CORE
Metadata, citation and similar papers at core.ac.uk
Provided by South East Academic Libraries System (SEALS)

TAX 11

THE DEDUCTIBILITY OF INTEREST

Richard Gunn/Lilla Stack

Abstract

The deduction of interest expenditure, for the purpose of calculating the South African taxable income on which normal tax is levied, must satisfy the requirements of the preamble to section 11 and section 11(a) of the Income Tax Act 58 of 1962, read with section 23(g), unless a particular section makes specific provision for its deduction. There appears to be a presumption that if interest expenditure is incurred in the production of income derived from carrying on a trade, it is deductible and we need look no further. This presumption may underlie the 2005 amendment of sub-section (2) of section 24J, which provides that interest is deductible provided it has been incurred "in the production of income" and "for the purposes of trade" (sections 11(a) and 23(g)). This paper discusses the deductibility of interest and, in particular, whether there are circumstances in which interest paid on a loan used to acquire a capital asset could be of a capital nature. The provisions of the Income Tax Act and court decisions relating to the deductibility of interest, as well as opinions expressed by authoritative writers on tax, are subjected to critical analysis. The paper first distinguishes the tests for determining whether an expense has been incurred "in the production of income" and whether the expense is "of a capital nature". Specific court decisions relating to the deductibility of interest are then analysed. The research considers section 24J of the Act, to determine whether its provisions have settled the debate, and refers briefly to the provisions of section 11(bB), in the context of the research question. The conclusion reached in the research is that there are occasions where the courts appear to have confused the tests for determining whether interest expenditure was incurred "in the production of income" and whether it is "of a capital nature", in certain instances have also failed to address the question of the capital or revenue nature of the interest expenditure under scrutiny, and that the matter does not appear to be settled that interest incurred on funds used to acquire a capital asset used to produce trade income is automatically deductible.

Key words: interest, taxation, capital, revenue, in the production of income

1. Introduction

The question to be addressed in this paper is the deductibility of interest expenditure and particularly whether there are circumstances in which interest expenditure could be considered to be of a capital nature. "Taxable income" is calculated by deducting from "gross income" as defined, amounts exempted from tax in terms of sections 10 and 10A, the result being "income" as defined, and then deducting from income "all the deductions allowed . . . to be deducted [from] or set off . . ." (section 1 of the Income Tax Act, 58 of 1962). Unless the deduction or set off of an amount is provided for in a specific section of the Income Tax Act, 58 of 1962 (referred to as "the Act"), the amount would have to qualify for deduction in terms of what is usually referred to as "the general deduction formula", this being the preamble to section 11 and section 11(a) of the Act, read with section 23.

The preamble to section 11 and section 11(a) of the Act provide as follows:

> For the purpose of determining the taxable income derived by any 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 . . .

This section must be read in conjunction with section 23(g), which prohibits the deduction 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 purpose of trade.

In the context of the research question it is assumed that the interest expenditure has actually been incurred during the year of assessment (section 11(a)) and has been "laid out or expended for the purpose of trade" (section 23(g)). The enquiry therefore focuses on the question of whether or not the interest expenditure has been "incurred in the production of income" and is "not of a capital nature" (section 11(a)).

What exactly these requirements encompass is not set out or defined in the Act and it is necessary to have recourse to the large number of decisions in which the courts have been called upon to provide clarity on what each requirement entails and specifically with regard to interest expenditure. "Interest" is not defined in general in the Act, but a definition was given the judicial stamp of approval in *Commissioner for Inland Revenue v Genn & Co (Pty) Ltd* 1955 (3) SA 293 (A) wherein Schreiner J.A. stated that "the commission together with the interest formed in effect one **consideration** which the company had to pay **for the use of the money** for the period of the loan" [own emphasis]. This understanding of what interest is has not been challenged and can be accepted as adequate for the present research.

There are a number of sections or subsections in the Act which deal directly or indirectly with interest. Many of these sections are anti-avoidance measures (for example, sections 8E, 8F and 31) or provide special rules which override the normal provisions of the Act (for example sections 24J and 24K). Other than a discussion of section 24J and a brief reference to section 11(bB), these special provisions are disregarded for the purposes of this research. While it could be said that section 24J has made the application of section 11(a) in relation to the deductibility of interest expenditure unnecessary and, in fact, its application prohibited in terms of section 23B, this paper argues that, under certain circumstances, interest expenditure must still comply with the requirements of section 11(a) in order for it to be deductible.

The deductibility of interest expenditure has been considered by the courts on numerous occasions, more often because the requirement of whether the expense was incurred "in the production of income" has been in issue. In the majority of cases, once it was found by the court that the interest expenditure was incurred "in the production of income", it was held

that the interest expenditure was deductible, with little if any consideration being given to the requirement of whether or not the interest expenditure was "of a capital nature".

Huxham and Haupt (2005:83) appear to be of the opinion that all interest expenditure is of a revenue nature and they state as follows:

> Interest is a payment for the use of funds and is therefore of a revenue nature. It is equivalent to rent paid for the use of a capital asset. The cases which deal with the deductibility of interest have focused on whether the interest is incurred in the production of income.

In addressing the question of the deductibility of interest expenditure, this paper:

- differentiates between the tests for expenditure incurred "in the production of income" and "not of a capital nature";
- provides a critical analysis of case law dealing with the deductibility of interest expenditure:
- establishes that there are decided cases which appear to have confused the tests and others which have failed to consider the possible capital nature of interest expenditure; and
- discusses whether or not section 24J(2), as amended in 2005, has settled the question of the deductibility of interest expenditure.

