Ibid.*

of interest, the section is only applicable to an "instrument" as defined.[61] Some of the arrangements specifically included are stock, bonds, debentures, bills of exchange, promissory notes, deposits with banks, any loan, advance or debt, any repurchase or resale agreement and any acquisition or disposal of an right to receive interest or the obligation to pay interest, in term of an interest-bearing arrangement. Arrangements excluded are lease agreements and certain credit agreements qualifying for allowance in terms of section 24(2).[62] Thus in terms of s24J interest is deemed to accrue and to be incurred on a day-to-day basis. However, in the situations where s24J does not apply, the *Cactus* judgment will prevail, providing that interest is incurred in the year in which the interest-bearing arrangement is entered into, since an unconditional obligation to pay arises when the lender makes the funds available to the borrower.

In conclusion, has been shown that the conflicting judgments of the Special Court no doubt prompted the legislature to enact section 24J to avoid the potential prejudice SARS would suffer if interest expense were to incur upfront. As a result of the section 'the timing of the recognition of any interest is no longer largely a matter of choice and negotiation between the parties.'[63] Thus while s24J is the essential port of call regarding the timing for tax purposes of any interest[64]; it is nevertheless important that in the unlikely event of a taxpayer falling outside the ambit of s24J (given the wide reaching effect of the section), cognizance be taken of the *Cactus* judgment, lest the ability to deduct interest payable in the future is lost.

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[61] *Ibid.*
[62] *Ibid* at 109.
[63] Broomberg & Kruger *Tax Stratergy* 3ed 1998 at 74.
[64] *Ibid.*

***In the production of income***

This requirement must be read in conjunction with s 23(f), which provides that any expenses incurred in respect of any amounts received or accrued and which do not constitute income as defined in s1 of 'The Act' are not deductible. It is submitted in accordance with the views of Emslie *et al* that this section merely repeats the 'in the production of income' test embodied in the general deduction formulae.[65] The leading authority on which expenditure will be in the production of income is *Port Elizabeth Electric Tramway Co Ltd v CIR.*[66] In this case a driver employed by the taxpayer, a tramway company, was injured while driving a company tram in the course of his employment and claimed compensation from the taxpayer accordingly.[67] In determining whether the expenditure was incurred in the production of the taxpayer's income, Watermeyer AJP formulated a two-legged test for application to this requirement. These two components will be considered in turn. The first provides that-

1. 'The act to which the expenditure is attached must be performed in the production of income. This test is subjective: an act will be regarded as being performed in the production of income if it is performed *bona fide* for the purpose of carrying on the trade which earns the income.'[68]

Thus in regard to this first part, the purpose of the act entailing the expenditure must be established. It appears that Watermeyer AJP to some extent conflated the tests of 'in the production of income' (s11 (a)) and

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[65] Emslie et al *Income Tax: Cases and Materials* 3rd ed (2001) at 330 relying on the authority of CIR v Nemojim (Pty) Ltd 1983 (4) SA 935 (A).
[66] *Port Elizabeth Electric Tramway Co Ltd v CIR* 1936 CPD 241 at 244.
[67] *Op cite* (note 1) at 330.
[68] *Op cite* (note 66) at 246.

'wholly and exclusively' for the purposes of trade,' (s 23(g)) whereas these are distinct tests, each governed by unique criteria for deductibility.[69] Invariably, the tests are closely linked, in that a person carrying on a trade will have as his purpose the production of income, although income may not in fact result. The converse does not necessarily follow, thus the fact that income is being produced does not mean that a trade is being carried on,[70] though this is a strong indicator. The court formulated the second leg in the following terms-

> 2. 'The expenditure in question must be so closely linked to such act that it can be regarded as part of the cost of performing it. Provided that it is so linked, it does not matter whether the expenditure in question is necessary for the performance of the act, attached to it by chance or *bona fide* incurred for the more efficient performance thereof.'[71]

This second part of the test requires an examination of whether the expenditure is linked to the act closely enough. It provides the parameters for how closely linked the expenses have to be to the income earning act before they will be deducted-

> 'All expenses attached to the business operation *bona fide* performed for the purpose of earning income are deductible whether such expenses are necessary for its performance or attached to it by chance or are *bona fide* incurred for the more efficient performance of such operation provided they are so closely connected with it that they may be regarded as part of the cost of performing it'[72]

On the facts of the case found that the employment of drivers carried with it as a necessary consequence the potential liability to pay compensation in the

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[69] *Op cite* (note 1*)* at 333.
[70] Tager 'The deduction of interest payments for income tax purposes' (1976) 12 *SALJ* at 27.
[71] *Op cite* (note 68).
[72] *Op cite* (note 66) at 247.

event of drivers being injured in the course of their employment.[73] It is interesting that the court regarded the employment of drivers as the act to which the expenditure was attached; as opposed to the act of driving the tramway itself. It arguably did do to avoid the question of negligence, and in this regard made an obiter remark that where the act in question, though performed in the production of income, is unlawful or negligent; the expenditure attendant upon such act would probably not be deductible. [74]

It is interesting to consider a later decision of the Supreme Court of Appeal, in which on similar facts to *PE Tramways*, a different conclusion was reached based on the issue of negligence. The case is that of *Joffe and Co (Pty) Ltd v CIR*[75] in which a taxpayer claimed that the cost of damages incurred due to an accident (caused by its employees negligence) in the course of its engineering business, was an expense incurred in the production of its income. The court however adopted a strict approach and based on considerations of public policy asserted that no deduction should be allowed where negligence is concerned. [76] It is submitted that the courts approach was unduly restrictive and a better approach would have been to acknowledge the reality that negligent acts are bound to happen 'human nature being what it is'[77] and that this is an eventuality which is inseparable from the carrying on of a business.[78] Therefore that in certain circumstances negligence can 'be properly regarded as an inevitable concomitant of carrying on a business or profession.'[79]

The meaning of the words 'they may be regarded' was briefly discussed in the case of *CIR v Genn & Co (Pty) Ltd*, and it was asserted that the phrase means that it would be 'proper, natural, or reasonable'[80] to regard the expenditure as part of the cost of performing the income earning act. Whether the closeness

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[73] *Op cite* (note 66) at 247.
[74] *Op cite* (note 66) at 245.
[75] 1946 AD 157 at163.
[76] *Op cite* (note 1) at 336.
[77] *Op cite* (note 66) at 247.
[78] *Op cite* (note 1) at 336.
[79] *Ibid.*
[80] *CIR v Genn & Co (Pty) Ltd* 1955 (3) SA 293 (A) at 296.

of the connection would properly, naturally, or reasonably be regarded as such, is a factor dependent on the facts of each case.[81]

In terms of the 'purpose test', the purpose of the act that caused the expenditure must be examined. If the purpose was to produce income, then the expenditure is deductible. However, in the case of interest expense, this single enquiry is insufficient, in that the purpose of the act entailing the expenditure is to obtain loan finance. This borrowing in turn may or may not be in the production of income. Thus the purpose of the borrowing must be examined, and it is this purpose which must be for the production of income.[82] The courts draw a distinction between the different purposes for which money is borrowed, and the decisions thus reveal a variety of ways in which this purpose test has been applied and extended. The initial purpose of the taxpayer in borrowing may be decisive, but since this may change, the ultimate intention may override the initial purpose. Furthermore, a taxpayer may borrow for general purposes, that is, without a single purpose motivating the borrowing; or he may have a dominant purpose, albeit with other incidental purposes.[83] Needless to say the onus of showing such a change of purpose rests on the taxpayer, and the significance of this will become evident as the practical application thereof is examined through a variety of commercial contexts; where it has been by far the most litigious requirement.

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[81] *Ibid.*
[82] *Op cite* (note 10) at 28.
[83] *Ibid.*

## ***Not of a Capital Nature***

Interest is usually regarded as being of a revenue nature on the basis that it is consideration paid for the *use* of money and is akin to rental paid for the use of a thing,[84] which is inherently of a revenue nature. This analogy does however have its limitations, and the deductibility of interest is decided by subjecting interest to the same tests to which other forms of expenditure are subjected.[85] Several tests have been established by our courts to determine the capital or revenue nature of expenditure. However while the recognized tests are 'useful in some circumstances...many of them have turned out to be insufficient and inconclusive when applied to other circumstances. Thus, no single test can be regarded as decisive, and the true character of the transaction has to be examined.'[86] Tager[87] submits that interest, for the purpose of deduction, should be regarded as *sui generis* , and that the true nature of the transaction should be examined where interest is concerned, since the established tests for determining the capital nature of the expenditure cannot meaningfully be applied to the deduction of interest.[88] The conventional tests will be examined in turn, and it will become apparent that they are not easily or effectually applied in the case of interest expense. Furthermore, it will be shown that the tests give rise to conflicting results, such that inconsistency arises where expenditure is subjected to more than one of the accepted tests. It will become clear that the courts have avoided addressing the issue, and have instead based their findings on the 'in the production of income' requirement; which is more easily applicable. This avoidance is unsatisfactory, as the two enquiries are non-synallagmatic, and are based on entirely distinct rationale. It will be argued however that the issue

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[84] Emslie, Davis & Hutton *Income Tax: Cases and Materials* (1994) at 448.
[85] Tager 'The deduction of interest payments for income tax purposes' (1976) 12 *SALJ* at 37.
[86] *Ibid* at 36.
[87] *Ibid.*
[88] *Ibid* at 36.

is not one which should be deferred to the legislature, but rather should be addressed by the courts.

***The purpose / closeness of connection test***

This test for establishing the nature of expenditure is arguably the most useful and is sometimes expressed in the following terms:[89] 'Is the purpose of the expenditure 'part of the cost incidental to the performance of the income - producing operations', or is it for the purpose of the equipment of the income producing machine?'[90] Expenditure which is incurred for the purpose of 'establishing, improving or adding to the equipment of the income-producing structure is capital expenditure, whereas expenditure which is incurred as part of the cost of performing the income-producing operations is revenue expenditure.'[91]

The same test was expressed albeit slightly differently, in the following terms-

> 'There is a great difference between money spent in creating or acquiring a source of profit, and money spent in working it. The one is capital expenditure, the other is not. The reason is plain; in the one case it is spent to enable the concern to yield profits in the future, in the other it is spent in working the concern for the present production of profit '[92]

This tests however present much difficulty when applied to the deduction of interest, since in theory every amount of interest expended in the purchase of a capital asset must certainly be so closely identified with that capital asset to

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[89] *Ibid* at 37.
[90] *Ibid.*
[91] *New State Areas Ltd v CIR* 1946 AD 610 at 621.
[92] *George Forest Timber Co Ltd, CIR v* 1924 AD 516 at 525.

itself be regarded as being of a capital nature and not deductible.[93] However in the practical application of the test, the courts seem to suggest (without conclusively deciding) that interest resulting from the purchase of a capital asset with borrowed money might nevertheless be deductible. Thus the difficulty lies in the divergence between the theoretical application of the test and courts suggested practical application thereof. In the *Burgess* case the following obiter observation was made-

> 'Even if the money had been borrowed to procure a capital asset, the interest paid on that loan was the recurrent 'rental' payable for the continued use of the money lent to it. Such interest was not intended to improve, augment, or preserve the aforementioned capital assets, or form part of or add to the cost of acquiring them or enhance their value. Consequently, the interest was not so closely identified with the capital asset to be regarded as being of a capital nature.'[94]

The court thus suggested that a link should not be drawn between the capital asset purchased with the borrowed funds, and the interest expense incumbent thereon. It is unfortunate that the court failed to discuss the practical implications of this observation.

The door for denying deduction on the capital nature of the interest was left open in *CIR v Genn & Co (Pty) Ltd* where it was held that –

> 'Interest paid on money borrowed and used for the purposes of a business would appear to be expenditure actually incurred in the production of the business, whether the loan was for the acquisition for fixed or floating capital. *There might, of course, be the further question whether or not, because of its association with the fixed*

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[93] *Op cite* (note 10) at 38.
[94] *Burgess v CIR* 1993 (4) SA 161 (A) at 182.

> *capital into which the loan is turned, interest on such a loan may not properly be said to be expenditure of a capital nature (*my own emphasis*).*'[95]

In the case it was unnecessary to pursue the question since the interest was paid on a loan used to acquire the company's trading stock , and was not 'aimed at augmenting the fixed capital or maintaining an enduring asset of the company but was directed towards a rapid turnover of the company's floating capital.'[96] Thus the practical applicability of the purpose test remains uncertain.

In *ITC 1126*,[97] interest was paid on a loan which was used to acquire shares. The court found that the main purpose in acquiring the shares was to obtain control of the business and since this was a capital intention it followed that the interest was of a capital nature and therefore non-deductible.[98] The judge was however reluctant and uncertain of this finding, and said that even if he was wrong on this ground, that that expenditure was not made in the production of income, nor wholly and exclusively for trade. This case affirms the reticence of the courts to determine the applicability of the purpose test.

Silke[99] states the following regarding the capital aspect of the deduction of interest-

> 'It does not necessarily follow that because a loan liability is incurred for acquiring fixed capital assets the interest paid on such a loan must also be of a capital nature. As long as the interest is not intended to improve, augment, or preserve the capital assets of the business, or

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[95] 1955 (3) SA 293 (A) at 300.
[96] *Ibid.*
[97] *ITC 1126* (1968) 31 *SATC* 111 at 112.
[98] L Tager 'The Deduction of Interest Payments for Income Tax Purposes' (1976) 93 SALJ at 39
[99] *Silke on South African Income Tax* at 246.

> form part of or add to the cost of acquiring them or enhance their value, it cannot be regarded as being so closely identified with capital assets that it must be regarded as being of a capital nature.'

Tager[100] correctly observes that the learned author merely states that the tests that are applied to determine the capital nature of expenditure generally are equally applicable to determine the deductibility of interest.[101] With respect, it seems that Silke is as such begging the question, as he arguably fails to recognize or address the problem that arises when the tests of capital are applied to interest, namely that 'every amount expended in the payment of interest on a loan procured to purchase a capital asset must surely be so closely identified with a capital asset that it must itself be regarded as being of a capital nature.'[102]

In *New State Areas* the court encapsulated the test as follows-

> 'The conclusion to be drawn from all these cases seems to be that the true nature of the 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 it is a 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 earning operations as distinguished from the equipment of the income producing machine, then it is revenue expenditure...'[103]

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[100] *Op cite* (note 10) 38.
[101] *Ibid.*
[102] *Ibid.*
[103] 1946 AD 610 at 620.

In that case the court found that sewers constructed on the taxpayers property formed part of the equipment of the income-producing structure (viz the mine), and hence expenditure incurred thereon was of a capital nature.[104] The difficulty which arises where interest expense is concerned is this- if the taxpayer had borrowed money in order to construct this capital asset, would the interest paid on the loan be regarded as expenditure of a capital nature? The purpose test when applied to interest expense, would theoretically seem to advocate that if a loan is used to acquire a capital asset, then the interest thereon will also be of a capital nature. Thus the test certainly leaves the door open for the commissioner to argue that interest expenditure which is more closely connected to the equipping or improving of the income producing machine than it is to the income producing operations, should as such be regarded as capital expenditure itself.[105] However, the courts have intimated that this might not necessarily be so, yet have failed to address the issue. Thus manifest uncertainly exists in this chasm of possible divergence between the theory and the way in which the courts might apply the test.

