IN THE HIGH COURT OF SOUTH AFRICA
(WESTERN CAPE DIVISION, CAPE TOWN)

Case No: A124/2017

L TAXPAYER Appellant

and

THE COMMISSIONER FOR THE SOUTH AFRICAN REVENUE SERVICE Respondent

Court: Justice R Allie, Justice J Cloete *et* Justice L Nuku
Heard: 31 January 2018
Delivered: 27 February 2018

JUDGMENT

CLOETE J:

Introduction

[1] This is an appeal in terms of s 133 of the Tax Administration Act[1] against the judgment of the Tax Court handed down on 13 December 2016 in which it upheld the disallowance by SARS of interest deductions claimed by the taxpayer in respect of the 2010 to 2012 years of assessment.

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1 No 28 of 2011.

[2] The central issue is whether, as the taxpayer contends, there is a sufficiently close connection between the interest expense incurred by him on a loan facility with Investec Bank ("the Investec loan") and the interest earned from time to time on the outstanding balance of his director's loan to his employer, Bowman Gilfillan ("the Bowmans loan") for purposes of s 11(a) of the Income Tax Act ("ITA").[2]

[3] Section 11(a) provides *inter alia* that in the determination of taxable income, a taxpayer is entitled to the deduction of expenditure (save for capital expenditure) actually incurred in the production of income from any trade.

[4] In its rule 31 statement SARS also relied on s 23(g) of the ITA which stipulates that monies outlaid or expended for purposes other than trade may not be claimed as a deduction. This reliance was abandoned at the commencement of proceedings in the Tax Court, SARS having conceded that it would be impermissible in terms of rule 31(3) of the Tax Court rules, given that this did not form the basis of the original disallowance.

[5] The taxpayer was thus not obliged to show that the interest expense was incurred for the purposes of trade, and thus not prohibited by s 23(g).

[6] In his tax returns for the years in question the taxpayer claimed as a deduction a portion of the interest expense on the Investec loan to the extent that he had to "fund" the Bowmans loan.

[2] No. 58 of 1962

[7] SARS disallowed the deduction essentially on three grounds: First, SARS practice note 31 ("PN 31") requires the underlying capital to be borrowed and then lent for the interest income to qualify for purposes of s 11(a). Second, the interest on the amount owed under the Investec loan was not incurred in the production of interest income on the Bowmans loan. Third, the Bowmans loan was not sourced from the Investec loan.

[8] PN 31[3] provides as follows:

> *'1. To qualify as a deduction in terms of section 11(a) of the Income Tax Act (the Act) expenditure must be incurred in the carrying on of any "trade" as defined in section 1 of the Act. In determining whether a person is carrying on a trade, the Commissioner must have regard to, inter alia, the intention of the person. Should a person, therefore, borrow money at a certain rate of interest with the specific purpose of making a profit by lending it out at a higher rate of interest, it may well be that the person has entered into a "venture" and is thus carrying on a trade (50 SATC 40). In other words, interest paid on funds borrowed for purposes of lending them out at a higher rate of interest will, in terms of section 11(a) of the Act, constitute an admissible deduction from the interest so received by virtue of the fact that this activity constitutes a profitmaking venture.*
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> *2. While it is evident that a person (not being a moneylender) earning interest on capital or surplus funds invested does not carry on a trade and that any expenditure incurred in the production of such interest cannot be allowed as a deduction, it is nevertheless the practice of Inland Revenue to allow expenditure incurred in the production of the interest to the extent that it does not exceed such income. This practice will also be applied in cases where funds are borrowed at a certain rate of interest and invested at a lower rate. Although, strictly in terms of the law, there is no justification for the deduction, this practice has developed over the years and will be followed by Inland Revenue.'*

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[3] Dated 3 October 1994.

Background facts

[9] The taxpayer is a qualified solicitor in England and Wales but is not qualified as an attorney in South Africa. On 8 June 2004 he was offered a position by attorneys Bowman Gilfillan within its corporate department. Because he lacked the South African qualification he was unable to be appointed as an equity director, but would *'carry the status of and be treated'*[4] as such. He accepted the offer and took up employment in early October 2004.