2. Differentiating between the "in the production of income" test and the "not of a capital nature" tests

The tests for determining whether expenditure is incurred "in the production of income" and is "not of a capital nature" are entirely different tests, but have on occasions in the past been confused, and it is therefore important to differentiate between them. Before setting out the difference between the two tests it is necessary to consider and understand each of the tests individually.

The "in the production of income" test

The "in the production of income" requirement has occupied the court's attention on numerous occasions and the courts have in a number of cases needed to determine whether certain expenditure could be held to have been incurred "in the production of income". Arguably the most influential decision with regard to determining whether expenditure may be said to have been incurred in the production of income is that of *Port Elizabeth Electric Tramway Co Ltd v Commissioner for Inland Revenue,* 1936 CPD 241. In the *PE Electric Tramway* case the company was obliged to pay compensation to the widow of one of its employees who was killed in an accident involving one of the company's vehicles, which the employee was driving at the time. The company sought to deduct, *inter alia*, the compensation paid to the deceased employee's family from its gross income for the year. The Commissioner for Inland Revenue refused to allow such deduction on the basis that the compensation paid was, *inter alia*, not expenditure incurred "in the production of income" as contemplated by the relevant section. Ultimately, the Cape Provincial Division was tasked with determining, *inter alia*, whether such expenditure was incurred in the production of income. The court held, *per* Watermeyer AJP at 245, that in determining whether expenditure is incurred in the production of income:

> Two questions arise (a) whether the act to which the expenditure is attached is performed in the production of income and (b) whether the expenditure is linked to it closely enough.

With regard to part (a) it was held at 245 that "provided the act is *bona fide* done for the purpose of carrying on the trade which earns the income the expenditure attendant on it is deductible". Further, with regard to question (b) that:

> all expenses attached to the performance of a 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.

The principles enunciated in the *PE Electric Tramways* case for determining whether expenditure has been incurred "in the production of income" have been approved in a great number of cases since the decision was handed down and were summarised in *Commissioner of Taxes v Rendle* 1965 (1) SA (SR, AD) as follows (62B – D):

> [T]here are three types of expenditure
>
> (1) Expenses which are necessary for the performance of the business operation;
> (2) Expenses which are attached to the performance of the business operation by chance; or
> (3) Expenses which are *bona fide* incurred for the more efficient performance of such business operations.
>
> All of these types of expenditure are deductible provided that they are [so] closely connected with the performance of the business operation …

What is important in the *Rendle* decision is that which was held with regard to the type of expenditure stated in (2) above, namely "chance" expenditure. The court held at 62E that:

> In deciding whether such an expenditure is deductible … the enquiry must be whether the "chance" of such expenditure being incurred is sufficiently closely connected with the business operation. The enquiry is not whether the actual expenditure itself (should it ever eventuate) is sufficiently closely connected.

The essence of the test is therefore the determination of the *purpose* of the act, which if found to be to produce income, moves the inquiry onto the second part, which is to determine whether the expenditure is closely enough linked to the act, and the courts have set out three types of expenditure, namely necessary expenditure, chance expenditure and expenditure to achieve "more efficient performance", which will satisfy this latter requirement.

The "not of a capital nature" test

Unlike the "in the production of income" test, there is no one single test for determining whether or not expenditure is of a capital nature. One case is often quoted by writers and judges alike, namely the case of *New State Areas Ltd v Commissioner for Inland Revenue* 1946 AD 610 (14 SATC 155) in which the court was called upon to decide whether two different amounts, which were paid in monthly instalments, were expenditure not of a capital nature and therefore deductible. The decision is important for the principles which it laid down for determining whether or not expenditure is of a capital nature. The Appellate Division, after considering a variety of court decisions (the majority of which were delivered by English courts) held *per* Watermeyer CJ, who delivered the decision for the full bench, that:

> The problem which arises when deductions are claimed is … usually whether the expenditure in question should properly be regarded as part of the cost of performing the income-earning operations or as part of the cost of establishing or improving or adding to the income-earning plant or machinery.

The court then relied on the decision of *Commissioner for Inland Revenue v George Forest Timber Co. Ltd* 1924 AD 516 (1 SATC 20) wherein Innes CJ stated at 525 that:

> money spent in creating or acquiring an income-producing concern must be capital expenditure. It is invested to yield future profit; and while the outlay does not recur the income does. 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.

After considering the *dictum* in the *New State Areas* case Schreiner J.A. held in *Commissioner for Inland Revenue v Genn & Co (Pty) Ltd* 1955 (3) SA 293 (A) (20 SATC 113) that:

> In deciding how the expenditure should properly be regarded the Court clearly 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.

It is submitted that the above is the essence of the test for determining the capital nature of expenditure. The purpose of the expenditure and what it actually effects must be looked at to determine whether it can be said to be more closely connected with performing the income-earning operations, in which case the expenditure is revenue in nature and therefore deductible, or establishing, improving or adding to the income-earning structure, in which case the expenditure is capital in nature and not deductible in terms of section 11(a).

The view has been expressed by the courts on numerous occasions, that the facts of each case are extremely important. This was highlighted by Watermeyer CJ in the New State Areas case wherein he stated at 170 that:

> [t]he true nature of each transaction must be enquired into in order to determine whether the expenditure attached to it is capital or revenue expenditure. Its true nature is a matter of fact and the purpose of the expenditure is an important factor; if it is incurred for the purpose of acquiring a capital asset for the business it is capital expenditure even if it is paid in annual instalments; if, on the other hand it is in truth no more than part of the cost incidental to the performance of the income producing operations, as distinguished from the equipment of the income producing machine, then it is a revenue expenditure even if it is paid in a lump sum.