Thus it appears that the general practice of the courts is not to question the nature of interest expenditure[106] and the few cases that exist on the issue in which the deduction was denied on this point, can be explained in that one of the other requirements for the deduction of expenditure was not present.[107] An anomaly arises in the fact that if the taxpayer spent money which was already in his coffers to acquire a capital asset, such expenditure would be regarded as expenditure of a capital nature and not be deductible.[108] The two situations are indistinguishable, and it is on this basis that Olivier submits that this test for determining the capital nature of expenditure is not an appropriate one to

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[104] *Ibid.*
[105] Olivier 'The deductibility of Interest- A Problem Unresolved?' (1998) 44 *Stellenbosch Law Review* at 52.
[106] *Ibid* at 44.
[107] *Op cite* (note 10) at 38.
[108] *Ibid.*

apply to the deduction of interest.[109] However, since the problem lies in the unique nature of interest expense itself, arguably the test should be appropriately adapted for application to interest expense. In this regard perhaps the obiter in the *Burgess* case offers a solution- whereby the purpose test is limited in its application such that the interest paid on a loan is regarded as recurrent 'rental' payable for the continued use of the money lent to it and a connection is not further drawn to the usage thereof. However this approach too would render an inevitable outcome, albeit on revenue account, and would thus make application of the test seemingly superfluous.

***Enduring Benefit***

In spite of the anomalous situation which arises in relation to the purpose test, on the basis of two of the other (albeit generally less utilized) tests which the courts apply to establish the nature of an expenditure, interest is of a revenue nature and thus deductible. In terms of the enduring benefit test, expenditure is not normally deductible if it was incurred to bring into existence an asset for the enduring benefit of the taxpayer's trade, since such expenditure would be considered capital in nature. In *New State Areas*, this test was discussed relying on English decisions[110]-

> 'When an expenditure is made...with a view to bringing into existence an asset or an advantage for the enduring benefit of a trade, I think that there is very good reason (in the absence of special circumstances leading to an opposite conclusion) for treating such an expenditure as properly attributable not to revenue but to capital.'

This was elaborated on in the case of *Anglo-Persian Oil Co v Dale*[111]-

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[109] *Ibid.*
[110] *British Insulated Helsby Cables v Atherton* 1926 AC 205.
[111] *Anglo-Persian Oil Co v Dale* 1932 1 *KBD* 124.

> 'Enduring' is meant in the way that fixed capital endures. An expenditure on acquiring floating capital is not made with a view to acquiring an enduring asset. It is made only with a view to acquiring an asset that may be turned over in the course of trade at a comparatively early date. Nor, of course, need the advantage be of a positive character. The advantage may consist in the getting rid of an item of fixed capital that is of an onerous character.'

In the Rhodesian courts this test was relied on in *Nchanga Consolidated Copper Mines Ltd*[112] where the taxpayer made a lump sum payment to another mine in the same group to stop producing copper for one year, owing to conditions in the world copper market. The court held that-

> 'The expenditure was incurred as part of a temporary arrangement to meet a temporary situation, and the benefit to the taxpayer was of no more than one year's duration. The expenditure accordingly brought no 'enduring benefit' to the taxpayer's trade, and for this reason could not be regarded as being of a capital nature.'[113]

In our courts the test was relied on in *Palabora Mining Co Ltd,*[114] where in order to hasten the completion of a barrage necessary for the supply of water to its mining plant, the taxpayer incurred expenses in the form of inducements and special incentives paid to sub-contractors to finish the work as expeditiously as possible. It was held that-

> 'The expenditure in issue did not create or preserve any right or asset for the taxpayer, but gave rise to a short-lived advantage, namely the

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[112] *Nchanga Consolidated Copper Mines Ltd* 1962 (1) *SA* 381 (FC) at 386.
[113] *Ibid.*
[114] *Palabora Mining Co Ltd* 1973 (3) SA 819 (A) at 829.

> supply of water eight months earlier than would otherwise have been the case.'[115]

However, the same difficulties encountered in the application of the purpose test similarly arise in relation to the enduring benefit test. The essential question is the following- does the mere fact that the purpose of the loan was to obtain a capital asset which falls within the enduring benefit test automatically mean that the interest is also of a capital nature?[116] That is, should a link be drawn between the capital asset purchased with the borrowed funds and the interest expense. The court in the *Burgess* suggested this should not be done, however failed to provide an alternative solution. Tager[117] argues that due to the transitory economic nature of interest it can never be regarded as an expenditure incurred with a view to bringing into existence an enduring benefit.[118] This test thus presents difficulty in so far as interest expense is concerned in that if the submission made by Tager is accepted, then the test is superfluous since the conclusion is foregone that interest is inherently not of an enduring nature. Thus similarly to the purpose test, if the link between the asset and the interest expense is not drawn, then a revenue finding is the inevitable outcome. In ITC 1124[119] the taxpayer borrowed money to purchase shares in two timber-milling companies, in order to gain control of the said companies and thereby secure an enduring advantage in the form of a steady form of timber to an associated company. The deduction of the interest expenditure was disallowed not on the basis that it was a capital expenditure, but that it was not sufficiently closely connected with the production of income.[120] In terms of the enduring benefit test, it is clear that the interest expenditure attendant upon the loan enabled the taxpayer to secure an enduring advantage for the benefit of his trade. The court held that a

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[115] *Ibid.*
[116] *Op cite* (note 105) at 52.
[117] *Op cite* (note 10) at 36.
[118] *Ibid.*
[119] ITC 1124 (1968) 31 SATC 53.
[120] *Op cite* (note 10) at 37.

sufficiently close identification between the capital benefit and the interest did not exist,[121] but it is not clear how the court arrived at this conclusion. Furthermore, in the *Drakensberg Garden Hotel* case[122], the interest expenditure incurred on acquiring shares certainly seemed to produce an enduring advantage for the business (security of tenure). In this regard the court asserted that –

> 'The distinction between expenditure disbursed to protect or preserve a capital asset and expenditure aimed at improving such an asset and making it more productive is a fine one. In the present case the respondent had a capital asset-the leases-which the acquisition of the shares would no doubt help to protect and preserve so long as they lasted, while ensuring their renewal after expiration. *However, precisely when expenditure upon a capital asset is itself of a capital nature cannot easily be stated and for present purposes need not be further examined* (own emphasis).'[123]

In spite of this clear indication that the interest expenditure was capital in nature based on its association with the capital acquisition, in an *obiter* finding the court asserted that the expenditure was not of a capital nature, based on the fact that the purpose of the expenditure was to ensure the continuance of and to secure an increased income from trading and letting.[124] Tager[125] correctly submits that it is difficult to follow this reasoning,[126] since the nature of expenditure is determined with reference to defined criteria relevant to the capital-versus-income issue, and the mere fact that expenditure does or does not produce income, should not be included as one of these criteria.[127] This is an issue relevant to the inquiry as the whether the expenditure was incurred

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[121] *Ibid.*
[122] 1960 (2) SA 475 (A).
[123] *Ibid* at 479
[124] *Ibid.*
[125] *Op cite* (note 10).
[126] *Ibid* at 37.
[127] *Ibid.*

prior to trading or whether it was incurred in the production of income. Tager asserts that it is a 'most inconsistent and incorrect approach that in many cases once an asset becomes productive of income, many items of expenditure, in particular the payment of interest, which were previously disallowed, are then regarded as expenditure of a non-capital nature and allowed as a deduction.'[128] This was recognized in the *Sub-Nigel*[129] case-

> 'In considering whether expenditure is of a capital nature, or non-capital nature it is well to bear in mind that it does not necessarily follow that because expenditure produces income, such expenditure is of a capital nature.'[130]

In conclusion through its reliance upon irrelevant criteria the court in *Drakensberg Gardens* avoided addressing the essential issue of when interest expenditure attendant upon a capital asset is itself of a capital nature. Thus in the same way that the inquiry was left open in the *Genn* decision in relation to the purpose test; the courts have similarly failed to address the same problems encountered in relation to the enduring benefit test. It is in light of such uncertainty that Tager submits that the enduring benefit test is on the most part inappropriate when applied to interest.[131] While her observation is valid, there may nevertheless be scope for the courts to appropriately adapt the tests taking the unique nature of interest expense into account.

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[128] *Ibid.*
[129] 1948 (4) SA 580 (A).
[130] *Ibid* at 588.
[131] *Op cite* (note 10) at 36.

***Once-and-for-all test***

In terms of this test-

> 'Capital expenditure is a thing that is going to be spent once and for all, and income expenditure is a thing that is going to recur every year.'[132]

On the basis of this test interest would be considered to be revenue based on its usually recurring nature. However, this test has not always found favour in our courts and thus is arguably not as persuasive as the previous tests. In *New State Areas* the court asserted that-

> 'If (the expense) is incurred for the purpose of acquiring a capital asset it is a capital expenditure even if it is paid in annual installments; if on the other hand it is in truth no more than part of the cost incidental to the performance of the income earning operations as distinguished from the equipment of the income producing machine, then it is revenue expenditure even if it is paid in a lump sum.'[133]

Furthermore, in the case of COT *v Rhodesian Border Timber Co Ltd*[134] the court held that the finding of the court *a quo* that the expenditure was not capital because it was of a recurring nature was open to attack and erroneous in law.[135] Thus while expense is often a recurrent item of expenditure, a factor indicative of a revenue nature, this is not always the case, and furthermore, interest might be payable in a lump sum which would in terms of

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[132] *Ibid* at 52.
[133] *Op cite* (note 103) at 620.
[134] COT *v Rhodesian Border Timber Co Ltd*24 SATC 602 at 605.
[135] *Ibid.*

this test render the expense capital in nature. The essential point is thus that this test gives rise to the same issues encountered in relation to the purpose and enduring benefit tests; and furthermore has largely been rendered redundant by the court in *New State Areas*.

***Conclusion***

It is clear that this non-capital requirement creates difficulty in respect of the deduction of interest expenditure and accordingly the question may be asked as to whether it is appropriate to deny a deduction of interest on the basis that it is of a capital nature.[136] Aside from *obiter* comments, the courts have failed to address the practical applicability of the conventional tests to interest and accordingly manifest uncertainty exists.[137] The majority of writers submit that the deduction of interest expenditure should never be denied on the basis that it is of a capital nature.[138] Tager submits that given the fact that the receipt/accrual of interest is always treated as revenue; the expenditure thereon should always be treated as non-capital in nature.[139] The Margo Commission recognized the soundness of this view, however did not make a recommendation to the same effect, on the basis that recipients of large amounts of interest, like pension funds are exempt from tax.[140] Furthermore Tager's view fails to take account of the fact that the tests applied in the gross income inquiry and those applied in the general deduction formulae are non-synallagmatic. Accordingly, since the applicable tests are different, it is questionable whether the fact that interest is treated as revenue in the gross income enquiry provides a sounds basis for treating the expenditure in the same way. Olivier submits a second basis upon which Tager's view might be criticized, to the effect that no justification exists for treating the deduction of interest as *sui generis* merely on the basis that the receipt/accrual of interest is

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[136] *Op cite* (note 105) at 50.
[137] *Ibid.*
[138] *Ibid* at 51.
[139] *Op cite* (note 10) at 39.
[140] *Ibid.*

always of a revenue nature, since equity does not play a role in the interpretation of tax statutes. Accordingly, the mere fact that tax has been levied on the recipient of an amount cannot be taken into account in determining the deductibility of the interest expenditure in the hands of the payer.[141] Thus on the basis of these two criticisms, it has been argued contrary to the views of Tager[142] that the uncertainly in respect of the nature of interest expenditure should be clarified by the courts as opposed to introducing a specific deduction for this purpose in the Act.[143]

It is clear that applying the conventional tests to the deduction of interest is problematic, since they do not easily accommodate the unique nature of interest. This is evident in the inconsistent results which the application of the various tests render. It further explains the courts avoidance of the issue and reliance instead on the 'in the production of income' requirement. However these inquiries probe entirely distinct issues and the courts interchangeable use thereof is unsatisfactory. Certainly the 'in production of income' enquiry is easier to apply, since it seeks the purpose of an expenditure with reference only to objective factors; whereas the capital/revenue inquiry seeks to determine the taxpayer's subjective intention albeit through the use of objective criteria. Thus while both tests rely on objective factors, the former test seeks to ascertain purpose, while the latter is concerned with intention. The essential point of drawing this distinction is to show that the courts should not rely on the income production test to the exclusion of the capital inquiry; since the two inquiries may feasibly render different results.[144] While the courts have made *obiter* comments it is submitted that the conventional tests should not be relegated in this way, but rather in appropriate cases should insofar as possible be adapted for meaningful application to interest expenditure.

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[141] *Op cite* (note 105) at 51.
[142] I*bid* at 53.
[143] *Ibid.*
[144] *Ibid.*

## ***Analysis of the practical application of the General Deduction Formulae by the courts***

### ***Borrowing for general trading purposes***

Insofar as borrowing for general business purposes is concerned, the Appellate Division laid down general guidelines in the case of in the case of *CIR v Standard Bank of South Africa.* [145] The inquiry turned on the 'in the production of income' requirement and hence such guidelines are pertinent to the application of this requirement where interest expense is concerned. These will be critically considered after a brief summation of the facts of the case. In this case, the taxpayer as an alternative to medium-term loans, occasionally entered into redeemable preference share transactions whereby, instead of lending money, it took up redeemable preference shares issued by a customer, the term of redemption being equivalent to what would have been the period of the loan. In fixing the dividend rate applicable to the shares, account was taken of the fact that the dividend received by the bank on those shares was exempt income in its hands; and this enabled the bank to offer a rate substantially lower than the interest rate on an equivalent medium term loan. The taxpayer only entered into a limited number of such transactions, and regarded them as purely incidental to its main purpose of borrowing and lending money.[146] The court asserted in accordance with the established principle that-

> 'the vital enquiry in the present matter is the Bank's purpose in borrowing the moneys upon which it paid interest to depositors; and in regard thereto it must be asked whether the connection between the

[145] *CIR v Standard Bank of South Africa* 1985 (4) SA 485 (A).
[146] *Ibid* at 501.

expenditure of the interest (or some of it) and the acquisition of the redeemable preference shares was sufficiently close to justify the conclusion that such expenditure was...an expense incurred in the production of...exempt income.'[147]

No such connection was established, and thus the entire deduction was allowed. The judgment is particularly useful as it lays down the following guiding principles[148] in determining whether expenditure is incurred 'in the production of income' –

a) 'In deciding whether moneys expended constitute expenditure incurred in the production of income, important the sometimes overriding factors are the purpose of the expenditure and what the expenditure actually affects; and in this regard the closeness of the connection between the expenditure and the income-earning operations has to be assessed.
b) More specifically, in determining whether interest (or other like expenditure) incurred in respect of money borrowed is deductible, a distinction might in certain instances have to be drawn between cases where a taxpayer borrows a specific sum of money and applies it to an identifiable purpose, and cases where a taxpayer borrows money generally and upon a large scale in order to raise floating capital for use in his or her business.
c) In the former type of case both the purpose of the expenditure (in the form of interest) and what it actually effects can readily be determined and identified: a clear and close causal connection can be traced; and both these factors are therefore important considerations in determining the deductibility of the expenditure.