[10] At all material times it has been a term of his employment contract that the taxpayer must loan funds to Bowman Gilfillan to assist with ongoing working capital requirements (the Bowmans loan). Initially this loan was funded by crediting his loan account with 20% of his annual gross remuneration in 36 equal monthly instalments.

[11] The taxpayer participated in the profits of Bowman Gilfillan at a percentage (his participation percentage) that varied marginally year-on-year. His budgeted profit share for each year was determined as his participation percentage of the budgeted profits for that year. He was entitled to a monthly draw (akin to a salary, including deductions) which, after expiration of the initial period referred to above, was determined as 65% of his budgeted profit share for the year, spread over 12 months. The remaining 35% was retained in part as a margin for any shortfall between actual profit and budgeted profit, and as an obligatory loan to fund cash flow. This obligatory loan constituted the growth in the Bowmans loan, year-on-year.

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[4] Record Vol 1 pp27-36, i.e. other than a salaried director.

Interest accrues monthly at prime rate on the amount standing to the credit of the Bowmans loan from time to time.

[12] Distributions based on actual profit and available cash on hand are made periodically (as determined by the CEO or finance committee in their sole discretion on recommendation of the financial director) and, in the case of the taxpayer, are debited against the Bowmans loan. The taxpayer also receives payment of interest accrued on that loan which is treated as taxable income in his hands. He cannot demand repayment of the Bowmans loan for so long as he remains an employee.[5]

[13] In August 2005 (i.e. 10 months after he commenced employment), the taxpayer purchased an immovable property for residence purposes. The purchase price was paid with the proceeds of a loan from Investec Bank (the Investec loan) secured by way of a mortgage bond registered against the title deed of that immovable property. This loan is a so-called access facility.[6] By 1 March 2009 the taxpayer had made payments into, and withdrawals from, the facility to fund a variety of expenses and continues to do so. The capital balance of the Investec loan, which thus fluctuates, attracted interest during the relevant period at the rate of prime minus 1.85% per annum.

[14] For the tax years in issue the taxpayer claimed, as a deduction, a portion of the interest accruing on the Investec loan (“the interest expense”) against the interest received on the Bowmans loan (“the interest income”). The interest deduction

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5 Record Vol 4 p296.
6 It was initially structured as two loans and consolidated into one loan in August 2011.

claimed was limited in two respects. First, it was calculated on an amount equivalent to the capital balance of the Bowmans loan. Second, it was less than the interest income received on the Bowmans loan due to the interest rate differential between the two loans.

[15] The taxpayer testified that, had the full amount of the Bowmans loan been repaid in the discretion of his employer during the 2010 to 2012 tax years, he would have paid it into the Investec loan.[7] This is supported by his conduct, at least from 1 March 2010, in which each significant distribution from his profit share resulted in a deposit of approximately the same amount into his Investec loan.[8]

[16] He also testified that, although clear from the agreement concluded in respect of the Investec loan that its initial purpose was to fund the purchase of his residence,[9] if he had no obligation to maintain the Bowmans loan its proceeds would have been paid into the Investec loan,[10] thereby reducing the capital and interest incurred thereon. It was for these reasons that the taxpayer claimed the deductions in question, submitting that there was a sufficiently close connection between the interest income and the interest expense for purposes of s 11(a), as read with PN 31.2.

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[7] Record Vol 4 pp296-297, 329 and 346.
[8] Record Vol 3 pp269-270.
[9] Record Vol 4 p369.
[10] Record Vol 4 pp371-372.

Findings of the Tax Court

[17] The Tax Court formulated the issue before it as follows:

> *'The question… is whether the amount in credit in the appellant's loan account constitutes monies borrowed on the basis of which the expenditure incurred, in the form of interest paid on the home loan account,* [is such as] *to justify a conclusion that the interest so paid could be said to have been expended to earn interest income'.*[11]

[18] It found that from the outset the taxpayer knew that the Bowmans loan could never be applied to *'reduce'* the Investec loan for so long as he remained employed. This was thus a fact known to him when he took out the Investec loan. The taxpayer was not entitled to the exemption contained in PN 31.2 because it contemplates interest earned on capital or surplus funds actually invested whereas in the taxpayer's case it was simply interest income earned on income retained by his employer in terms of his contract of employment.