There are a number of so-called "tests" which have been utilised or propounded by the courts when they have been faced with the task of determining whether or not an amount of expenditure is of a capital nature. The writers of this paper respectfully submit that these are not in fact alternative tests which may be used for different factual situations, but rather indicators which may be used together with the foundation of the test, as stated above, to give varying degrees of weight (depending on the facts) to either a revenue or capital expenditure conclusion. This conclusion is borne out by the dictum in *Rand Mines (Mining & Services) Ltd v Commissioner for Inland Revenue* [1997] 1 All SA 279 (A) (59 SATC 85), wherein it was stated at 92 that:

> An abiding problem has been to identify and then synthesise into a reasonably accurate and universally applicable yardstick the factors which are indicative of each of the two classes of

> expenditure. No such yardstick has yet been fashioned and the attempt has come to be regarded as futile and has been abandoned. Instead, the courts have identified useful *indicia* to which regard may be had, emphasising that they are no more than that and that in each case close attention must be given to its particular facts. In *Commissioner of Taxes v Nchanga Consolidated Copper Mines Ltd* Viscount Radcliffe warned against the notion that any of the *indicia* identified by the courts, taken singly, will always lead to the right conclusion.

3. The distinction between the two tests

In determining whether an amount is expended in the production of income, one enquires, firstly, into the purpose of the **act** entailing the expenditure, and secondly, whether the expenditure attendant upon the act is sufficiently closely connected to the act entailing the expenditure (Goldswain: 2005b). Whereas, in determining whether or not an amount of expenditure is of a capital nature, one has to enquire into the purpose of the **expenditure** to establish whether it is more closely connected with performing the income-earning operations, or establishing, improving or adding to the income-earning structure, taking into account the facts of the particular case.

One is enquiring into the purpose of two entirely different factors in each of the tests. It is, however, important to bear in mind that expenditure which is found to be "in the production of income" is not necessarily deductible, since it must still comply with, *inter alia*, the requirement that it is "not of a capital nature". Goldswain points out that "most capital expenditure meets the requirements for the 'in the production of income' test in that capital expenditure is normally to incurred produce income" (Goldswain, 2005b:3). This does not mean that expenditure which is "in the production of income" is automatically of a revenue nature.

4. A critical analysis of case law dealing with the deductibility of interest expenditure

The case law relating to the deductibility of interest expenditure is fairly extensive, with the majority of cases considering the issue within the context of interest expended on borrowed funds utilized to obtain shares or an interest in a company, close corporation or partnership. What follows deals only with those decisions which have formed the principles for the deductibility of interest expenditure, in respect of whether it is "in the production of income" and "not of a capital nature". The cases discussed pre-date the introduction of section 24J but, as this paper argues, there may be interest-bearing transactions to which this section does not apply. It is necessary, therefore, to discuss the decisions in relation to the two tests. The cases are considered in chronological order.

4.1 Case law on the deductibility of interest expenditure

Commissioner for Inland Revenue v Genn & Co (Pty) Ltd 1955 (3) SA 293 (A) dealt with the issue of whether finance charges (commission and interest) on loans taken up by the taxpayer company were deductible in terms of section 11(2)(a) read with section 12(f) and (g) of Act 31 of 1941, which sections, for the present purposes, are equivalent to those which form the general deduction formula. The funds from the loans were utilized for the purposes of financing the taxpayer's purchases of stock-in-trade. The court held, *per* Schreiner J.A., that in the circumstances of the case the commission and interest formed one consideration for the use of the money in respect of the loans. The court held further at 301 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 income of the business, whether the loan was for the acquisition of fixed or floating capital. There might of course be the further question whether or not, because of its association with the fixed capital into which the loan is turned, interest on such a loan may not properly be said to be expenditure of a capital nature. It is, however, unnecessary to pursue that question since in the present case the facts found by the Special Court show that the expenditure by way of interest or its equivalent was to meet a

> continuous demand for the means of acquiring the company's stock-in-trade, that it was not aimed at augmenting the fixed capital or maintaining an enduring asset of the Company …

The decision's significance lies in its *obiter* remarks with regard to the possible capital nature of interest expenditure, which have been relied upon in a number of cases that have dealt with the issue of the capital or revenue nature of interest expenditure.

In *Commissioner for Inland Revenue v Drakensberg Garden Hotel (Pty) Ltd* 1960 (2) SA 475 (A) the taxpayer company leased a hotel and a trading store situated on the same premises and subsequently purchased all the shares in the lessor company from which it leased the two premises, its object in doing so being "to enable it to have absolute control of the hotel and the store premises, thereby ensuring for itself security of tenure and the rights to make improvements as it desired and to sub-let at such increased rental or otherwise". Interest was payable to the sellers of the shares at seven per cent on the outstanding balance of the purchase price. The respondent sought to deduct this interest from its income in terms of section 11(2)(a) of Act 31 of 1941, which the Commissioner had disallowed. Schreiner J.A., who delivered the judgment for the majority, only dealt with the issue of whether the expenditure was in the production of income. The Commissioner's main contention was that the interest expenditure was incurred to purchase the shares, from which dividend income would be received, and since such income was exempt in terms of the Act, it could not be said that the interest expenditure was incurred "in the production of income". The majority found in favour of the respondent, holding that there was a sufficient connection between the interest expenditure and the taxpayer's income derived from rent and business profits for such expenditure to be deductible. The capital nature of the expenditure was not formally dealt with by the majority. Van Wyk A.J.A., who gave a dissenting judgment, found that the interest expenditure was of a capital nature. The learned judge did not however provide any

reasons for such a conclusion, and therefore one can only tentatively assume, from a reading of his judgment, that because the expenditure for the purchase of the shares was, in his view, of a capital nature, the interest attached thereto was also of a capital nature.