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[147] *Ibid* 500-501.
[148] *Ibid.*

d) In the latter type of case, however, there are certain factors which prevent the identification of such a causal connection and one cannot say that the expenditure was incurred in order to achieve a particular effect. All that one can say is that 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 in turn utilized.'[149]

The court asserts that a distinction must be drawn between circumstances where a taxpayer borrows a specific sum of money and applies it to an identifiable purpose, and cases where a taxpayer borrows money generally and upon a large scale in order to raise floating capital for use in his or her business. The distinction lies in the consideration the court will give to the effect of the expenditure. The rationale for this approach advocated by the court in *Standard Bank* is based on the impossible task the taxpayer would face of showing every particular usage to which working capital is put, when borrowed for general business purposes. Hence provided the original purpose is established, evidence would not have to be adduced as to every effect thereof. However, in making this assertion it is submitted that the court does not exclude the possibility of a change of this original purpose; such that if it can be proven that money originally borrowed as floating capital has consequently been put to specific non-revenue producing use; then the effect of the borrowing would become a material consideration. As a possible interpretation, it would be logically inconsistent, and arbitrary to regard court as advocating that merely because the original purpose of borrowing money was for general trading purposes that the courts would not consider whether there has been a change of usage of such money and hence a change of purpose. Thus it is submitted that the principles laid down in *Standard Bank* do take account of the possibility of a change of purpose in both the specific

[149] *Ibid.*

and general instances of borrowing; in which event the effect of the expenditure/use to which the money is put will be a material factor. Though in the latter case, since the funds are essentially 'mixed,' the onus of proving a change of purpose through the change of usage thereof will certainly be difficult to discharge. It was upon this evidentiary difficulty which the court in Standard Bank based its guidelines.

In the case of companies engaged in commercial, industrial, or similar income-producing undertakings, the rules relating to deduction are succinctly that 'if such companies borrow and invest money in their own or associated businesses to provide working capital for that business, the interest paid on the money borrowed would be deductible.'[150] In *Producer v COT*[151] a partnership in Rhodesia formed a South African company, for the purpose of selling the partnership's products in South Africa. The company was wholly owned by the partners. The partnership granted large credit facilities to the company, which it financed by borrowing money. The interest the partnership paid on this borrowing was allowed as a deduction. Several years later, the taxpayer company took over the whole of the partnership's business, with the result that the South African company was now indebted to it. Consequently, the South African company increased its share capital by the issue and allotment of a large number of shares to the taxpayer company. The purchase of these shares was funded by the partial cancellation of the outstanding debt. In its income tax return for the year in which the transaction took place, the taxpayer continued to deduct all the interest paid by it on its indebtedness. The commissioner disallowed a portion of the interest payable, on the basis that this part of the interest was incurred in connection with the taxpayer's

[150] Tager 'The deduction of interest payments for income tax purposes' (1976) 12 *SALJ* at 28.
[151] *Producer v COT* 1948 (4) SA 230 (SR).

purchase of shares from which it derived no income, and that accordingly it had not been incurred in the production of income.[152]

The court drew a distinction between borrowing for a specific purpose and borrowing for general trading purposes, and stated that-

> 'If a taxpayer borrows a specific sum of money and applied 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.'[153]

On the facts the court in *Producer v COT* asserted that the taxpayer company had for good reason borrowed money for use in its business; then instead of receiving payment of the debt owing to it, the taxpayer applied a portion of it to the purchase of shares. No specific amount of money was borrowed in order to purchase the shares. The money so applied was a debt (owed to the taxpayer) which had arisen in the ordinary course of business.[154] Thus the original purpose of the borrowing remained unchanged, and whatever the taxpayer did with the funds that it had accumulated to its credit, did not change the original ordinary business purposes for which the money was borrowed. Accordingly, there was no direct connection between the money borrowed and the purchase of the shares in the South African company, and the whole of the interest paid was allowed.[155]

Olivier[156] asserts that the correctness of this decision is questionable, on the basis that a change of intention with regard to the purpose for which the

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[152] *Ibid* at 233.
[153] *Ibid.*
[154] *Ibid.*
[155] *Ibid.*
[156] L Olivier 'The deductibility of Interest- A Problem Unresolved?' (1997) *Stellenbosch Law Review* at 304.

borrowed money was used did take place, and that while the money was originally used for general trading purposes, there was a clear change of intention in acquiring the shares.[157] The learned author further submits that 'no justification exists for not taking into account a change of intention in respect of incurring expenditure, but when dealing with the definition of 'gross income,' a change of intention with which the asset is acquired is of the utmost importance.'[158] It is submitted that her view regarding the legal implications of a change of purpose is correct, and in converse circumstances, in *ITC 953*[159] the original purpose of the borrowing was for a non-trading purpose, but the taxpayer was able to establish that there was a change of intention in relation to the utilization of the money.[160] Thus, the original purpose of the borrowing will 'not continue to govern the purpose for which money is later used when it is clear that the money has been put to fresh use.'[161] However, it seems that her criticism of the judgment is arguably misplaced, as the decision turned on that fact that there was insufficient evidence to show a connection between the borrowing and the share purchase. By implication, had there been sufficient evidence to indicate a change of intention (such as a clear causal connection regarding the use to which the money was put) then the court would have taken account of such a change in the original purpose. However, this is invariably more difficult to prove where money is borrowed for general purposes, as once the borrowed money is appropriated as 'floating capital' and 'mixed' with other such funds; it may be difficult to determine the specific use to which the loaned money is being put. Thus her criticism might be valid insofar as the courts factual evaluation is concerned; however not on the basis of legal principles, which the court implicitly observed. Furthermore, the basis for her submission in the analogy she draws between the general deduction formulae, and the test in the 'gross income' definition is arguably misplaced; as two different tests apply. The

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[157] *Ibid.*
[158] *Ibid.*
[159] *ITC 953* (1961) 24 SATC 552.
[160] *Ibid.*
[161] *Op cite* (note 10) at 28.

general deduction formulae is concerned with the taxpayer's subjective intention (relying on objective evidence together with the taxpayer's *ipse dixit*); while the general deduction formulae is a purely an objective purpose test. Olivier appears to use the notion of 'intention' interchangeably with 'purpose' and accordingly seems to suggest that the tests are synallagmatic. Thus while I agree with Olivier's conclusion that a change of purpose must be taken into account in the same way that a change of intention is taken into account; the basis for this conclusion should not conflate the two clearly distinct tests.

Investment companies are treated differently from commercial or trading companies, since there is an inference that where an investment company borrows money, it does so for investing in shares, which do not produce taxable income. Thus unless the taxpayer can rebut this presumed direct connection between the money borrowed and its application to non-productive purposes, the expenditure will not be deductible.[162] In the case of *Financier v COT,*[163] taxpayer was an investment company, and borrowed money for general purposes in its business, intending to make some investments productive of income, and others not.[164] The court made it clear that the decisive test is the purpose for which the money is borrowed. It accordingly applied the principles established in *Producer v COT*[165], that 'when money is specifically borrowed for an investment which will produce taxable income, the interest on such money should be allowable as a deduction; while, interest borrowed on money specifically borrowed for an investment that will not produce taxable income the interest must be disallowed.'[166] Furthermore, the court affirmed that where it is not possible to establish a specific purpose, the onus is on the taxpayer to show that a deduction of the interest was

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[162] *Ibid* at 30.
[163] *Financier v COT* 1950 (3) SA 293 (SR). at 295.
[164] *Ibid.*
[165] *Op cite* (note 151).
[166] *Op cite* (note 163) at 295.

permissible by reference to the use to which the money was put.[167] In this case the taxpayer was unable to show that all its investments were income-producing, thus an apportionment was made, and deduction was allowed only to the extent that this was shown. The court makes an essential point regarding the onus that is on the taxpayer to show that a deduction is permissible by reference to the usage thereof. Given the factual uncertainty which invariably arises where money is borrowed for general trading purposes, due to the difficulty in proving a specific use where the money is 'mixed;' the incidence of the onus becomes highly determinative.

In the *Allied Building Society*[168] case the taxpayer's basic business was borrowing money cheaply, and lending it more expensively. All monies borrowed, whether in respect of shares, savings accounts, or fixed deposits were paid into a central pool. A portion of the money was used to acquire vacant immovable property; accordingly a portion of the interest paid did not produce income. The court held that –

> 'The ultimate use or destination of the money is not...a decisive factor in determining the deductibility of the interest payable on that money. In determining the purpose of the borrowing, the ultimate user of the money may, no doubt, in certain cases be a relevant factor; but the dominant question remains: what was the true nature of the transaction? ...the most important factor in the enquiry is the purpose of the borrowing.'[169]

The court found that the Society's purpose in borrowing money was manifestly to obtain a means of earning income, by borrowing money cheaply and lending it more dearly.[170] The money it borrowed constituted its floating

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[167] *Ibid.*
[168] *Allied Building Society* 1963 (4) SA 1 (A) at 12.
[169] *Ibid.*
[170] *Ibid.*

capital which it employed to earn income in the form of interest. The acquisition by the society of non-revenue producing properties was purely incidental to the business of borrowing money in order to earn income by investment, and accordingly the interest was deductible. The judgment establishes that the effect of the expenditure is a relevant but not a decisive factor when a loan is incurred for general trading purposes.[171] However, it is submitted that the majority erred in this case, and the dissenting judgment of Steyn CJ on the question of the deductibility of interest is preferable. Steyn CJ emphasized that notwithstanding the purpose in borrowing the money; the actual use to which the money was put could not be ignored; and that since the amount borrowed was used for the purpose of acquiring non-revenue producing properties, the expenditure in question was not deductible. In seeking to determine the 'true nature of the transaction' the majority placed undue emphasis on the original purpose of the borrowing, inspite of a clear change as regards this original purpose. While it is factually more onerous to establish the effect of money borrowed for general trading purpose; the legal principle remains in tact- that if a clear change of intention can be shown; it will be decisive.

In contrast to the approach taken by the majority in the *Allied Building case*, the Appellate Division in *CIR v Genn*[172] affirmed that where money is borrowed for the purpose of utilization as floating capital in the business; the court has to assess the closeness of the connection between the expenditure and the income earning operations, having regard both to the purpose of the expenditure and to what it actually effects.[173] On the facts of this case, the borrowed funds were used to purchase trading stock and hence the interest paid thereon was deductible.

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[171] *Op cite* (note 10) at 30.
[172] CIR v Genn 1955 (3) SA 293 (A).
[173] *Ibid* at 296.

In conclusion, it has been argued that the guidelines in the *Standard Bank* case for the application of the 'in the production of income' requirement cannot be interpreted as establishing a legal principle that the effect of expenditure borrowed for general trading purposes is an irrelevant factor; and that the original purpose remains decisive, despite a clear change of purpose evidenced through a change of use thereof. Rather than establishing a legal principle, the guidelines indicate that factually it is more difficult to show what the expenditure effects where the funds are borrowed for general purposes, and as such more weight can be accorded to the original purpose. However, this does not mean that where a clear change of purpose as regards the use of the funds takes place, cognizance must not be taken thereof. Finally, as was shown in *Producer v COT,* that given the difficulty of showing the effect of expenditure originally borrowed for general trade or showing the converse change of purpose where money was originally borrowed for non-trading purposes as evident in *ITC 953*; the incidence of the onus will operate as a highly determinative factor in the outcome of many cases.

***Interest in respect of a dividend credited to a shareholder's loan account***

The legal principle is clear, that where money is borrowed to enable a company to declare a dividend, the purpose of such borrowing is not in the production of income (since dividend income is exempt), and accordingly interest paid on the loan is not deductible. However contention has arisen in the situation where a company declares a dividend, but instead of paying it, credits the amount to the shareholder's loan account. If the purpose of a loan is to acquire working capital, as opposed to enabling the company to declare a dividend, then the interest expenditure should be deductible.[174] Difficulty has arisen in the context where the companies need to borrow working capital would not have arisen if the dividend had not been declared, since in such circumstances it seems that the companies main purpose in borrowing the amount is to declare a dividend.[175] Notably, the significance of this issue has increased since the exemption from normal tax of dividends, since it provides a tempting route for companies to distribute their accumulated reserves by crediting the amount thereof to shareholders' loan accounts. In this way the interest charged by shareholders can be deducted by the company and taxed instead at the lower marginal rate applicable to individuals.[176] However, the danger in this course of action, is that where a company borrows funds, whether from the shareholders or from any other source in order to pay a dividend, such usage cannot be regarded as 'in the production of income,' hence the interest expense thereon would fall outside the ambit of s11(a). The result would be that the interest received would remain taxable in the shareholders' hands, while not deductible by the company. The onus would rest on the taxpayer to thus prove that, notwithstanding the dividend

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[174] Olivier 'The deductibility of interest- A problem unresolved?' 1997 *Stellenbosch Law Review* 44 at 47.
[175] *Ibid.*
[176] 'Interest Charged by Shareholders or Members on Dividends Credited to their Loan Accounts' 1990 *The Taxpayer* 186-190.

declaration, the loan was incurred for general trading purposes.[177] Again in this context the contentious issue is the 'in the production of income' requirement. In this regard the legal test applicable remains an inquiry into the true purpose of the borrowing- this legal principle is not in dispute in any of the cases. Difficulty has arisen in the application of this legal test to the facts of each case; which entails an evaluation of the purpose of the borrowing using objective factors as evidence thereof. Accordingly it becomes clear once again, that the incidence of the onus is a significant factor in seeking to satisfy this objective test. Furthermore, it becomes crucial to determine whose purpose ought to be regarded as decisive where a company is concerned. This is an issue sourced in company law which has given rise to much criticism of the *Ticktin Timbers* judgment, and will be examined accordingly. Following this discussion of *Ticktin Timbers*, the two more recent decisions of the Supreme Court of Appeal, namely *Scribante*[178] and *BPSA*[179], in which the Supreme Court of Appeal came to a different finding, will be discussed and compared with *Ticktin*. Through this analysis, the evidentiary factors which the courts have regarded as decisive in determining the taxpayer's true purpose will be discussed for the purpose of prudent tax planning.