[19] Moreover, it found that the interest contemplated in PN 31.2 is that earned on funds first received and thereafter invested at the taxpayer's election.[12]

[20] The Tax Court also placed reliance on the fact that the taxpayer's intention in taking out the Investec loan was to pay for his residence. It found that *'there is no indication on the record of evidence of a change of intention or, if his initial intention had changed at some point, at what point was there a change of intention'.* It thus

[11] Judgment para [4], Record Vol 5 p383.
[12] Judgment paras [13] to [14], Record Vol 5 p388.

found that whatever interest was incurred on the Investec loan, it was due to the acquisition of a capital asset and the interest expenditure thus incurred was of a capital nature and was not actually incurred in the production of income as contemplated by s 11(a).[13]

[21] It must be mentioned that the Tax Court appears to have misconstrued the evidence before it in two material respects. First, it stated that the periodical distributions made by the taxpayer's employer pertained only to interest accrued on the Bowmans loan.[14] Second, it stated that the Investec loan was initially a "pure" home loan which was converted at a later stage to an access facility.[15] The taxpayer's evidence instead established that distributions were not limited to the interest component only, and that the access facility had been in place from the time that he purchased his residence.

Submissions on appeal

[22] The taxpayer's principal argument is that there is a direct causal link between the interest income and the interest expense, supported by his uncontested evidence that if the Bowmans loan were to be repaid to him, such repayment would in fact be appropriated to reduce the balance of the Investec loan (and concomitantly the interest incurred thereon) as evidenced also by what actually occurred since at least March 2010. Consequently, the reduction in the interest accrual brought about by

[13] Judgment para [24], Record Vol 5 p393.
[14] Judgment para [2], Record Vol 5 p381.
[15] Judgment para [3], Record Vol 5 pp381-382.

such repayment directly results (and would result) in a reduction of the interest expense.

[23] Put differently, he contends that the portion of the Investec loan equal to the Bowmans loan represents a loan payable (and an interest expense incurred) because the Bowmans loan receivable (upon which the interest income is earned) has not been paid. Herein lies the "sufficiently close connection" and consequently the interest expense should be deductible to the appropriate extent.

[24] He also submits that there is no requirement in PN 31.2 that the funds invested at interest must first have been "received" by the taxpayer. Rather, what is required is that there are *'capital'* or *'surplus'* funds that are invested and earn interest. There is also no implication that the funds must first have been borrowed and then invested. All that is required is that funds must be borrowed at a certain rate of interest and funds must be lent at a different rate. Accordingly there is no "timing" requirement as was found by the Tax Court.

[25] On the other hand, SARS contends that the purpose for which the Investec loan was taken is unrelated to the existence of the Bowmans loan and that there is thus no direct causal link between the interest income on the Bowmans loan and the interest expense on the Investec loan.

[26] It submits that the interest incurred by the taxpayer on the Investec loan is a private expense *'totally unrelated to the income earning part of his business'*. The taxpayer borrowed the proceeds of the Investec loan, albeit through an access facility, and

applied such proceeds to a purpose unproductive of income and not directly connected with the income earning part of his business. Therefore the interest expense cannot be claimed as a deduction against the interest income.

Discussion

[27] As a starting point, and as correctly identified by the Tax Court, SARS did not disallow the deduction claimed due to the taxpayer's failure to comply with the requirements contained in PN 31.2, but instead those contained in PN31.1.[16]

[28] To my mind, the plain wording of PN 31 contemplates two distinct scenarios. PN 31.1 provides that to qualify as a deduction for purposes of s 11(a) the expenditure must be incurred in the carrying on of any *'trade'* as defined in s 1 of the ITA.[17] It stipulates further that in determining whether a person is carrying on a trade the Commissioner *'must have regard to, inter alia, the intention of the person'.* Such intention appears to relate to the intention in incurring the expense, because it goes on to say that *'(s)hould a person, therefore, borrow money at a certain rate of interest with the specific purpose of making a profit by lending it out at a higher rate of interest, it may well be that the person has entered into a "venture" and is thus carrying on a trade'.*

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[16] Judgment para [15], Record Vol 5 p389.

[17] *'Trade'* is defined as including every profession, trade, business, employment, calling, occupation or venture, including the letting of any property and the use of or the grant of permission to use any patent as defined in the Patents Act or any design as defined in the Designs Act or any trade mark as defined in the Trade Marks Act or any copyright as defined in the Copyright Act or any other property which is of a similar nature. It thus bears the widest possible meaning.