Commissioner for Inland Revenue v Allied Building Society 1963 (4) SA 1 (A), in essence, involved the payment of interest on funds received as deposits from the public. The respondent derived its income from interest on loans made by it, interest on Government, municipal and other stock, *et cetera*. All moneys received by the respondent were regarded as forming a single pool which it used to meet all the payments due by it. Certain of the expenditure of the respondent, so it was contended on behalf of the Commissioner, related to immovable properties which were at the time 'temporarily, non-revenue producing, properties'. The Commissioner therefore contended that the expenditure relating to such properties, calculated in terms of an agreed upon formula, was not deductible in terms of section 11(2)(a) read with section 12(g) of Act 31 of 1941. This contention was based on the following submission:

> . . . expenditure incurred in respect of capital assets not employed by the Society in its income earning operations or in the course of its trade; that, consequently, such expenditure is, within the meaning of sec. 11(2)*(a)* of the Act, of a capital nature and not incurred in the production of the Society's income; and that, the expenditure not having been wholly or exclusively laid out or expended for the purposes of trade, it is, in any event, prohibited from deduction by the terms of sec. 12*(g)* of the Act.

The argument in support of this contention was that the true criterion of deductibility, it was submitted, is not the purpose for which the Society borrows but the actual use to which the borrowed money is put. Essentially, the enquiry involved the deductibility of pre-production interest expenditure on funds used to purchase capital assets which did not, during the year of assessment, produce income.

Ogilvie Thompson J.A. who delivered the judgment for the majority of the court, held that the ultimate use or destination of all the money borrowed was, on the facts of the case, not a decisive factor. Rather, relying on the *dictum* in the *PE Electric Tramways* case, the most important factor was held to be the 'purpose of the borrowing'. The learned judge then went on to state at 14 that:

> Again, in *New State Areas Ltd v Commissioner for Inland Revenue*, 1946 AD 610 at p. 627, the same learned Judge, then CHIEF JUSTICE, in his authoritative formulation of his conclusion, drawn from a large body of cases, regarding the distinction between capital and revenue expenditure, incorporated the statement that 'the purpose of the expenditure is an important factor'. In the present case, therefore, the vital enquiry, in my opinion, relates to the purpose for which the money is borrowed by the Society.

The majority went on to hold that the respondent's purpose in borrowing the money, on which it paid interest, was to obtain a means of earning income, *id est* was floating capital which it lent out and on which it earned interest. The interest paid on the money which it borrowed was clearly expenditure incurred 'in the production of income'.

With regard to the issue of the capital nature of the expenditure, the court held that on the facts of the case it would be "artificial to invoke the existence of these non-revenue producing properties as sufficient justification for regarding portion of the interest paid … as being expenditure of a capital nature…" (page 16). For this conclusion the court relied on the *dictum* in the *Genn & Co (Pty) Ltd* case, and that there was "no sufficiently close association between the borrowing and the non-revenue producing properties as to warrant the view that portion of the interest paid by the Society on the money it has borrowed is expenditure of a capital nature" (page 16).

Steyn C.J., who delivered a dissenting judgment, found in favour of the Commissioner in respect of the appeal. His reasons were that the purpose for which the money was borrowed

was composite, to obtain floating capital and to purchase the properties. The learned Chief Justice concluded at 10 as follows:

> [T}he interest in issue must be taken to have been paid in respect of an amount borrowed and used for the purpose of acquiring the properties in question. As these properties did not during the year of assessment form part of the respondent's income producing concern, the interest paid was expenditure of a capital nature…

It is submitted with respect that there appear to be certain misconceptions or perhaps misstatements of the law in both the majority judgment and that of Steyn C.J. In the majority judgment it was held that the vital enquiry relates to the 'purpose for which the money is borrowed', which is an enquiry into the purpose of the act, *id est* the test for the determination of whether the expenditure was incurred in the production of income. In coming to this conclusion Olgilvie Thompson J.A. referred to the statement by the court in the *New State Areas* case, that 'the purpose of the expenditure is an important factor'. It is not clear why reference is made to this part of the judgment since, as the learned judge notes, it relates to the distinction between capital and revenue expenditure. However, the majority correctly held that the purpose of the act (the borrowing of the money) was to obtain funds which it would in turn lend out, and thereby earn income in the form of interest. The expenditure, in the form of interest, which was attached to the act of borrowing and was necessary to obtain its 'floating capital', was therefore quite clearly incurred in the production of income. With regard to the issue of the capital nature of the expenditure, the majority concluded that there was not a sufficiently close association between the borrowing of the money and the non-revenue producing properties to warrant the conclusion that portion of the interest expenditure was of a capital nature. This however states the test for determining whether expenditure is of a capital nature incorrectly, since the true test is the purpose of the **expenditure**, and whether it is more closely associated with performing the income-earning operations, or establishing, improving or adding to the income-earning structure. This is not

to say that the overall conclusion is incorrect, for there is something to be said for distinguishing between interest expenditure for a specific purpose and that for general purposes. However, this latter issue is outside the purview of this paper.