***Ticktin Timbers***

In the case of *Ticktin Timbers*[180] the Supreme Court of Appeal addressed the question of whether, when a dividend is credited to a loan account, the purpose of the resultant loan is to pay the dividend or to avoid payment by allowing it to remain outstanding as a loan. If the former, then interest payable on the loan would not be deductible as it is a well established principle that interest for which a taxpayer is liable on money borrowed in order to pay a

[177] *Ibid.*
[178] *CSARS v Scribante Construction (Pty) Ltd* 1999 (4) SA 939 (SCA).
[179] *CSARS v BP South Africa (Pty) Ltd* 2006 (5) SA 559 (A).
[180] *Ticktin Timbers CC v CIR* 1999 (4) SA 939 (SCA) at 942.

dividend may not be deducted in terms of s11(a) ,[181] since it is incurred in the production of exempt income. If the latter, it was contended on behalf of the taxpayer, that 'assets formerly financed by retained earnings were now financed by debt , and that if such assets were used in the production of income, interest payable on the loan ought to be deductible as being in the production of income.'[182]

The taxpayer in *Ticktin Timbers* was a timber merchant. It came into being during 1985 when Dr Ticktin acquired the shares in this private family company and converted the company into a close corporation. He was obliged to pay interest on the unpaid portion of the price of the shares. Among the corporation's assets was a substantial amount of distributable reserves. To this end, Dr Ticktin caused the taxpayer to declare as a dividend these undistributed reserves. The dividend was in fact not paid out to Dr Ticktin, but was credited to his loan account in the books of the taxpayer. Interest was paid to him by the taxpayer in respect of the loan, which it utilized for the acquisition of trading stock. In years following this, Dr Ticktin caused the taxpayer to distribute its income in the form of dividends, and each dividend was similarly credited to Dr Ticktin's loan account. It was thus argued on behalf of the taxpayer that since the money borrowed from Dr Ticktin had been used in the production of income (purchasing trading stock); it was entitled to deduct the interest expense due to Dr Ticktin from its gross income.[183]

The Supreme Court of Appeal reasserted that the primary enquiry relates to the purpose for which the money is borrowed. Thus where a taxpayer's purpose in borrowing money upon which it pays interest is to obtain a means of earning income, the interest paid on the money so borrowed is *prima facia* expenditure incurred in the production of income.[184] On the other hand,

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[181] Dendy 'Borrowing money to pay dividends? -The Fisc Fortuitously Favoured' (1997) 114 *SALJ* 645.
[182] Emslie, Davis & Hutton *Income Tax: Cases and Materials* (1994) at 497.
[183] *Op cite* (note 180) at 942.
[184] *CIR v Allied Building Society* 1963 (4) SA 1 (A) at 422.

interest payable on money borrowed to enable a company to pay a dividend is not deductible, as the purpose of the expenditure is to enable the company to distribute its profits and not to produce income.[185]

In *COT v AB (Pty) Ltd* [186] the taxpayer was a company which declared a dividend in favour its shareholders and converted the dividend debt into a loan account. The shareholders were thereby given the right to payment of interest on the amount represented by the dividend. In a judgment of the High Court of Southern Rhodesia the court held that the loan and the payment of the dividend were all part of the same integral transaction; that the money was borrowed from the shareholders in order to pay the dividend; and that the loan was not employed in the production of income.[187] It was on the basis of this decision that the SCA in *Ticktin Timbers* found that the making of the distribution and the making of the loan were interdependent transactions, and were not intended to exist in isolation. It was this linkage which the court asserted was fatal to the taxpayer's case for it showed that the true reason why the taxpayer had to borrow back at interest from Dr Ticktin money which it had had and was under no obligation to part with, was because it wanted to make a distribution to Dr Ticktin. Thus in answering the question as to why the taxpayer incurred the debt, the court asserted its purpose was 'plainly because it wished to make a distribution to Dr Ticktin', and consequently the interest was not deductible.[188]

**Factors upon which the court relied in drawing the 'fatal linkage'**

The three factors which the court relied upon in making its decision were firstly the necessity for the borrowing, secondly, the express purpose of Dr Ticktin, and thirdly the surplus cash criterion. These three factors will be considered in turn-

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[185] *Ibid* at 423.
[186] *COT v AB (Pty) Ltd 25 SATC 366.*
[187] *Ibid.*
[188] *Op cite* (note 180) at 942 para 7.

***The necessity for the borrowing***

In drawing the fatal link between the transactions, Hefer JA relied on the fact that objectively the taxpayer did not need the loan finance. However, the test established in *PE Tramway* examines the purpose of the borrowing, without regard to the necessity of such borrowing.[189] In this regard Watermeyer AJP asserted-

> 'the words of the statute are 'actually incurred' not 'necessarily incurred.' The use of the word 'actually' as contrasted with the word 'necessarily' may widen the field of deductible expenditure. For instance, one man may conduct his business inefficiently or extravagantly, actually incurring expenses which another man does not incur; such expenses therefore are not 'necessary' but they are actually incurred and therefore deductible.' [190]

However, in this case, Hefer JA used this necessity criterion to link the dividend declaration onto the borrowing. In this regard it is submitted that Hefer JA arguably relied unduly on a factor which the court in *PE Tramways* was at pains to establish is not pertinent to the 'in the production of income' enquiry. Furthermore, in commercial terms, reliance on the fact of whether the loan finance was needed arguably constitutes an 'unwarrantable inroad into the corporate taxpayers entitlement to finance their business activity by debt'[191] and should thus not be a factor relied upon in seeking to determine the true purpose of the taxpayer in procuring loan finance.[192]

***The express purpose of Dr Ticktin***

The court relied on the express dicta of Dr. Ticktin who admitted that the whole scheme of diverting the corporation's funds and making them available again in the form of an interest-bearing loan was devised upon to ensure he

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[189] Van Der Merwe 'The Deductibility of Interest-Partnership Replacement Loans' (2000) *South African Mercantile Law Journal* 224 at 231.
[190] *Ibid* at 244.
[191] *Op cite* (note 181) at 649.
[192] *Ibid.*

was able to service his personal debt owing to his siblings after purchasing their share of the company. His express intention was thus to service his personal debt using the interest paid by Ticktin Timbers.[193] In drawing its conclusion, the court did not distinguish between Dr Ticktin in his capacity as director and that as sole shareholder, and merely asserted that the fact that he was the sole owner of the corporation made the point that there was only one corporate mind operating clearer.[194] It is on this point that the judgment has been subject to much criticism, and thus the issue warrants specific consideration in order to determine whether or not the court erred in conflating the dual capacity in which Dr Ticktin purported to act.

Emslie[195] asserts that although the intention of the corporation and the purpose of the member are found in the mind of the same person where a company has a sole owner; a distinction must be made for 'individuals can and often do act in more than one capacity.'[196] The learned author criticized Hefer JA's inconsistency in concurring with the minority in *CIR v Pick 'n Pay Wholesalers*[197] on the point that a distinction must be made between the different capacities in which Ackerman acted[198] and yet approving the majorities assertion that 'a man does not change his mind when he changes his hat' in the Ticktin decision. As counsel for the taxpayer, Emslie argued that the purpose of Dr Ticktin's actions (as member) were of no concern; and that what had to be determined was the corporation's purpose in taking up the loan (which based on the evidence of Dr Ticktin and the actual use thereof was to finance the corporation's trading activities).[199] The court dismissed this argument with the *dicta* of Nicholas AJA in the *Pick 'n Pay* case that 'a man

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[193] *Op cite (note 180).*
[194] *Ibid.*
[195] *Op cite (note 1).*
[196] *Ibid* at 497.
[197] *CIR v Pick 'n Pay Wholesalers* 1987 (3) SA (A) at 467
[198] *Op cite* (note 1) at 498.
[199] *Op cite* (note 180).

does not change his mind when he changes his hat.'[200] While I agree with its finding in this regard, the court must be criticized for not elaborating on this point; which is arguably indicative of a lack of understanding of company law, particularly on the attribution of the corporate mind. While it is beyond the ambit of this paper to discuss this issue in detail; with respect I will nevertheless seek to show that Emslie's criticism is rooted in an over-simplification of the 'directing mind' doctrine; and that in reality the attribution of the corporate mind is a far more complex doctrine than he appears to appreciate. This 'directing mind' legal doctrine will be considered accordingly.

Blackman[201] succinctly summarizes the issue as follows- 'a company being an artificial entity obviously cannot itself act; nor can it have a state of mind. Nevertheless, because of its corporate personality, its separate existence as a legal entity capable of acquiring rights and incurring obligations, it is necessary for the law to attribute to it the acts and states of mind of certain natural persons...When this attribution takes place the acts and states of mind of these persons are regarded as those of the company-it is as if the company is acting or forming intentions. This is known as the 'directing mind' doctrine.'[202] In applying the doctrine the court seeks 'the directing mind and will of the corporation, the very ego and centre of the personality of the corporation, i.e. the person or body who is in *de facto* control of the relevant operations of the company.'[203] The question is therefore always one of determining who is in actual control of the operations of the company.[204] Blackman notes that the directing mind might be found in officers other than directors, such as a secretary or manager or the members.[205] Three cases in

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[200] *Ibid.*
[201] Blackman, Jooste, & Everingham *Commentary on the Companies Act* 1 (2002).
[202] *Ibid* at 123.
[203] *Ibid* at 130.
[204] *Ibid* at 131.
[205] *Ibid.*

which the issue has arisen will be discussed in order to illustrate the practical application of the 'directing mind' doctrine.

In the case of *Elandsheuwel Farming*[206] the question was also one regarding whether a change of intention had taken place to render the sale of land subject to income tax. The company was owned by a group of shareholders who also acted as directors; thus while it was not a case of sole-ownership- there was not a separation between ownership and management. The majority in this case attributed the mind of the shareholders to the company. Corbett JA dissented asserting that the 'intention of the shareholders ...and the intention manifested by them as directors in the conduct of the affairs of the company were distinguishable.'[207] The courts disagreement on this issue was essentially a factual one in the determination of who had *de facto* control of the company.

In *CIR v Malcommess Properties*[208] the taxpayer was a wholly owned subsidiary, and the argument was made that the intention of the 'controlling' shareholder, to make a profit from the sale of the property, ought to be attributed to the taxpayer.[209] The court noted that the shareholder did not have control in the sense necessary to attribute its mind to that of the taxpayer company and that the control necessary was 'not the power to control the company in the sense of holding the levers of power in the company but rather the *de facto* control of the companies day-to-day activities, exercised by the persons through whom the company acted.'[210]

The case of *Richmond Estates*[211] is highly relevant to the present case as it also involved a company with a sole shareholder and sole director. The legal question in that case was whether the taxpayer had changed the intention with which it held land from that of trading stock into a fixed capital asset. Pertinent to the inquiry was whose intention should be regarded as decisive.

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[206] *Elandsheuwel Farming (Edms) Bpk v SBI 1978* (1) SA 101 (A) at 110.
[207] *Ibid.*
[208] *CIR v Malcommess Properties (Isando) (Pty) Ltd* 1991 (2) SA27 (A) at 32.
[209] *Ibid.*
[210] *Ibid.*
[211] *CIR v Richmond Estates (Pty) Ltd* 1956 (1) SA 602 (A) at 605.

The court observed that since a company is 'an artificial person with no body to kick and no soul to damn,'[212] the only was of ascertaining its intention is to find out what the directors acting as such intended; and that their formal acts constitute evidence as to the intention of the company.[213] However the court went on to differentiate this situation from that where a company has only one director, who is also the managing director and the sole beneficial owner of all the shares. In such instances the court asserted that 'in such a case it is not going too far to say that his mind is also the mind of the company.'[214] Thus given the fact that it was a closely held company the court attributed the mind of the shareholder to the company. In so doing the court did not disregard the distinct personality of the company and so violate a fundamental principle of company law. Instead the court was merely observing that the 'mind' of the company was being controlled to such an extent by the shareholder; that in reality his mind was the mind of the company. The legal observance of the distinct *personae* of the company and the shareholders remained in tact, though the mind of the shareholder was attributed to the company.

Thus, with respect, the error of Emslie was that he reasoned that in attributing the mind of the shareholder to the company, the court was ignoring the different *personae* of the company and that of the shareholders. However, as the discussion on the doctrine of the controlling mind has shown; it is because the distinct personality of the company is preserved that it is necessary for the law to attribute a state of mind thereto. Furthermore, with respect Emslie erroneously assumed that the directing mind of the company is that of the directors, however it is clear that this is not the case, and the real question as to whose mind should be attributed to the company turns on who had *de facto* control of the company. Where there is a clear separation of management and shareholders, it is far less likely that *de facto* control will be exercised by the shareholders. However, in a closely held company, particularly though certainly not exclusively, one that has a sole owner and director, it is highly

[212] *Ibid.*
[213] *Ibid.*
[214] *Ibid.*

likely that *de facto* control lies with such shareholder and accordingly that 'such shareholder's mind is also the mind of the company.'[215] Accordingly it is submitted that though the court in *Ticktin Timbers* did not expressly follow this legal reasoning; it was on the facts of the case correct in attributing the mind of Dr Ticktin qua shareholder to the company.

***The surplus cash criterion***

The court used the criterion of the non-existence of surplus cash to assert that the dividend declaration and the subsequent borrowing were-

> 'plainly interdependent and neither was intended to exist without the other. It is this linkage which, to my mind, is fatal for appellant's case'[216]

On this basis the *Ticktin* judgment has been regarded as authority for the proposition that, 'where a company declares a dividend in circumstances where it would not be possible for that company to make a payment of the declared amount of the dividend other than by way of a simultaneous loan, the irresistible inference to be drawn is that the purpose of the loan was to fund a dividend which could not have been paid in any other way.'[217] It is submitted that the court was correct in weighing this factor heavily in determining the true purpose of the loan; however that confining the question to whether the loan was made simultaneously is too narrow and heightens the artificiality of the inquiry which seems to simply turn on the timing of the transaction. For example as opposed to happening simultaneously, a dividend could be declared either at a point in time preceding the loan finance, or some time after the borrowing- it would be highly artificial to simply conclude that the transactions were thus no longer connected; and thus the issue becomes how much time between the declaration and the borrowing is necessary to sever the fatal connection. Perhaps this uncertainty could be remedied by a specific

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[215] *Op cite* (note 211).
[216] *Op cite* (note 180) at para 9.
[217] 'Interest Charged by Shareholders or Members on Dividends Credited to their Loan Accounts' 1990 *The Taxpayer* 186-190.

legislative provision stipulating the necessity for a certain time lapse, outside of which a rebuttable presumption would operate in favour of the taxpayer; but inside of which the taxpayer will not get a deduction.