[29] On the other hand, PN 31.2 commences with the words *'(w)hile it is evident that a person (not being a moneylender) earning interest on capital or surplus funds invested does not carry on a trade and that any expenditure incurred in the production of such interest cannot be allowed as a deduction, it is nevertheless the practice of Inland Revenue to allow expenditure incurred in the production of the interest to the extent that it does not exceed such income'.*

[30] Accordingly, PN 31.1 concerns itself with whether or not a deduction should be allowed on the basis that the interest expense was incurred in the carrying on of a trade, whereas PN 31.2 proceeds from the premise that the person concerned does not carry on a trade with regard to the expense, in which event the deduction is allowed under certain specified circumstances.

[31] Although given SARS' abandonment of its reliance on s 23(g) the taxpayer was not obliged to show that the interest expense was incurred for the purposes of trade, it does not therefore follow that the taxpayer had himself relied on PN 31.1 in claiming the deduction. He has always relied on PN 31.2.

[32] Accordingly the only question to be answered is whether the interest expense on the Investec loan (limited in the respects set out above) was incurred in the production of the interest income on the Bowmans loan.

[33] This in turn requires an assessment of the closeness of the connection between the income and the expense. Where there is a *'clear and close causal connection'* this is an important consideration. The causal connection is also not necessarily

established between the raising of the loan and the initial use to which the capital raised is put. It is the purpose of the expenditure (i.e. the purpose in incurring the interest expense) that must be considered, together with what that expenditure actually effects[18] (i.e. causes to happen or brings about).[19]

[34] The taxpayer's essential contention is that the purpose of maintaining the relevant portion of the Investec loan was to allow him to facilitate the Bowmans loan, which generated interest income for him. Therefore, the purpose of the incurral of the interest expense, to that degree, was to produce such interest income and it also had that effect.[20]

[35] He relies mainly on *CIR v Smith*.[21] There the taxpayer was one of two partners in a practice. They had previously each loaned the partnership monies to purchase fixed assets and float working capital. It was agreed that their respective capital contributions would not be left in the partnership permanently but would be repaid if and when the partnership was able to do so.

[36] A point was reached at which such repayment could be made, but both knew that capital contributions in essentially the same amounts would again be required in the near future. The taxpayer was repaid his loan and used the proceeds to settle the balance owing under a mortgage bond registered against the title deed of his matrimonial home (which was registered in his wife's name). He then took a bank

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[18] *CIR v Standard Bank of SA Ltd* 1985 (4) SA 485 (AD) esp at 500H-501F.
[19] *'(E)ffects'* as defined in the Concise Oxford English Dictionary.
[20] Appellant's heads of argument para 37.
[21] 60 SATC 397, a Full Bench decision of the then Natal Provincial Division.

loan, secured by the same bond, and in turn advanced the proceeds to the partnership.

[37] As in the present matter, there was no dispute that the funds made available by the taxpayer to the partnership were necessary for its business operations and to enable it to earn an income from its business activities. Similarly, if capital had not been made available from this source, it would have had to be obtained from another.

[38] It was found that the fact that the partners previously funded the practice from their own resources did not mean that they were obliged to do so in the future. They were free to obtain funds from another source which would charge interest, and that interest was, at least on the face of it, expenditure incurred in the production of income. It was held that:

> *'In applying* [the] *test the first point to note is that the expenditure in the present case is the interest paid on the loan. The purpose of that expenditure was to ensure that the financial institution would lend the money to the respondent in order that he could in turn lend it to the partnership. The fundamental purpose of the loan was therefore to provide the capital which the partnership needed. This was also the effect of the loan, the present being a case where there is no difference between the purpose and the effect of the expenditure which it is claimed should be deducted.'*[22]

[39] What played an important role in the Court reaching its decision was the agreement between the partners that their capital accounts would not remain in the partnership permanently but would be repaid if and when it was able to do so. This rendered the

[22] At p402.

facts distinguishable from those in *ITC 1583* (1993) 57 SATC 58[23] where the taxpayer, an attorney, withdrew the full amount of his loan account from which he settled the bond over his matrimonial home registered in his wife's name. In terms of a prior arrangement with the loan creditor, funds were thereupon re-advanced in the same amount (to his wife) and the taxpayer in turn paid them into his loan account the following day. The taxpayer's withdrawal of the full amount of his loan account, although with the agreement of his partners, was on the express condition that he immediately repay it. At all relevant times the partnership required the loan capital, and it was not a case of the partnership being in a financial position to repay the loan.