In his dissenting judgment Steyn C.J. stated the gist of the capital nature test correctly, wherein he said that it was necessary to enquire into the true nature of the transaction, which is a matter of fact, and that the purpose of the expenditure is an important factor. The learned judge's findings differed from those of the majority on the basis that the purpose of at least part of the expenditure was, in his opinion, quite clearly for the purchase of the unproductive properties, as opposed to the majority view that such purpose was merely incidental to the main purpose of the Society, being the obtaining of floating capital. It is, however, important to note in relation to Steyn C.J.'s judgment that he concluded that because the relevant properties did not, during the year of assessment, form part of the respondent's income producing concern the interest paid was, *inter alia*, expenditure of a capital nature. The fact that the properties do not form part of the income producing concern is not important to the enquiry into the capital nature of the expenditure, since expenditure on a capital asset which does form part of the income producing concern could, it is argued, still be expenditure of a capital nature. The conclusion that the properties do not form part of the income producing concern is a conclusion more congruent with a finding that the expenditure was not incurred in the production of income. Justice Steyn appears to be stating that the interest was of a capital nature because the properties in question did not yield income and not, I argue with respect, that the properties were inherently of a capital nature. Section 11(bA) has since been introduced into the Act to deal specifically with the deductibility of interest expenditure to acquire capital assets, which is incurred in a year of assessment prior to the year in which the assets are brought into use.

In *Income Tax Case No 1124*, (1968) 31 SATC 53 (T), the issue before the court was whether an amount of interest expenditure was deductible from the ordinary income of the taxpayer company in terms of section 11(a) of Act 58 of 1962 as an expense not of a capital nature, incurred in the production of income. Trollip J, delivered the judgment of court and held with regard to the capital nature of the interest expenditure that the loan liability incurred by the appellant company for the acquisition of the two companies was of a capital nature, since it enabled the company to acquire capital assets in the form of shares, and thereby a possible enduring benefit in the form of a constant supply of timber. However, relying on the *dictum* in *Genn & Co (Pty) Ltd* the learned judge held that the interest on the loan was not of a capital nature (at 56):

> In the present case the interest paid was the recurrent or periodical charge or 'rental' payable for the continued use by the appellant company of the money lent to it. Such interest was not intended or calculated to, nor did it in fact, improve, augment or preserve those aforementioned capital assets, or form part of or add to the cost of acquiring them or enhance their value. Consequently, we do not think that in the circumstances of this case the interest was so closely identified or associated with those capital assets that it must itself be regarded as being of a capital nature.

From the above conclusion it appears that the learned judge based his conclusion on the principle that the interest expenditure was not "so closely identified or associated with [the] capital assets that it must itself be regarded as being of a capital nature". It is submitted that this is not an entirely correct statement of the test, and that the true nature of the test is not whether the expenditure is so closely associated with the capital asset, but rather whether it is more closely connected with performing the income-earning operations, or establishing, improving or adding to the income-earning structure. It is difficult to see in what way the interest expenditure was more closely associated with performing the income-producing operations than the income-earning structure in this case. Furthermore, it appears that a

certain amount of reliance was placed on the fact that the interest expenditure was recurrent, which is not a conclusive factor, but at best a mere indicator.

The requirement that, to be classified as expenditure "of a capital nature", the interest would need to meet the requirement that it would "improve, augment or preserve those aforementioned capital assets" appears to have found support in the opinion of the authoritative writer De Koker, who takes the following view of the issue:

> It does not necessarily follow that because liability under a loan is incurred for the acquisition of 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 or calculated to nor does it in fact improve or augment the capital assets of the business or form part of or add to the cost of acquiring them or enhance their value, it cannot be regarded as being so closely identified or associated with capital assets that it must itself be regarded as being of a capital nature. (De Koker, 2005:7-36)

It is important to note that the *dictum* of this case was authoritatively relied upon by the Appellate Division, as it was then, in the case of *Burgess v Commissioner for Inland Revenue* 1993 (4) SA 161 (AD).

In *Income Tax Case No 1126*, (1968) 31 SATC 111 (T), the appellant, an individual taxpayer, was employed by a private company and in order to increase his income, purchased shares in the company. To fund the purchase of these shares the taxpayer borrowed a substantial amount of money on which he was required to pay interest. The issue upon which the court was called upon to decide was whether the interest payment was allowable as a deduction in terms of section 11(a) of Act 58 of 1962, being expenditure incurred in the production of income, not being expenditure of a capital nature.

The court held, *per* Galgut J., that the taxpayer's main purpose when acquiring the shares was to obtain a "major share and control in a profitable business concern" (page 112), and stated further at 112 that:

> The purchase price paid by the appellant when acquiring the shares was clearly capital expenditure. When the expenditure was made – that is the purchase of the shares - it was made with a view to bringing into existence an asset or advantage for the benefit of the appellant. The benefit which he wished to obtain was the control of a profit-making concern which would produce income.

On the basis of the above the learned judge went on to hold at 113 that:

> Here the purchase price was paid to acquire the shares which gave appellant control of the company. Such expenditure was of a capital nature in that the control he acquired can be likened to the acquisition of the income-earning structure. The money to pay the price was borrowed. Interest payable on such price is, in my view, also capital expenditure and thus not deductible in terms of section 11(a) of Act No 58 of 1962, or its associated section 23(g).

The learned judge did not rely on any authority for the conclusion that the interest expenditure was not deductible. Rather, his conclusion was based on the interest expenditure's association with the purchase price of the 'income-earning structure' in the form of shares in the company, being a capital asset. It is for this lack of reference to authority that the judgment has been criticised.