The courts reliance on the circumstances in which the dividend was declared in this way has however been subject to criticism on the basis that consideration of the financial circumstances of the company violates the shareholders right to dividends irrespective of the liquid resources of the company.[218] Such criticism is based on the assertion that 'shareholders may vote in their own interest without regard to the interests of the company and if a dividend is voted it becomes the obligation of the company to find the means to pay it.'[219] The essence of the criticism is thus that shareholders of a company have a right to put their own interests above that of the company, and accordingly that the *Ticktin Timbers* judgment infringes this right by disallowing the interest deduction payable on the borrowed funds in circumstances where a distribution and simultaneous borrowing back is made without the existence of surplus funds. The argument is that a distribution need not be commercially justifiable from the company's perspective. However, this criticism fails to observe the fact that 'a company is not obliged to pay a dividend irrespective of the financial circumstances in which it finds itself '[220] as accurately observed by Hefer JA in *Ticktin Timbers*. It is very rare for the articles of a company to grant shareholders the right to declare a dividend independent of the directors. In the usual course of events, the directors propose a dividend which is approved by the shareholders. Even so, directors are bound in law to observe to solvency and liquidity requirements in s90 of the Companies Act before any distribution is made; and can accordingly refuse to make a distribution despite the shareholders wishes. Furthermore, where the company is in insolvent circumstances, the directors

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[218] 'Interest on loan account arising from a dividend declaration' August 2000 *The Taxpayer* 151-152.
[219] 'Ticktin v Scribante' 2003 *The Taxayer* 161-167 at 167.
[220] *Op cite* (note 180).

owe a fiduciary duty to the companies creditors, which would include the duty not to make any distributions. Thus the argument that shareholders are entitled to dividends, regardless of whether the payment thereof favours them to the detriment of the company is entirely inaccurate. Shareholders do not have a right to dividends per se; such a right only arises once a dividend has been declared; and this cannot be done without the approval of the directors, usually in terms of the articles, but if not, then certainly in terms of s90 and their fiduciary duties. It is therefore submitted that the court was entitled to draw a negative inference from the circumstances in which the dividend was declared, and in so doing did not violate the legitimate expectation which shareholders have to receive dividends.

**Close Corporation or Company?**

A crucial factor was not considered by that court, namely that *Ticktin Timbers* was a close corporation and not a company. Though a close corporation still has a distinct legal personality, there is a difference in the management structure of the two entities. That is, in a close corporation there is no separate board of directors and management is the responsibility of the members.[221] As such the entire issue regarding the attribution of the corporate mind is irrelevant to the case, since where a close corporation is concerned the law would not distinguish between the mind of the directors and that of the shareholders. Accordingly, Dr Ticktin did not have two distinct capacities- as member and director, and his management powers were sourced in his membership. Failure to appreciate this basic distinction between a company and a close corporation is a glaring error by both counsel and the court alike.

[221] Cilliers et al *Close Clorporations Law* 3rd ed 1998 at 16.

**Policy Considerations**

Corporate taxpayers are entitled to finance their business activities by means of borrowing, and are entitled to borrow such funds from their shareholders or members, and are entitled to claim a tax deduction on interest lawfully due to lenders on borrowed capital.[222] This fact affirms that the fact of the *necessity for the money to be borrowed at all*, relied upon by Hefer JA constitutes an unwarrantable inroad upon those rights.[223] To illustrate this point the judgment of Galgut J in *ITC 1603*[224] is helpful in that the learned judge expounds on what he refers to as the 'basic truths' governing the deductibility of interest.[225] The first of these 'basic truths' he stated as follows-

> 'Where a taxpayer requires capital to finance his income-earning operation, it is entirely up to him to choose the source from which he derived such capital. Even if he happens to have liquid cash available for such purpose there is nothing which compels him to use such cash. There is in other words nothing which precludes such a taxpayer from borrowing money for the said purpose, and in so doing the taxpayer is free to borrow from whatever source he chooses. What must be stressed, however, is that whatever the source, the fact that he chooses to borrow the money will not debar him from deducting the interest payable on the loan. Provided the borrowed money is used in the production of income (and of course meets the requirements of s11 (a)), it will likewise be n the production of income that the interest

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[222] Dendy 'Borrowing money to pay dividends? - The Fisc fortuitously favoured' 1997 *SALJ* at 649.
[223] *Ibid* at 651.
[224] ITC 1603 (1996) 58 SATC 212.
[225] Vorster 'The Deductibility of Interest: The Basic Truths and the Cash-Flush Borrower' 1998 *SALJ* at 418.

> thereon will have been laid out and such interest will therefore be deductible,'[226]

A potential policy consideration is thus whether disallowing an interest deduction where money is borrowed for the purpose of paying a dividend undermines the corporate taxpayers right to choose the funding structure of their business, and particularly the choice to do so by debt rather than equity. Perhaps the entire transaction should be viewed in broader policy terms as a legitimate restructuring of finance, as opposed to the current more narrow and formalistic approach. However adopting this broader policy approach in the narrow circumstances of corporate restructuring would in turn open the floodgates in a variety of other commercial contexts where allowing such an interest deduction would be against the dictates of policy.

***Conclusion***

*Ticktin's* case turned primarily on the inter-related purpose inferred from the facts, of the company and the shareholder to provide the shareholder with interest to meet his personal obligations. In so doing the court identified the shareholders' purpose in voting for a distribution as also the purpose of the company.[227] The court drew inferences as to the members intention from the financial circumstances of the company, specifically from the fact that the company was without any surplus cash hence the dividend declaration was entirely contingent upon the simultaneous loan funding.[228] Through relying on both these factors the judgment has been criticized as undermining two fundamental principles of company law. That is, to the legal distinction between the personae of a company and the personae of the shareholders, and to the right of shareholders to put their own interests above those of the

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[226] *Ibid.*
[227] *Op cite* (note 180).
[228] *Ibid.*

company.[229] However, it has been argued that such criticism is in both instances based on a failure to understand these principles of company law in question. Furthermore, a fundamental oversight was made in the failure to take cognizance of the different management structure of a close corporation, whereby there is no separation in law between the membership and management. The facts in *Ticktin* very obviously exposed the true purpose of the taxpayer and the court was correct in drawing the conclusion that purpose of the loan was to facilitate the dividend declaration. The broad purpose of the taxpayer was ultimately to change the financial structuring of his business, from debt to equity, and to thereby secure an interest payment in his hands as member, and a deduction for such interest payable for the corporation. The policy issue was thus raised, whether disallowing the interest deduction undermines the corporate taxpayers right to finance their business by debt. However arguably adopting a broader purposive approach in this context would, based on the floodgates argument, be unsustainable.

***Critical analysis of Scribante and BPSA***

It is useful to consider the two Supreme Court decision's subsequent to *Ticktin*, namely, *Scribante*[230] and *BPSA,*[231] in both of which the court adhered to the strict legal proposition that the enquiry relates primarily to the purpose for which the money has been borrowed. The facts of the *Scribante* case were as follows-the taxpayer was a private (family) company, the shareholding of which vested in three family trusts. The company's main business activities were civil engineering and construction operations. Over the years, in accordance with family policy, bonuses payable to the directors were left in the company in what was considered to be 'a banking sort of fund' and were

[229] *Op cite* (note 218).
[230] *CSARS v Scribante Construction (Pty) Ltd* 2002 (4) SA 835 (SCA).
[231] *CSARS v BP South Africa (Pty) Ltd* 2006 (5) SA 559 (A).

retained until they were required for further investment. The directors preferred to use these moneys in the operation of the company rather than operate on bank overdraft. Where interest was credited to the director's loan accounts, it was treated as company expenses. In the 1991 tax year the taxpayer declared a dividend of R6 573 076 out of its reserves available for distribution. A portion of the dividend, namely R3 373 242 was credited to shareholders' interest-bearing loan accounts. The case was concerned with whether or not, the interest payable on such loan accounts was deductible, or whether the purpose of the borrowing had been to facilitate the dividend payment. [232]

Unlike the court in *Ticktin*, the court acknowledged that the decisions here were taken by the members of the family unit wearing their different caps as directors and shareholders of the company. The court did not thus attribute the mind of the shareholders to the company. On the facts *de facto* control was not exercised by the shareholders and thus the court was correct in distinguishing their intentions. This was made clearer still by the fact that the company was not under sole ownership and management. Furthermore, the court found that the fact that the transactions were linked was not fatal to the taxpayers cause (contrary to the finding of Hefer JA in *Ticktin Timbers*). This was due to the factual circumstances in which the declaration and consequent borrowing were made. In regard to this factual matrix the court observed the decisive distinguishing factor was the fact the company did not have to borrow money from a bank in order to pay the dividends. It was solvent and financially sound throughout and there were always sufficient liquid funds available for it to meet its commitments. The courts emphasis on this point (seen in light of the other circumstances) was that the availability of surplus meant that the company did not pay the dividends with the money borrowed

[232] *Op Cite* (note 230) at 841.

back from the shareholders, thus the money was not borrowed for the purpose of paying dividends.'[233]

It is submitted that reliance on this factual criterion in distinguishing the facts from *Ticktin* was a valid basis of distinction. The availability of surplus cash certainly does serve to dilute the connection between the declaration and the subsequent loan funding; since the dividend could not then said to be contingent upon the loan finance. However, the artificiality of the exercise remains, since this evidentiary factor of surplus cash could itself be subject to manipulation. For example, a corporation could feasibly declare a dividend, and continue to operate without simultaneously borrowing back funds for a period of time necessary to break the link between the transactions- even in the absence of surplus funds as contemplated by the court in *Scribante.* This could be achieved, for instance, through running down stock. The argument is therefore, that while in appropriate circumstances surplus cash is a useful indicator of the true purpose of a transaction; with careful timing planning, it could be artificially used to disguise the true purpose. The question thus becomes how long must the time lapse between each transaction be, and how much surplus cash is sufficient to break the link? Furthermore, if the transactions are simultaneous (which it was argued should create a strong presumption in favour of Revenue) how much surplus cash should the corporation nevertheless have in its coffers; that is hypothetically for how long should it have the capacity to operate without borrowing? Perhaps this issue could be clarified by legislative intervention.

In the case of *CSARS v BP South Africa (Pty) LTD,*[234] the issue before the court yet again was to determine the purpose of a loan in issue, and specifically whether such loan was to enable a dividend to be paid out or

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[233] *Ibid* at 841.
[234] 2006 (5) SA 559 (A).

whether it was used to pursue income earning activities of the taxpayer-company. BP Southern Africa (PTY) Ltd (BPSA) was the taxpayer which declared a dividend to its parent company, British Petroleum Company plc (BP plc), and simultaneously entered into a loan agreement with this parent company, whereby the taxpayer-company borrowed about half of the declared amount from its parent company which was credited to the parent company's loan account. The taxpayer-company claimed a deduction of the interest paid by it on the aforementioned loan. Notably, British Petroleum Company plc (holding company) is the sole-shareholder in BP Southern Africa (PTY) Ltd. At the end of 1990, BPSA, notwithstanding the payment of part of the dividend, still had R427 million in cash, which was more than was required to pay the balance of the dividend in full. It would therefore have been possible to have paid the full declared amount and run the business of BPSA until the end of 1990 but, the company would have experienced serious financial difficulties at some stage during 1991 if it did so. Thus, the money on loan account, while it was in the bank, helped BPSA to overcome shortfalls in working capital.[235]

The court was confronted with an argument which was sourced ultimately in the decision of the Supreme Court of Appeal in *Ticktin Timbers CC and* an opposing argument based upon the judgment in *Scribante.* It was thus necessary for the court *a quo* to distill the ratio from each of these judgments in order to determine into which factual matrix the present case fitted. Accordingly, the court affirmed that the decisive test is whether there is sufficient cash available for the company to declare a dividend and continue its business activities without the immediate need to procure finance by way of a loan. [236]

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[235] *Ibid* at 551-566.
[236] *Ibid* at 565-566.

On this basis, the court found that since there was cash available to pay the dividend, there was therefore no need to borrow money to pay that dividend. While cash would be needed in the short term future, such cash would have been raised at such a later date by increasing the issued share capital or by a loan at that stage. Thus the purpose of the loan from the perspective of BPSA was to continue its income-producing activities and that the interest paid on the loan was accordingly deductible. [237] The court thus asserted that the amount of surplus cash necessary to break the link between the two transactions need only be sufficient to pay the amount of the dividend without the need to immediately borrow back funds. However, this does not clarify how immediate the necessity for such borrowing would have to be for the transactions to be fatally linked. Thus corporate taxpayers should tread with caution, since where the declaration and loan are simultaneous, as evident in *Ticktin Timbers*, the onus becomes difficult to discharge and the criterion of surplus cash has not be adequately defined by the courts.

***Conclusion***

Thus the Supreme Court of Appeal in *Scribante* and *BPSA* came to different conclusions as to the deductibility of the interest payable on a loan resulting from a dividend declaration reached in *Ticktin*, based not on the law but on factual grounds. The essential factual difference was the availability of cash resources to pay the dividend, and to continue meeting day-to-day 'working capital requirements' in the latter decisions versus an inability to pay the dividend from its own funds in Ticktin. Thus the court has drawn a clear factual distinction between the case where 'a company is able to pay the dividend but needs or may need to replenish its resources by borrowing( from third parties or its shareholders) and the case where the company is unable to

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[237] *Ibid.*

pay the dividend unless it borrows in order to do so.'[238] The entire exercise becomes one of showing on the facts that the link between the declaration and the borrowing has been broken; and it has been argued this adds an artificial dimension to the inquiry whereby taxpayers might through prudent planning as to timing and the appearance of surplus cash, mask the true purpose of the borrowing. Thus while the courts have effectively created a strong presumption in favour of the taxpayer where there is surplus cash available, this criterion requires further clarification. In this practical application of the 'in the production of income' the difficulty of determining the true purpose of the taxpayer using objective evidence, particularly where the borrowing was not for a specific purpose, is well illustrated. As such it is submitted that the issue will often ultimately become one which rests largely on the incidence of the onus.

***Borrowing for Domestic Purposes***

[238] *Op cite* (note 219) at 167.