[40] The Court found that:

> *'It has been emphasised in cases such as Commissioner for Inland Revenue v RB Saner 1927 TPD 162 at 172, that it is the substance and not the form that must be looked at. In this regard it might well have been said that the scheme resorted to by the appellant in ITC 1583 had been artificial. To say, in the instant case however, that there was essentially no difference between the position before the scheme had been embarked upon and the position after it had been implemented, ignores two relevant matters relating to the taxpayer's partnership. It ignores firstly that it had been agreed that the partners' capital contributions would not remain in the partnership permanently but would be repaid if and when the partnership was able to make repayment. It ignores secondly the fact that at the relevant time the partnership could in fact have continued operating for some weeks without the partners first repaying their capital contributions. It is of course true that taxpayer in the instant case had planned the whole scheme in advance… Despite all of these facts, the features which… distinguish the instant case from the facts in ITC 1583 are in our view sufficient to show that the scheme was not artificial. Indeed they*

[23] A decision of the Cape Special Court.

> *show that it was not just in form but also in substance that the loan on 1 March had been raised and therefore that it was in the production of income that the interest thereon was paid.'*[24]

[41] In the present matter the taxpayer falls somewhere between the facts in these two cases. On the one hand, he cannot demand repayment of the Bowmans loan for so long as he remains employed. This not only applies to the full amount of the loan, but also to any portion thereof (I am not referring here to the interest earned on the Bowmans loan). On the other hand, as a fact, he received payment of distributions which were debited against his Bowmans loan.

[42] Assuming in his favour that the funds standing to the credit of the Bowmans loan[25] from time to time are *'capital'* or *'surplus'* funds, any distributions made are nevertheless entirely within the discretion of his employer. Put differently, he cannot rely on the existence of any anticipated distribution. It is also a term of his employment contract that a certain amount must at all times be retained in the Bowmans loan for his employer to fund working capital requirements. Potentially therefore, and depending upon actual profit and available cash on hand, he might not receive any distribution (other than interest earned) at all. To my mind, that he in fact received such periodic distributions during the relevant period should not be conflated with any entitlement or potential entitlement to receive them.

[43] That he intended to pay, and did pay, those distributions he received into the Investec loan does not necessarily mean, that without them, he was unable to

[24] At p404.
[25] Excluding interest earned thereon.

reduce the balance on the Investec loan. There is no evidence to suggest that he was solely reliant on those distributions for this purpose. In my view, this is where the taxpayer's argument breaks down.

[44] The chronology shows that the Investec loan, albeit an access facility from inception, was only acquired some 10 months after he became employed, at a time when he well knew that he could not place any reliance upon receipt of either the full payment, or partial repayment, of the Bowmans loan. The distributions he received were to all intents and purposes fortuitous, being dependent upon extraneous factors.

[45] Had the taxpayer not received the distributions he would still have had to maintain the Investec loan in order to benefit from the access facility. He has in fact maintained the Investec loan and therefore must have done so from resources other than the distributions alone, whether from income or other capital injections. While his evidence that he would have repaid the Investec loan had he received repayment of the Bowmans loan must be accepted, the purpose of the Investec loan, during the relevant periods, was to provide him with an access facility and not to maintain, as he submits, the Bowmans loan. Nor did the interest expense on the Investec loan bring about the interest income on the Bowmans loan. That interest income accrued to him irrespective of the existence of the Investec loan.

[46] It is for these reasons (albeit different to those of the Tax Court) that I am persuaded that the appeal must fail. The Tax Court made no order as to costs.

There is no cross-appeal against that order, and in any event SARS did not seek costs in the event of it succeeding in this appeal.[26]

[47] **The following order is thus made:**

'The appeal is dismissed with no order as to costs.'

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CLOETE J

I agree.

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ALLIE J

I agree.

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NUKU J

[26] Judgment para [29], Record Vol 5 p396, respondent's heads of argument para 85.