In *Income Tax Case No 1356*, (1981) 44 SATC 139 (EC), the taxpayer, which was an investment holding company, appealed against the disallowance by the Commissioner of deductions of certain interest expenditure incurred on borrowed money, which was borrowed, *inter alia*, for the purpose of acquiring shares/interests in subsidiary companies and to make interest-free loans to these subsidiaries. The court held that the purpose in acquiring the shares in the subsidiary companies was not what it purported to be, but specifically to obtain income for management services rendered to such companies. The court, *per* Smalberger J., held at 142, relying on the *dictum* in *ITC 1126* (*Supra*) that:

> The overall intention of the appellant appears to have been to acquire capital assets to obtain a source of income. In that case the expenditure incurred in acquiring the shares was of a capital nature, and the interest paid thereon likewise capital expenditure, and therefore not tax deductible.

By virtue of the court's reliance on *ITC 1126* the decision has been criticised for very similar reasons as the aforementioned case. It is not clear why the court did not make reference to any further authority for its conclusions.

The facts of *Commissioner for Inland Revenue v Standard Bank of SA Ltd*, 1985 (4) SA 485 (A), are similar to that of the *Allied Building Society* case in that the respondent taxpayer was a bank which 'borrowed' money from members of the public (its customers) on which it was required to pay interest. Whereas the *Allied Building Society* case involved 'non-revenue producing properties', the present dispute concerned the utilization by the respondent of part of the above deposit moneys for the purchase of redeemable preference shares. By virtue of the fact that the dividends received on these shares were exempt in terms of section 10(1)(k) of Act 58 of 1962, the Commissioner contended that a proportionate share of the interest paid by the respondent should be disallowed as a deduction, not being expenditure incurred in the production of income, not of a capital nature.

Relying extensively on the *Allied Building Society* case and *Financier v Commissioner of Taxes* 1950 (3) SA 293 (SR) Corbett JA, who delivered the court's judgment, held that the following could be established:

> (1) Generally, in deciding whether money outlayed by a taxpayer constitute (*sic*) expenditure incurred in the production of the income (in terms of the general deduction formula) important and sometimes overriding factors are the purpose of the expenditure and what the expenditure actually effects; and in this regard the closeness of the connection between the expenditure and the income-earning operations must be assessed.

> (2) More specifically, in determining whether interest (or other like expenditure) incurred by a taxpayer in respect of moneys borrowed for use in his business is deductible in terms of the general deduction formula and its negative counterparts in the Act, a distinction may in certain instances have to be drawn between the case where the taxpayer borrows a specific sum of money and applies it to an identifiable purpose, and the case where, as in the instance of the Society in the *Allied Building Society* case and the Bank in the present case, the taxpayer borrows money generally and upon a large scale in order to raise floating capital for use in his (or its) business.
>
> (3) 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. Both these factors are, therefore, important considerations in determining the deductibility of the expenditure.
>
> (4) In the latter type of case, however, and more particularly in the case of institutions like the Society and the Bank, 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. (page 501)

The court concluded that the purpose of the bank borrowing the money was to obtain floating capital with which to run its business. Hence, the interest expenditure was incurred "in the production of income" and therefore deductible. The court did not deal with the capital or revenue nature of the expenditure.

In (1) above the court stated that in determining whether expenditure is incurred in the production of income "important and sometimes overriding factors are the purpose of the expenditure and what the expenditure actually effects; and in this regard the closeness of the connection between the expenditure and the income-earning operations must be assessed". The learned judge used the word "sometimes" and, in the context of the decision, this comment is an *obiter* remark. It is again submitted, with respect, that the court has misstated

the test for determining whether an amount of expenditure is in the production of income as contemplated by the general deduction formula. This is in fact the test for determining whether or not expenditure is of a capital nature. The test for determining whether expenditure is in the production of income, is whether the purpose of the act (in this case the borrowing of the money) is to produce income and whether the expenditure (the interest expenditure in this case) is closely enough linked to such act.

As in the *Allied Building Society* case, the distinction was made by the court with regard to borrowing a specific sum of money and applying it to an identifiable purpose, and the case where the taxpayer borrows money generally and upon a large scale in order to raise floating capital for use in its business. This issue, however, is not within the purview of the present paper.

The appellant taxpayer in *Income Tax Case No 1604*, (1995) 58 SATC 263 (EC), was the managing director of a company, which was converted into a close corporation. The appellant purchased a forty-nine percent interest in the close corporation, which agreement also included employment as managing director at an agreed remuneration and a *pro rata* share of the profits of the corporation. In order to fund part of the purchase of such interest the appellant obtained a loan from a financial institution. The appellant sought to deduct from his income the interest which he incurred on the aforementioned loan in terms of section 11(a) of Act 58 of 1962. The issue before the court was whether the interest was deductible in terms of the general deduction formula. The Commissioner's main contention was that the appellant, by obtaining the interest in the corporation, had acquired an 'income-earning structure' *id est* a capital asset, and therefore the interest, because it was more closely related to the capital asset, was not deductible as it was expenditure 'of a capital nature'.