## ***Borrowing for Domestic Purposes***

The deduction of domestic expenditure is prohibited in terms of section 23(b) of 'The Act'[239] which provides that-

> 'No deductions shall in any case be made in respect of ...domestic or private expenses...'[240]

Such expenditure would similarly be prohibited in terms of s23 (g) to the extent that it is not laid out or expended for the purposes of trade.[241] Thus, for example, if residential property is not used for trading purposes, it is not possible to deduct the interest paid on the mortgage bond. It would therefore be more tax efficient to use cash, represented by a credit balance in a capital loan account, to repay personal indebtedness and then to borrow the funds required to be contributed to such capital account. Furthermore, a taxpayer is entitled to be discriminating in the conduct of his/her affairs, and as such the Commissioner is not entitled to infringe this right, through for example, preventing the use of surplus cash to repay an interest-bearing business debt instead of redeeming a home loan. Accordingly, in both *ITC 1583*[242] and ITC 1603[243] (*CIR v DG Smith*[244] on appeal) the taxpayers' embarked on schemes with a view to reducing their tax liability. Again in this context, the taxpayers' stumbling block was the requirement that the expense be incurred 'in the production of income.' The problematic application thereof in this context will accordingly be considered. The schemes worked as follows: In each case the taxpayer withdrew money from his capital (loan) account in his business and used such capital to satisfy a private interest bearing expense on which

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[239] Olivier 'The deductibility of interest- A problem unresolved?' 1997 *Stellenbosch Law Review* 44 at 47.
[240] Income Tax Act 58 of 1962 at s23 (b).
[241] Ibid at s23 (g)
[242] *ITC 1583 (1995)* 57 SATC 58.
[243] ITC 1603 (1996) 58 SATC 212.
[244] *CIR v DG Smith* (1997) 60 SATC 397.

would be potentially be deductible (on satisfying s11 (a) read with s23 (g)), whereas the taxpayer could not previously claim a tax deduction for the interest paid on the private expense. In order to illustrate the fiscal implications of such arrangements these two cases will be examined in turn. Whereas the facts in each are similar, only in the latter case did the taxpayer succeed in securing a deduction for the interest expense incurred, thus for tax planning purposes it is important to determine the points of distinction, if any. In a discussion of *ITC 1583* I will argue that the decision in that case was wrong and unjustifiably infringed the right of the taxpayer to rearrange the financing of partnership capital in a tax efficient way. Following from this, *ITC 1603* will be examined, with the intention of critically assessing the grounds upon which *ITC 1583* was purportedly distinguished. The discussion will conclude with practical tax planning advice gleaned from these cases, since the divergent decisions in these cases highlight the somewhat artificial necessity to arrange the factual context of a loan with careful attention to the timing, structure, and subtlety thereof.

In *ITC 1583* the taxpayer practiced as an attorney in partnership and had a credit capital account of R32 037 with his firm.[245] This amount was being used in the production of the partnership income, and he was paid taxable interest for the use thereof. His wife had a mortgage bond on the matrimonial home, on which she owed R24 615. Interest on this amount did not qualify for a deduction as it was a domestic expense. The taxpayer considered it wasteful to be paying non-deductible interest and receiving taxable interest income, and thus rearranged his financial affairs.[246] The partnership repaid him from his capital account an amount sufficient to extinguish the debt owing on the mortgage bond, but since the loan accounts were required by the firm as working capital, this was done on condition that the taxpayer immediately

[245] Moosa 'Borrowing from Peter to pay less to Paul' 1998 *Juta's Business Law* at 20.
[246] *Ibid* at 21.

replace an equivalent sum.[247] The debt on the mortgage bond was settled on the 28th of February 1985. On January 30th 1985 the taxpayer's wife applied to the same lender for a re-advance of R25 000 for the stated purpose of loan finance to her husband's attorney's practice by himself.[248] This was granted and on March 1st 1985 the re-advance was paid to the partnership and thereby replaced the capital which had been drawn from the capital account. Thus in effect, the mortgage bond was swapped for the loan account in the business. However the court found that the interest expenditure was not deductible as it was not incurred in the production of the taxpayer's income. This was on the basis that the restructuring of the partnership's capital (that is, replacing the loan capital with the new borrowed capital) did not in any way impact on the partnership's income earning capacity[249] and the fact that the taxpayer was no longer funding his capital account from his own resources, was irrelevant to the partnership's income producing operations.[250] Notably, the court stated that if it was a matter of repaying surplus capital to the taxpayer and at a later stage, for operational reasons, borrowing fresh capital, the deduction would have been allowed.[251] The court in closing asserted that-

> 'to be deductible, the expenditure should at least be calculated to produce income' and that 'rearrangement of the appellant's affairs was designed to secure a fiscal advantage, not to maintain the flow of income from his practice.' [252]

This judgment has been subject to criticism on four grounds. These will be discussed in turn. Firstly, De Koker & Urquhart[253] criticize the decision on the

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[247] *Ibid* at 20.
[248] *Ibid.*
[249] *Op cite* (note 105) at 48.
[250] 'Partner withdrawing his capital and borrowing money to replace the withdrawal' January 1997 *The Taxpayer* 12-18.
[251] *Op cite* (note 242) at 62.
[252] *Ibid.*
[253] De Koker & Urquhart *Income Tax in South Africa* par 10 3 6.

basis that the new capital would also be used in the production of income as working capital, and thus interest paid on a loan to acquire such capital should be deductible. This point is similarly made by Emslie et al[254] who assert that 'if the capital was being used in the partnership in the production of its income before the taxpayers rearrangement and continued to be so used afterwards, there is no reason why there should not be a sufficiently close connection between the incurral of the interest and the production of the taxpayers partnership income.'[255] Furthermore in this regard, in *CIR v DG Smith*[256] (in which *ITC 1603* was confirmed on appeal), Booysen J, in delivering the judgment of a full bench of the Natal Appellate Division, said the following about *ITC 1583*-

> 'I have some difficulty in agreeing with the decision in that case that the interest paid was not deductible in essence because the replacement of the old capital with the new borrowed capital did not in any way impact upon the partnership's income earning capacity. If that partnership had had to borrow capital from another source and pay interest, it would have impacted on its income earning capacity.' [257]

Secondly, the following reasoning relied on by the court in *ITC 1583* requires further elaboration, and will be discussed accordingly-

> 'The situation would be quite different if an income producer *repaid capital which was surplus to his requirements* (my own emphasis) and later, for operational reasons, decided to borrow fresh capital. If that capital had to be borrowed by the lender to on lend to the income producer interest paid on the loan would,

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[254] Emslie, Davis & Hutton *Income Tax: Cases and Materials* (1994) at 497 at 500.
[255] *Ibid.*
[256] *CIR v DG Smith* 60 SATC 397.
[257] *Ibid* at 405.

> provided all other requirements were met, be deductible as having been incurred in the production of income.'[258]

Thus according to this reasoning, 'a taxpayer who has committed his own capital to the partnership, for as long as the partnership requires capitalization can not withdraw it in order to replace it with borrowed funds.'[259] Thus it seems that the court has established a presumption that as long as the partnership does not yield surplus income, a deduction on the interest paid on borrowed capital will be disallowed. While the incidence of surplus cash is certainly a valuable evidentiary factor in seeking to determine a taxpayer's true purpose; it should not be elevated to a seemingly non-rebuttable presumption (akin to a legal principle) which the court seemed to advocate. If a company or a partnership owes its shareholders or partners capital, which it uses in producing it's income, the borrowing of funds by the respective entities to repay the partners/ shareholders, would not affect the purpose for which the borrowed money is used, namely to produce income,[260] any more than if the capital had in the first instance been borrowed from outside parties or whether surplus funds were available.[261] The essential point is thus that the fact of there being no surplus funds in a partnership, cannot itself be a decisive factor in denying the deduction of interest on borrowed capital. This is supported by the fact that where a taxpayer requires capital to finance his income earning operations, it is entirely up to him to choose the source from which he derives such capital. For example, the fact that he chooses to borrow capital when he has cash available will not preclude him from deducting the interest payable on the loan, provided that the borrowed money is used in the production of income.[262] This freedom of choice given to the partners, on how to structure the capital needs of the partnership, is preserved throughout its

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[258] *Op cite* (note 242) at 60.
[259] 'Partner withdrawing his capital and borrowing money to replace the withdrawal' January 1997 *The Taxpayer* 12-18 at 14.
[260] *Ibid* at 15.
[261] *Ibid.*
[262] *Op cite* (note 243) at 215.

existence, regardless of whether the partnership has surplus funds available or not.[263] Thus the incidence of surplus cash should retain its evidentiary value as to indicating intention, without being given 'pseudo-legal' status. Furthermore, accepting the evidentiary nature thereof, the requirement requires further development by the court, given the vague nature thereof. The amount of surplus cash required and accordingly the timing of the borrowing are two requirements which give rise to uncertainty and artificiality. This will become evident in a discussion of *ITC 1603*, where a strained interpretation was placed on what time is sufficient to satisfy this 'later' factor and furthermore, although the partnership in that case was theoretically able to repay the capital, it was not practically able to operate without it. [264] Thus this surplus cash requirement needs further clarification, by the courts or possibility the legislature, in order to assist in alleviating the vague nature thereof which in turn facilitates artificial tax structuring to conceal a taxpayers true intention.

The third ground upon which the judgment has been criticized is that the cases relied on by the Commissioner's representative (namely *ITC 241*[265] and *ITC 829*[266]), were clearly distinguishable on the facts.[267] In each of these cases cited the taxpayers' raised bonds to pay for their homes, and not to fund their trading operations in their respective partnerships. They claimed deductions on the ground that had they borrowed the money to capitalize their partnerships instead of using their own funds, they would have been able to deduct the interest. Clearly, the purpose of the act (raising the loan) entailing the expenditure (the interest) was to finance private domestic expenditure and not to produce income.[268] It is thus obvious that those cases are distinguishable from the facts which Conradie J had to consider in *ITC 1583*.

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[263] *Ibid.*
[264] Op cite (note 189) at 232.
[265] *ITC 241* 6 SATC 365.
[266] *ITC 829* 21 SATC 199.
[267] *Op cite* (note 259) at 15.
[268] *Ibid.*

The fourth ground of criticism is that the court problematically examined whether the interest expenditure was incurred in the production of the partnerships income (regarding it as the 'income producer'), as opposed to the attorney personally. This issue which first arose in *ITC 1583,*[269] was perpetuated in *CIR v DG Smith*[270], where again the court considered how the rearrangement of the partnership's capital impacted upon the partnerships income, on the basis that the partnership was the 'income producer'.[271] However, with respect, I concur with Vorster[272] that the issue which both Conradie J in *ITC 1583* and Booysen J in *CIR v DG Smith* ought to have considered was 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 his income, namely a share in the partnership profits in terms of the partnership agreement.[273] Thus the 'income producer' to which the learned judges referred ought to have been the taxpayer (who earned interest on his capital account) rather than the partnership.[274] This follows from the fact that in South African law a partnership is not considered a separate legal entity distinct from its partners. Furthermore, in terms of the Income Tax Act only the partners, as individuals, are taxable. [275]

The references made by Conradie J and Booysen J to the partnership as the income producer may be understood in light of the fact that the individual partner's income is directly linked to the fate of the partnership's income-earning ability,[276] however such justification is unsound in law. Considering

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[269] *Op cite* (note 242).
[270] *Op cite* (note 244).
[271] Op cite (note 1) at 500.
[272] Vorster 'The deductibility of interest: The basic truths and the cash-flush borrower' 1998 *SALJ* at 417.
[273] Ibid.
[274] Op cite (note 1) at 500.
[275] Van Der Merwe 'The Deductibility of Interest-Partnership Replacement Loans' 2000 *South African Mercantile Law Journal* 224 at 233.
[276] *Ibid* at 228.

the impact of the rearrangement on the partnerships income earning ability amounts to fallacious reasoning, and is clearly at odds with the legal principles governing the deductibility of interest in these circumstances. The interest expenditure was incurred by the attorney personally and not by the partnership and thus the only relevant inquiry is whether that was an expenditure incurred in the production of his income. For purposes of illustrating the point fully, the relevant legal principles will be discussed to respectfully argue that errors were made by both learned judges. However the discussion will focus on Conradie J's judgment in *ITC 1583*, since the arguably erroneous reasoning contributed to the taxpayer's detrimental outcome in that case.

Watermeyer AJP in *Port Elizabeth Electric Tramway Company Ltd v CIR*[277] laid out two questions which must be addressed in determining whether expenditure is incurred 'in the production of income.' This are-

1. Whether the act to which the expenditure is attached, is performed in the production of income ; and
2. Whether the expenditure is linked to it closely enough.

The first question requires that the purpose of the act entailing the expenditure be established. If the purpose of the act is for earning income, then the expenditure attendant upon it is deductible. In addressing the first question (in relation to the facts of *ITC 1583*), the act entailing the interest expenditure was the loan made by the partner to partnership. His purpose in doing so was to fund his capital account, which the partnership agreement obliged him to do. Thus the loan was clearly made for the purpose of earning income in the form of interest on his capital account and profit distributions in terms of his partnership agreement. This question is an objective inquiry into the purpose of the taxpayer, and accordingly Vorster submits that 'the operational

[277] *Port Elizabeth Electric Tramway Company Ltd v CIR* 1936 CPD 241.

requirements of the partnership are entirely irrelevant.'[278] However, arguably regard might be had to such operational requirements as an evidentiary factor indicating tax evasion.

The second question posed by Watermeyer AJA simple entails an enquiry into whether the expenditure (the interest) is sufficiently closely connected to the taxpayer's business operations so as to be regarded as part of the cost of performing it. An expenditure would satisfy this criterion if 'it would be proper, natural, or reasonable to regard the expenses as part of the cost of performing the operation.'[279] Thus it is clear that the connection that must exist is between the expenditure (the interest) and the activities of the taxpayer incurring that expenditure (the partner). To this end-

> 'it is axiomatic that the interest on the money borrowed with a view to making that contribution (to the capital account) is sufficiently closely connected to the partner's income producing activity ( an attorney) to be regarded as part of the cost of performing that activity. There is no relevance in the fact that the maneuver to 'replace the old capital with the new (borrowed) capital' could have no impact on the firm's earning of income.'[280]

Thus, it is submitted that the finding in *ITC 1583* was clearly wrong and a taxpayer is fully entitled to rearrange the financing of partnership capital in a tax efficient manner.[281] The only grounds upon which a restructuring of this nature might be disallowed, is if on the facts, the court found that in substance the expense entailed in the rearrangement was not in the production of the taxpayers income; in other words that the transaction was a sham.

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[278] Vorster 'The deductibility of interest: The basic truths and the cash-flush borrower' 1998 *SALJ* at 417.
[279] *CIR v Genn & Co (Pty) Ltd* 1955 (3) SA 293 (A) at 299.
[280] *Op cite* (note 278) at 418.
[281] *Ibid.*

The discussion will now turn to an examination of *ITC 1603*, in order to critically evaluate the merits of the grounds upon which it was distinguished from *ITC 1583*. The facts of this case were that the taxpayer and his partner had agreed to contribute the capital required to operate a business. They agreed further that their capital accounts would not be left permanently in the partnership but would be repaid when the partnership was able to do so. By the end of February 1988, the partnership was in a position to repay the capital accounts, but would nevertheless require to be recapitalized within a few weeks thereafter in order to function properly. Thus, for fiscal advantages, the partnership repaid the taxpayer a portion of his capital which he used to repay the bond on his wife's property and within a few days borrowed money from the same bondholder which was immediately credited to his capital loan account in the partnership.[282] Pertinent points emphasized by the court a quo were, firstly, that where a taxpayer requires capital to finance his income earning operations, it is entirely up to him to choose the source from which he derives such capital. The fact that he chooses to borrow the money when he has cash available will not preclude him from deducting the interest payable on the loan, provided that the borrowed money is used in the production of income. Secondly, that although the essential, if not the sole, motive of the taxpayer had been to gain a tax advantage, the question was whether it was in the production of income. Finally, and most pertinent for the sake of this discussion, the facts were distinguished from those in *ITC 1583*, on the grounds that unlike *ITC 1583*, it was always envisaged that the partners' capital accounts would be paid out if and when the partnership was in a position to do so, and at the time when they were repaid the partnership was in a position to continue without a further injection of capital for some weeks.[283]

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[282] *Op cite* (note 1) at 501.
[283] *Ibid.*

In regard to the aforementioned grounds of distinction, is submitted in accordance with Emslie et al that a preferable basis for the decision would have been that 'on the facts and having regard to the substance rather than the form of the taxpayer's actions, no real borrowing to finance the taxpayer's capital account with his firm had in truth taken place in ITC 1583.'[284] These accords with the dicta of Galgut J in *ITC 1603* where he asserted that the scheme resorted to by the taxpayer in *ITC 1583* had been artificial. [285] However, instead the court in *ITC 1603* purported to distinguish the case before it from ITC 1583, on seemingly indistinguishable facts. These points of distinction were firstly that the partners in the present case had agreed that the capital contributions made by each of them would not remain in the partnership permanently, but would be repaid as soon as the partnership was able to do so. Following from this point, the second was that while the capital was repaid within a few days, the partnership would in fact have been able to continue for at least some weeks.[286] This scenario was contrasted with that in *ITC 1583*, whereby the loan was made on condition that the partner immediately replace the capital, since the partnership was in no position to continue without the loan capital.[287] However, this distinction is certainly more perceived than real, since a result of the capital repayment was that the partnership would have to rely on its overdraft facility, and this could only be sustained for a few weeks. Thus in commercial reality (with regard to the partnerships capacity to continue its income earning operations without relying on borrowed funds), the partnership was not in a position either to make the capital repayment, or to operate without the funds (accepting that the ability to operate for a mere few weeks on an overdraft facility does not constitute financial fluidity significantly distinct from the position of the

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[284] *Ibid* at 500.
[285] *Op cite* (note 243) at 217.
[286] *Op cite* (note 259) at 17.
[287] *Ibid.*

partnership in *ITC 1583*).[288] Furthermore, in regard to the first purported distinguishing factor, it is in fact unclear from the judgment in *ITC 1583* whether or not there was in fact any agreement as to the repayment of the partner's capital accounts.[289] This was not a factor considered for purposes of the judgment. Thus aside from the problematic reliance on this surplus cash factor in law discussed above in relation to *ITC 1583*, it is further clear that there were insufficient factual grounds to sustain a distinction on this ground in *ITC 1603*. Thus, while there are small differences between the two cases, it is evident that the distinctions drawn by Galgut J 'owe more to judicial deference than to differences which go to the heart of the matter'.[290] Thus, in conclusion, and with respect to both Conradie J and to Galgut J, the only possible real distinction between the two cases may be, in terms of Emslie et al that-

> 'in *ITC 1583* there was insufficient substance to support the form of the maneuver performed by the taxpayer, whereas in *ITC 1603* this problem did not arise.' [291]

Thus in substance in *ITC 1583*, the partner in fact borrowed money to on-lend to the partnership, and he did so not to fund its business operations, but in order to pay himself. While in *ITC 1603*, the partnership in substance borrowed money from a partner in order to funds its business operations. [292]

In conclusion, and for tax planning purposes, these cases illustrate that the manner in which a particular set of actions in implemented, may determine its outcome, since judicial deference can be steered in a particular direction through careful planning so as to avoid suspicious factual scenarios.[293] For

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[288] *Ibid.*
[289] Op cite (note 189) at 232.
[290] Op cite (note 1) at 504.
[291] *Ibid.*
[292] *Op cite* (note 189) at 233.
[293] *Ibid.*

instance, it was conceded by council for the commissioner in *CIR v DG Smith* that if the taxpayer had allowed a decent interval, of at least two months, to pass before borrowing money to replenish the partnerships capital, there would have been no objections in principle.[294] In addition to adopting a capital repayment policy, the same would apply to *ITC 1583*. In light of the accepted fact that a taxpayer may conduct and arrange his affairs so as to attract the least possible tax,[295] with respect to the taxpayer, *ITC 1583* provides a prime example of the effects of a lack of subtlety in tax planning. Thus, the lessons learned from *ITC 1583* are that caution in regard to timing, structure and subtlety in tax planning are essential. This case should not be seen as all together limiting the right a taxpayer to rearrange his/her financing of partnership capital in a tax efficient manner in the absence of surplus cash; since it has been argued, that this is merely an evidentiary factor which can be rebutted with sufficient evidence to the contrary. Thus taking cognizance of the evidentiary complexities encountered in relation to the 'in the production of income' requirement in this context; the observation of this paper is affirmed that the incidence of the onus will often be the determinative factor; and taxpayers should take heed of this burden incumbent upon them.

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[294] Moosa 'Borrowing from Peter to pay less to Paul' 1998 *Juta's Business Law* at 20.
[295] *Op cite* (note 189) at 232.

***Borrowing with the purpose of acquiring shares in a company or interest in a close corporation***

An issue which often confronts the purchaser of an asset owned by a company is whether he should acquire the asset directly from the company or whether he should acquire the total issued share capital of the company owning that asset.[296] Interest paid on funds borrowed for the purposes of acquiring assets which do not produce taxable income, is not deductible for income tax purpose. Generally the only income that shares produce is dividend income, which is exempt from tax in terms of section 10(1) (k) of the Income Tax Act.[297] Accordingly, expenditure in the form of interest on money borrowed to acquire the shares cannot be said to be incurred 'in the production of income', and is not allowed as a deduction in terms of s11 (a) of 'The Act.'[298] This is a major drawback of a purchase of shares, and is often a compelling reason from the purchaser's perspective to acquire the assets in the company directly, rather than purchasing the shares in the company owning the assets. However, if it can be established that the purpose of the borrowing was to produce some other form of income, and not to earn dividends, then such interest may nevertheless be deductible. A discussion of the cases will show various attempts made by taxpayers to establish 'some other purpose' in the purchasing of shares and so thereby secure a deduction. The inconsistent manner in which the courts have dealt with this issue will be critically examined in order to determine whether any general principles can be derived from the cases. Notably the discussion will turn once more on the requirement that the expense be incurred 'in the production of income;' which has in the course of this paper been shown to be the taxpayer's nemesis.

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[296] *Op cite* (note 63) at 36.
[297] Income Tax Act 58 of 1962.
[298] *Ibid.*

The question of the deductibility of interest payments on money borrowed to finance the purchase of shares was pinpointed in *Shapiro v CIR*.[299] The taxpayer contended that the purchase of the shares was necessary to secure his appointment as managing director, which in turn brought income in the form of a salary and allowances, and as such the interest paid by him was deductible from that income. The court rejected this argument on the grounds that the taxpayer earned his salary by working for it and that there was as such no direct causal link between the expenditure to acquire the shares and the income earned by the taxpayer as managing director.[300] Thus, although the expenditure incurred in purchasing the shares qualified the taxpayer for the position of managing director and so provided him with the opportunity to earn the income in question, such expenditure did not in itself actually produce these sources of income. Accordingly, none of the interest paid was expenditure incurred in the production of income and was not deductible.[301] However in numerous consequent decisions, such as *ITC* 1504[302], *ITC* 1604[303] and *ITC* 1428[304], on arguably indistinguishable facts, the Special Court has found in favour of the taxpayer, asserting that the purpose of the taxpayer in purchasing the shares in a company was to earn the salary income.[305] The aforementioned cases will be critically discussed with the ultimate aim of deriving a fundamental principle to be followed in tax planning so as to avoid structuring a transaction on the wrong side of this apparent treacherous legal indecision.

In *Shapiro,* the argument advanced on the taxpayer's behalf was premised on the understanding that the agreement for the purchase of the shares and the taxpayer's consequent appointment as managing director was an 'indivisible

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[299] *Shapiro v CIR* 1928 NPD 436.
[300] *Op cite* (note 63) at 40.
[301] *Op cite* (note 1) at 505.
[302] *ITC* 1504 53 *SATC* 349.
[303] *ITC* 1604 58 *SATC* 263.
[304] *ITC* 1428 50 *SATC* 34.
[305] *Op cite* (note 63) at 38.

venture.'[306] The court dismissed this contention as a fallacy on the basis that although the agreement was contained in one document, in effect two separate agreements were entered into. The first agreement was for the purchase of the shares and the second was his appointment as managing director.[307] The fact that the first was a *sine qua non* to the second did not taint the dual nature of the agreement. In effect the court relied on the duality of the contract to find that the connection between the interest and the financial benefits attached to the position of managing director was insufficiently close. In making this point Matthews J held that-

> 'there was no evidence from which an indivisible venture on the part of the taxpayer must be inferred from the agreement, his trade was his continuous occupation as managing director; and interest paid on borrowed moneys even to acquire the share qualification which entitled him to become managing director and so earn the salary and commission was not really incidental to the trade itself.[308]

It was not the taxpayer's position qua majority shareholder that produced the income, but the taxpayers 'energy and ability'[309] exercised in carrying on the companies business as managing director. His acquisition of the shares was a *sine qua non* in that it merely qualified him for the position as managing director and so provided him with the opportunity to earn the income. If the taxpayer defaulted on his interest payments, this would not affect his position as managing director, hence indicating that 'his position as such and the incumbent financial benefits was a contract which stood entirely on its own footing.'[310]

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[306] *Op cite* (note 299) at 447.
[307] Olivier 'The deductibility of interest-A problem unresolved? 1997 *Stellenbosch Law Review* 296 at 304.
[308] *Op cite* (note 299) at 451.
[309] Tager 'The deduction of interest payments for income tax purposes' 1976 *SALJ* 12 at 31.
[310] *Op cite* (note 299) at 447.

Based on the courts reasoning in this case it seems that where income is produced by personal effort, it is such effort which produces the income and any share purchases, whether to secure a position, gain control of the company, or finance the company so as to prevent its extinction, can only be regarded as remotely connected with that income.[311]

However in spite of this conclusion, subsequent cases dealing with the deductibility of interest paid on a loan incurred for the acquisition of shares in order to be promoted or appointed to a specific position, have rendered the position all but clear.[312] Recent decisions of the special income tax court will serve to illustrate the inconsistencies which have arisen in this factual context. In *ITC 1428*, the taxpayer, in order to be promoted to the position of director and so secure a significant salary increase, was obligated to purchase shares in the company. To finance the purchase the taxpayer obtained a bank overdraft on which he paid interest and he sought to deduct this interest expense from his salary income.[313] Yet on these seemingly analogous facts to *Shapiro*, the court both criticized and purported to distinguish the factual scenario in *ITC* 1428 from the earlier Provincial Division decision. The basis upon which the court did so-

i) In the *Shapiro* case the taxpayer's primary objective was the acquisition of the shares, from which flowed his appointment as managing director (the court was hereby essentially eluding to the dual nature of the agreement in the *Shapiro* case). Whereas in this case the taxpayers primary objective was to be promoted to directorship so as to increase his salary and bonus earnings.[314]

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[311] *Op cite* (note 10) at 32.
[312] *Op cite* (note 8) at 307.
[313] *Op cite* (note 1) at 511.
[314] *Op cite* (note 304) at 38.

ii) In the *Shapiro* case the taxpayers expenditure on the shares did not itself actually produce any of the sources of the taxpayers income, while in this case the amount paid by the taxpayer formed part of the company's working capital which in turn became a source of income production.[315]

The interest paid was therefore held to be deductible as it was sufficiently closely linked to earning of the appellants income.

These factual distinctions drawn by the court are unconvincing and have been criticized accordingly by Olivier-

i) In *Shapiro* the primary purpose of the taxpayer was held to be the acquisition of shares, yet on substantially similar facts the primary purpose of the taxpayer in *ITC* 1428 was held to be his appointment as director. There were no rational grounds for this distinction drawn by the court in the latter case.[316]

ii) The use to which the company put the money was irrelevant since the relevant income was that of the taxpayer and not that of the company in which the shares were acquired.[317]

Finally, having purported to distinguish the cases factually, the entire rationale for the Shapiro decision was criticized in so far as the court held that the taxpayer did not earn his income from the purchase of the shares in the company but rather from his own energy and ability expended in the

[315] *Ibid* at 39.
[316] Op cite (note 8) at 306.
[317] *Ibid.*

company's affairs.[318] In assessing this reasoning followed in the *Shapiro* decision Tebbutt J in ITC *1428* asserted-

> 'With the greatest respect, that appears to be begging the question. He simply could not have earned the income unless he bought the shares.'[319]

In *ITC 1504*[320] the taxpayer had been a member of a partnership to which he had been required to contribute working capital. This capital was raised through interest bearing loans. In 1976 the partnership was wound up and its practice was sold to a company. The taxpayers share in the net capital of the partnership was repaid to him. In terms of a service agreement with the purchasing company the taxpayer would be employed by the company, subject to his purchase of a specified number of shares in the company. To finance this, the taxpayer used the capital repaid to him as a result of the winding up of the partnership.[321] Thus in effect he used the money he had borrowed earlier as working capital for the partnership, and continued to pay interest thereon.[322] The special court held that the income was deductible as the purpose for acquiring the shares was to protect his existing income, and furthermore that there was a direct link between the expenditure incurred and the income actually received.[323] The *Shapiro* case was distinguished on the grounds that the taxpayers primary purpose in that case was to gain control of the company, whereas in the present case the share purchase was not affected with the purpose of vesting control in the taxpayer. Having purported to distinguish the facts from *Shapiro*, Selikowitz J followed the *Drakensberg Garden Hotel* [324]case. However, as Olivier has argued, the grounds upon

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[318] *Ibid.*
[319] *Op cite* (note 304) at 39.
[320] *Op cite* (note 302).
[321] *Op cite* (note 8) at 306.
[322] *Ibid.*
[323] *Ibid.*
[324] *Drakensberg Garden Hotel* 1960 (2) SA 475(A).

which the latter case was adopted over the former are tenuous.[325] In the *Drakensberg Garden's case*, the main purpose of the taxpayer was also to gain control of the company. Thus the two decisions were distinguished on a finer ground than the mere acquisition of control, namely the taxpayer's purpose of gaining control in each case. While in *Shapiro* control was gained in order to be appointed as managing director and so enjoy increased financial benefits, in *Drakensberg Garden's case* the purpose of gaining control was to ensure the continuance of income from trading operations through securing tenure of the hotel and trading store. However there seems to be no reason why these different purposes of gaining control should be treated differently. The pertinent question is whether there is a sufficiently close link between the interest expense and the taxpayer's income producing activities. This link was established in the *Drakensberg Gardens* case but was not proven in the *Shapiro* case.