With regard to the issue of the capital nature of the interest expenditure, Melunsky J, who delivered the court's judgment, relied extensively on the case of *ITC 1124* 31 SATC 53. The learned judge held at 271, based on the facts of the case that it was:

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

The court distinguished the cases of *ITC 1126* (31 SATC 111) and *ITC 1356* (44 SATC 139) on the basis that neither of them made any reference to the *Genn & Co (Pty) Ltd* case. The court preferred the decision in *ITC 1124*, certain aspects of which have already been criticized, which criticism, in as much as it relates to this case, holds true for the present purposes. A further point which must be highlighted is the court's reference to the interest expenditure lacking the characteristic of improving, augmenting or preserving any capital asset of the corporation, or adding to the cost of doing so. It is submitted that although these characteristics may form part of the broader test, the true basis of the test is whether the expenditure is more closely associated with performing the income-earning operations, or establishing, improving or adding to the income-earning structure, not whether it in fact has such effect.

4.2 Concluding remarks in respect of the cases

Perhaps the most notable point which is highlighted by the above cases is that which was pointed out by Goldswain, whereby he states that the courts have in the past had a habit of confusing the two deduction tests, referring to the "in the production of income" test and the "not of a capital nature" test. The probable reason the learned writer identifies for this

phenomenon is that most capital expenditure meets the requirements for the "in the production of income" test, because the purpose of the capital expenditure is normally to produce income (Goldswain: 2005b). Goldswain stressed the importance of differentiating between the tests and stated that "it will be seen that although the tests may seem similar for determining whether expenditure is incurred in the production of income or whether expenditure is of a capital nature, they are definitely not the same tests" (Goldswain 2005a:4).

The similarity in the tests, as has already been pointed out, is that they both require an enquiry into the purpose of something, namely the **act** or the **expenditure**. Furthermore, one is looking for some form of close link, either with the expenditure to the act in the case of the "in the production of income" test, or whether there is a closer link between the expenditure and the income-earning operations or income-earning structure for the "not of a capital nature" test. It is evident from the cases discussed that the courts have on various occasions confused the tests, which has created a certain amount of uncertainty. In some instances the court stated the test incorrectly, but then proceeded to apply the correct formulation of the test. As a result of this a further problem which arises is that, because the *dicta* in the above cases are relied upon as authority for formulation of the tests with regard to the deductibility of interest expenditure, the incorrect application and/or misstatement of the tests continue. An example of both of these occurrences can be found in *Income Tax Case No 1504* (1991) 53 SATC 349 (C) wherein the court relied on the *dictum* in the *Standard Bank of SA Ltd* case (*Supra*) for holding that the test for determining whether the interest expenditure under consideration was incurred in the production of income, one had to "seek to determine both the purpose of the payment of interest and whether a clear and close causal connection can be found between the payment of interest and the production of … income" (page 349). The

court did however correctly go on to enquire into the purpose of the loan *id est* the act, as opposed to the purpose of the expenditure.

Another issue, or perhaps misconception, that is evident from the cases is the court's requiring the expenditure to be intended or calculated to, or in fact, improve, augment or preserve the capital asset(s), or form part of or add to the cost of acquiring them or enhance their value, before it will be classified as capital expenditure. This is not entirely a correct statement of the test, for in terms of the *New State Areas* case it is stated at 164 that usually whether the expenditure in question should properly be regarded as part of the cost of performing the income-earning operations or as part of the cost of establishing or improving or adding to the income-earning plant or machinery is the true test. Therefore it does not have to have the effect of augmenting or improving, but rather merely properly be regarded as part of the cost thereof *id est* be more closely associated with the income-earning structure.

From the court decisions discussed it appears that the courts

- have on occasions confused the tests for "in the production of income" and "not of a capital nature"; and
- on occasions have failed to consider the capital nature of the interest expenditure.

5. The effect of section 24J

Section 24J was inserted into the Act by section 21(1) of Act No. 21 of 1995. The section, under the heading "incurral and accrual of interest" deals with interest which, for the purposes of the section, includes the gross amount of interest, finance charges, discount or a premium payable or receivable in respect of a financial arrangement, whether calculated with reference to a fixed or variable rate or whether payable or receivable as a lump sum or in

unequal instalments during the term of the financial arrangement (section 24J(1)). The accrual or incurral of interest is calculated on the basis of the yield to maturity on the financial arrangement (with one exception not relevant to this discussion).

For the purposes of this research, it is sufficient to note the provisions dealing with the accrual and incurral of the interest. Any person (the issuer) shall be deemed to have incurred an amount of interest during the year of assessment (as calculated in terms of section 24J), "which must be deducted from the income of that person from carrying on any trade, if that amount is incurred in the production of income" (section 24J(2)). Also, an amount of interest (as calculated in terms of section 24J) is deemed to have accrued to a person (the holder) and "must be included in the gross income of that person during that year of assessment (whether or not that amount constitutes a receipt or accrual of a capital nature)" (section 24J(3)).

In the Explanatory Memorandum to the Revenue Laws Amendment Bill, 2004 (page 22), it was stated that:

> Currently section 24J does not provide for the inclusion in gross income of a taxpayer of interest accrued or the deduction from the income of a taxpayer of interest incurred. In order to provide certainty as to the tax treatment of interest and to introduce the principle that interest should always be treated on revenue account it is proposed that section 24J be restructured to specifically provide for the inclusion in gross income of interest deemed to have accrued or the deduction from income of interest deemed to have been incurred in terms of that section. Section 24J(2) and (3) are to be amended to give effect to this principle.

The reason given for the amendment of the sub-sections clearly states the intention of the legislature to regard all interest as being of a revenue nature. Yet, the question can be asked why the legislature provided specifically in section 24J(3) for the inclusion of interest, **whether or not it is of a capital nature**, but failed to make the same provision in relation to

the deduction of interest in section 24J(2)? Can this be interpreted to mean that once the interest has met the "in the production of income" and "carrying on a trade" tests, the legislature considered it to be settled law that it is automatically deductible? It is submitted with respect, in the light of the apparent uncertainty arising from the court decisions discussed, that the law is not settled and that the present formulation of section 24J(2) has not placed the matter beyond doubt. It is submitted that the interest sought to be deducted would still have to meet the test of not being "of a capital nature". Furthermore, in determining whether interest expenditure has been incurred "in the production of income", it is essential that the appropriate tests should be used.

6. Conclusion – have the legislature and the courts got it right?

If the deductibility of interest expenditure only requires the taxpayer to satisfy the "in the production of income" and "trade" tests, section 24J has, indeed, settled the matter. Comments such as those made in the case of *Commissioner for Inland Revenue v Shapiro* 4 SATC 29 (N) wherein Matthews J stated at 35 "[t]he payment of interest on borrowed money obviously not being an outgoing of a capital nature, the contention was that it was an outgoing actually incurred during the year of assessment in the production of the taxpayer's income", or those in *Income Tax Case No 1625* (1996) 59 SATC 383 (T) wherein at 394 it was held that "[t]here can be no doubt that the interest expenditure incurred by the appellant in the year of assessment was for the purpose of financing the acquisition of the property from which it derived income. Interest recurrently … so expended is not of a capital nature", seem to indicate that, in relation to the issue as to whether interest expenditure may in certain circumstances be of a capital nature, it has been settled that it can not. However, from the discussion in this paper of the case law on the issue, it appears that the matter is not entirely settled. Section 24J(2) is not the final word.

The conclusion that in certain circumstances interest expenditure may correctly be said to be "of a capital nature" is further borne out by section 11(bB) of the Act, which provides, *inter alia*, for the deduction as follows of:

> any finance charge incurred by the taxpayer in respect of the purchase or contract price owing under an agreement for the acquisition, installation, erection or construction of any machinery, plant, aircraft, utensil, article or livestock used by him for the purposes of his trade, … which deduction shall be lieu of any deduction or allowance in respect of such finance charge which may be allowable under any other provision of this Act…

A 'finance charge' as contemplated by this section is in essence a payment for the use of money payable to acquire the asset in question, and therefore is very similar to an interest payment on borrowed funds. In fact the only distinction between the two is that a finance charge is calculated in advance and added to the cash cost of the asset for the purpose of calculating the instalments to be paid in order to settle the liability within the contract period. It would therefore appear from the mere fact that section 11(bB) was introduced into the Act, that the Legislature contemplated that, under certain circumstances, "finance charges" could be of a capital nature, and hence the cost of borrowing may be of a capital nature. Section 24J includes "finance charges" in the definition of interest and, with the amendment of sub-section 24J(2), section 11(bB) would have become redundant if all interest is deductible.

The conclusion that must therefore be reached is that, on a proper application of the test for determining whether expenditure is of a capital nature or not, interest expenditure incurred on money borrowed to acquire a capital asset is expenditure of a capital nature. Therefore, decisions such as those in *ITC 1126* and *ITC 1356* are, other than for their lack of authoritative reasoning, correct. In the interest of certainty, it would seem to be necessary that

the legislature should place the matter beyond doubt by a further amendment to section 24J(2).

Bibliography

Literature

DE KOKER, A. (2005). *Silke on South African Income Tax.* Vol 1. Durban: LexisNexis Butterworths.

GOLDSWAIN, G. (2005). *Module 5: Postgraduate Certificate in Advanced Taxation* (Unpublished). Pretoria: University of South Africa.

GOLDSWAIN, G. (2005). *Module 6: Postgraduate Certificate in Advanced Taxation* (Unpublished). Pretoria: University of South Africa.

HUXHAM, K. and HAUPT, P. (2005). *Notes on South African Income Tax* (24th ed)**.** Roggebaai: H. & H. Publications.

Statutes

Income Tax Act No. 58 of 1962 (and its predecessors).

Cases

Burgess v Commissioner for Inland Revenue 1993 (4) SA 161 (AD).

Commissioner for Inland Revenue v Allied Building Society 1963 (4) SA 1 (A).

Commissioner for Inland Revenue v Drakensberg Garden Hotel (Pty) Ltd 1960 (2) SA 475 (A).

Commissioner for Inland Revenue v Genn & Co (Pty) Ltd 1955 (3) SA 293 (A).

Commissioner for Inland Revenue v George Forest Timber Co. Ltd 1924 AD 516 (1 SATC 20).

Commissioner for Inland Revenue v Shapiro 4 SATC 29(N).

Commissioner for Inland Revenue v Standard Bank of SA Ltd 1985 (4) SA 485 (A).

Commissioner of Taxes v Rendle 1965 (1) SA (SR, AD).

Financier v Commissioner of Taxes 1950 (3) SA 293 (SR).

Income Tax Case No 1124 (1968) 31 SATC 53 (T).

Income Tax Case No 1126 (1968) 31 SATC 111 (T).

Income Tax Case No 1356 (1981) 44 SATC 139 (EC).

Income Tax Case No 1504 (1991) 53 SATC 349 (C)

Income Tax Case No 1604 (1995) 58 SATC 263 (EC).

Income Tax Case No 1625 (1996) 59 SATC 383 (T).

New State Areas Ltd v Commissioner for Inland Revenue 1946 AD 610 (14 SATC 155).

Port Elizabeth Electric Tramway Co Ltd v CIR 1936 CPD 241.

Rand Mines (Mining & Services) Ltd v Commissioner for Inland Revenue [1997] 1 All SA 279 (A) (59 SATC 85).