In *ITC 1604*[326], a recent decision of the special income tax court, *ITC 1428* and ITC 1504 were followed without reference to the *Shapiro* case. In this case the taxpayer concluded an agreement in terms of which he purchased a 49% interest in a closed corporation and was thereby appointed as a managing director. The profits of the business were to be shared by the members as taxable executive bonuses as opposed to exempt dividend distributions. The taxpayer acquired a loan to finance the transaction, and it was the interest payable on this sum which formed the subject of the dispute.[327] It was held that the interest was incurred in the production of income as 'there was a sufficiently close connection between the acquisition of the interest in the corporation and to the earning of his income by way of increased financial rewards.'[328]

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[325] *Op cite* (note 8) at 306.
[326] *ITC 1604* 58 SATC 263
[327] *Op cite* (note 8) at 307.
[328] *Ibid.*

From the above cases it is clear that the position on the deductibility of interest paid on a loan incurred for the acquisition of shares in order to be promoted of appointed to a specific position is unclear. However Olivier[329] submits that there is a rationale basis for the divergent decisions discussed, and that such basis is to be found in the systematic application of the test laid down by Watermeyer CJ in the *Port Elizabeth Electric Tramway case,* which entails asking two questions-

1. Whether the purpose of the act entailing the expenditure was to produce income. Hereby the facts of each case must be taken into account to determine whether the main purpose in acquiring the shares was to gain control of the company or whether it was to be appointed to a specific position. In this regard the *Shapiro* case is subject to criticism as there was nothing in the facts which indicated that the gaining of control over the company was more important than the taxpayer's resultant appointment as managing director.

2. The second inquiry entails asking whether the expenditure is closely enough linked to this established purpose of appointment/promotion to a specific position. The answer hereto is a matter of degree which allows room for divergent factual findings.[330]

While Olivier does provide some rationale basis for reconciling the cases discussed, caution must be taken in allowing a taxpayer to become exposed to this apparent judicial indecision. Thus from a tax planning perspective, the fundamental principle to be followed is this-

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[329] *Ibid.*
[330] *Ibid* at 308.

> 'when a taxpayer borrows money to purchase shares in a company, and the only income that can be earned ***directly*** (own emphasis) from this source will be dividends that may accrue in respect of those shares, expenditure, in the form of interest on the moneys borrowed to purchase shares, cannot be said to be said to be incurred in the production of income, and the expenditure is not allowed as a deduction in terms of section 11(a) of the Act.'[331]

However, in the *Drakensberg Gardens Hotel* case, the taxpayer company was allowed to deduct the interest payments it made in respect of the acquisition of shares in a property-owning company. Notably the *Drakensberg Gardens Hotel* case is of higher authority and is more recent than the Shapiro case and is as such the leading decision in which the production of dividends was held to be incidental to the main purpose of producing income. On the facts, it was held that the shares were acquired in order to secure for the company income in the form of rental and trading profits from business activities conducted by the taxpayer on the property owned by the company,[332] as opposed to dividend income. It is difficult to reconcile this decision with *Shapiro's* case and it will accordingly be discussed to determine firstly whether the cases are in fact irreconcilable and secondly, whether a distinct legal principle emerges from this case which would allow the taxpayer to rely safely on the deductibility of interest in similar circumstances.

In this *Drakensberg Gardens Hotel* case the taxpayer, a company of which Mr and Mrs Robinson were the sole shareholders, leased a hotel and a trading store from the Stiebel Company. In 1954 the taxpayer purchased all the shares in the Stiebel Company by way of an interest bearing loan. The effect of this purchase conferring absolute control of the hotel and store premises would be to ensure continuity of income in the form of rental and trading profits as well

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[331] *Op cite* (note 63) at 39.
[332] *Ibid.*

as security of tenure.[333] The commissioner argued that the interest was not deductible on two grounds-

i) 'That the interest was not expended in the production of income as defined, the shares being only productive of dividend income which, being exempt, was not income as defined', and

ii) 'that there was not a sufficiently close link between the purchase of the shares and the production of the taxpayer's income for the interest payments to be regarded as part of the cost of producing the income.'[334]

Schreiner JA rejected the Commissioner's first contention on the basis that 'the income from which a deduction was claimed was not dividend income but the income derived from rent and business profits.'[335] In rejecting the second contention Schreiner JA asserted that since the object of the purchase was to obtain absolute control and to ensure security of tenure, the fact that this was done by means of buying shares did not remove the interest payments too far from the production of the income to preclude deduction. The taxpayer's purpose in buying the shares was 'to ensure the continuance of and an increase in, its income from subletting and trading'[336]; and there was therefore 'a clear connection between the purchase of the shares and the production of the taxpayer's income.'[337] Whether this connection was close enough, the court held was 'essentially a matter of degree', which was reasonably found to exist by the Special Court.[338]

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[333] *Op cite* (note 324) at 481.
[334] *Op cite* (note 1) at 509.
[335] *Op cite* (note 324) at 480.
[336] *Ibid* at 481.
[337] *Ibid.*
[338] *Ibid.*

While the court in this case distinguished the Shapiro case seemingly on the ground that the share purchase in the latter case was concluded with a dual purpose, namely to earn dividends and to attain the position of managing director;[339] it is widely held by academics that *Shapiro's* case and *Drakensberg Gardens* case are 'incompatible and irreconcilable; as a matter of legal principle.'[340] However, Tager[341] argues that a proper ground of distinction between the cases is the fact that in the earlier *Shapiro* decision, 'the connection between the income and the expenditure was too remote; since a salary does not flow automatically form the purchase of shares, but entails personal effort and exertion. In contrast, the purchase of shares in a property-owning company in order to ensure the continuance of income from subletting and trading is sufficiently closely connected to the production of that income, and is in effect almost akin to payment of interest on money borrowed to purchase the asset itself.'[342] I find her analysis in this regard a compelling ground of distinction. Thus the principle established in the *Drakensberg Gardens* case is that if the taxpayer's purpose in buying shares is to ensure the continuance of the income from trading or business operations, the interest paid on the money borrowed to acquire the shares is properly deductible from that income.[343]

In summation, the interest paid on funds borrowed for the purposes of acquiring assets which do not produce taxable income, is not deductible for income tax purpose. Generally the only income that shares produce is dividend income, which is exempt from tax in terms of section 10(1) (k) of 'The Act.' Accordingly, the interest incurred on funds borrowed to purchase shares is generally not income tax deductible, and this is a major drawback of a purchase of shares, and it often necessitates complex asset-backed financing

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[339] *Op cite* (note 10) at 34.
[340] *Op cite* (note 63) at 39.
[341] *Op cite* (note 10).
[342] *Ibid* at 34.
[343] *Op cite* (note 324) at 481.

deals to be put in place in order for the acquirer to raise the funds required to purchase shares. However, as the *Drakensberg Garden Hotel* case illustrates, there are exceptions to this general principle of non-deductibility. Thus if over-riding commercial considerations compel a purchaser to acquire the shares in a company, rather than purchase the assets directly, 'hope springs from this Appellate Division decision.' [344] In short, while it would be advisable to steer a transaction as far as possible away from potential controversies concerning the deductibility of interest on money borrowed to purchase shares[345]; provided the taxpayer's case falls within the narrow ambit of the principle stated above, I agree with Broomberg[346] that certainly 'forceful arguments could be made for the deductibility of such interest payments.' [347] However, the taxpayer ought not lose sight of the onus upon himself to show that he falls within this narrow ambit carved by the necessity that expenditure be 'in the production of income.' Together with the strong presumption operating against himself where the purchase of shares is concerned; this requirement will often prove to be an insurmountable evidentiary mountain for the taxpayer to climb.

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[344] *Op cite* (note 63) at 38.
[345] *Ibid.*
[346] *Ibid.*
[347] *Ibid* at 39.

## ***Conclusion***

This paper has shown that no special provision is made in the Act for the treatment of interest expenditure. Such expenditure is thus only deductible if it complies with the requirements of the general deduction formulae and it not specifically prohibited in terms of s23 of 'The Act.'[348] All four requirements of the general deduction formulae give rise to particular problems in respect of the deductibility of interest. As regards the *trade requirement*, while a recent amendment to the section allows apportionment and has thus made the requirement less onerous; it is nevertheless difficult to apply. This is since it is now necessary to identify trade and non-trade purposes, and where both are present, to 'attach weight to each in a precise manner so as to effect an apportionment, an expenditure or loss being deductible to the extent that it was incurred for the purposes of trade.' [349] Uncertainty regarding when interest is *actually incurred* has been clarified by the introduction of s24J into 'The Act.' Though since the section is not all in compassing, it is thus essential that both the ambit of the section and the legal effect of falling outside of it are understood for tax planning purposes. The question of whether the *purpose of the act entailing the expenditure* was to produce income and whether the expenditure is closely enough linked to this purpose, is a factual one.[350] Where factual distinctions are made, judicial discretion invariably leads to conflicting judgments which are difficult to reconcile. This in turn leads to uncertainty in so far as tax planning is concerned, undermining the foundational tenant of predictability, which is necessary for a fair and efficient tax system. Furthermore, through a discussion of the cases it was shown that this requirement gives rise to the most litigation in relation to the deductibility of interest. In this regard, due to the often awkward application

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[348] Tager 'The deduction of interest payments for income tax purposes' (1976) 12 *SALJ* at 52.
[349] *Ibid.*
[350] *Op cite* (note 105) at 53.

of the test to interest, together with evidentiary difficulties which arise due the purely objective nature of the enquiry; it was argued that the onus on the taxpayer will often become an unduly burdensome one to discharge, and will as such often operate as the determinative factor. The unique nature of interest gives rise to particular difficulties in respect of the requirement that the interest must be of a *non-capital nature*, since the general tests in this regard cannot be meaningfully applied to interest expense and render inconsistent results. This requirement is 'potentially the biggest stumbling block' in the deductibility inquiry[351] evident in the courts avoidance of the issue and unsatisfactory reliance on the 'in the production of income requirement' instead. Tager argues that the manifest uncertainly in respect of the nature of interest expenditure should be clarified by introducing a specific deduction for this purpose in the Act; to the effect that interest expense is always of a revenue nature.[352] However contrary to this proposition, it was submitted that before deferring to the legislature, the courts should seek to appropriately develop and adapt the enquiry; beyond the cursory *obiter* comments which have thus far been made.

An examination of various specific commercial contexts in which these tests have been applied, served to illustrate the complexities which arise in practice, given the awkward application of the general deduction formulae to interest expenditure. Notably, in each of the four contexts discussed, it was the requirement that the expense be incurred 'in the production of income' which gave rise to the litigation. When borrowing for general trading purposes problems arise when the borrowed funds are used as floating capital as opposed to for a specific identifiable purpose. Given the evidentiary difficulty presented by the former situation, the courts have seemed to emphasis the original purpose of the borrowing as decisive. However, the submission of this paper is that this approach should not be construed as precluding a change

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[351] *Ibid.*
[352] *Op cite* (note 10) at 36.

of purpose. Certainly the party seeking to prove such a change will face difficulty due to the fact that such funds have been 'mixed' and the link between a subsequent change of usage and the original borrowing is weakened. However as evident in ITC 953[353] this is nevertheless possible and accordingly the guidelines established in the *Standard Bank* case should not be misapplied as legal principles. Needless to say, the onus will play an important role in this context, possibly to the advantage of the taxpayer in circumstances where SARS is seeking to show a change of intention which is obscured by the facts.

It was shown that interest in respect of a dividend credited to a shareholder's loan account is in most cases not deductible. This conclusion is due to the controversial decision of *Ticktin Timbers,* in which our Supreme Court attributed the corporate mind of the sole member of a close corporation to such corporation; and accordingly found that the purpose of the loan was not in the production of the taxpayer's income. The judgment has been criticized on the basis that this reasoning was indicative of an incorrect understanding of company law. However, the submission of this paper was that while the court failed in not discussing the 'directing mind' doctrine, it was correct in its approach and finding. Further criticism of the judgment was premised on the assumption that a shareholder has a right to dividends irrespective of the financial circumstances of the company. This too was shown to be based on an incorrect understanding of the company law applicable. Furthermore, a fundamental error made by both the court and counsel, was the failure to distinguish between the management structure of a close corporation as opposed to a company; which would have nullified the contention surrounding the courts attribution of the corporate mind. In the subsequent *Scribante* and *BPSA* decisions the court came to a different finding based on evidence as to the existence of surplus cash. While this is a useful factor in seeking to determine the taxpayers true purpose; it also introduces elements of

[353] *Op cite* (note 159).

uncertainty which allows for artificial tax structuring using the criterions of surplus cash and timing. Thus these factors should arguably be clarified by legislative intervention-such as by a provision creating a presumption in favour of the taxpayer where the declaration and borrowing take place within a specified duration. Though this should be rebuttable by evidence such as the abnormal running down of stocks to provide the façade of surplus cash and so meet the timing threshold. Given the difficulties presented by seeking to determine a taxpayer's subjective intention using objective criteria, the burden in terms of s82 on the taxpayer will often prove insurmountable. It has thus been the observation of this paper that in light of the complexities presented by interest expense, the incidence of the onus has and will continue to operate as the determinative factor in many cases.

As regards *borrowing for domestic purposes*, while the deductibility of interest paid on money borrowed for such purposes is precluded; this fact must not be used to infringe the taxpayer's right to be discriminating in the conduct of his/her affairs. Regrettably, the Special Court in *ITC 1583*, did exactly that, and prevented the use of business loan capital to satisfy a private interest bearing expense. On analogous facts, the court in *ITC 1603*, allowed the deduction based on arbitrary factual distinctions which the court purported to draw. The seemingly arbitrary result could have been avoided if the court in ITC 1583 had relied on the fact that the structure lacked substance and was accordingly a sham.

Finally in the context of borrowing for purposes of purchasing shares in a business, the anomalous position created by the divergent *Drakensburg Gardens* and *Shapiro* decisions have created uncertainty; and a narrow ambit within which to discharge the onus. The taxpayer will thus have to tread with caution in seeking to establish his case in the narrow channel carved by the former favourable decision.

Given the complexities and inconsistencies posed by the deductibility of interest expenditure, this paper has aimed to highlight that heed must be taken of two essential factors when 'wading in the murky waters' of interest expenditure. The first of these is the necessity for careful planning taking into account the manner in which the courts have dealt with the issue both factually and legally; and secondly given the 'murky' nature of the inquiry, the decisive role which the onus will play must not be under-estimated by both the taxpayer and SARS in limited circumstances. The following observation is a pertinent point of conclusion to this enigmatic area of taxation-

> *'A modern Midas might complain that everything he touches turns into tax. Many ordinary mortals, unhappily, seem to suffer from the same malaise. In fact, because of the gradual broadening of the tax base, it is no longer easy to call to mind any economic act devoid of tax implications. If, of course, these fiscal repercussions were certain and immutable, the only responses would be to rise in revolt (which used to be the fashion) or to wince and bear it. However, the tax laws do not fall evenly. One result is that timeous tax planning can achieve positive tax savings; while a failure to maintain tax efficiency could conceivably cause a catastrophe.'*[354]

[354] EB Broomberg *Tax Strategy* 2nd ed (1983) at 3.

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***Legislation***

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