being dealt with in terms of part VI of the Immigration Control Act as prohibited immigrants. As such they were detained in custody with no prospect of release on bail pending finalization of the trial and no indication as to what period would be spent in custody awaiting trial. Finding themselves between a rock and a hard place, the decision was apparently made to plead guilty and to later appeal the conviction and sentence. Both the high court and the supreme court of Namibia were however not prepared to entertain such legal acrobatics and with reference to the applicable principles, correctly dismissed the appeal.

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THE TRADE AND PRODUCTION OF INCOME REQUIREMENTS FOR THE DEDUCTIBILITY OF INTEREST

Unitrans Holdings Ltd v Commissioner for the South African Revenue Services (A3094/2022) 2024 ZAGPJHC 3 (9 January 2024)

SAMEVATTING

DIE BEOEFENING VAN ’N BEDRYF EN IN DIE VOORTBRENGING VAN INKOMSTE VEREISTES VIR DIE AFTREKKING VAN RENTE

Ten einde ’n rente uitgawe wat voortspruit uit ’n skuldinstrument te kan aftrek, moet ’n belastingbetaler aan beide die vereistes van “in beoefening van ’n bedryf” en “die voortbrenging van inkomste” voldoen. Die beoefening van ’n bedryf-vereiste behels dat die belastingbetaler moet aantoon dat hulle ’n positiewe stap geneem het, nie bloot ’n passiewe rol vertolk nie. Ten einde aan die voortbrenging van inkomste-vereiste te voldoen, moet die belastingbetaler aantoon dat die uitgawe nou verwant is aan die voortbrenging van inkomste soveel so dat dit as deel daarvan geag kan word. Alhoewel die algemene aftrekkingsformule vereis dat die belastingbetaler ’n bedryf moet uitoefen en die uitgawe vir doeleindes daarvan aangegaan moes wees, vereis die spesiale reëls betreffende die aangaan en toevalling van rente, sowel as die insluiting en aftrekbaarheid van rente, soos vervat in artikel 24J van die Inkomstebelastingwet 58 van 1962, nie so ’n skakel nie.

Die belastingbetaler in *Unitrans Holdings Ltd v CSARS* ((A3094/2022) 2024 ZAGPJHC 3 (9 Jan 2024)) het probeer om meer as wat nodig was aan te toon om ’n aftrekking te eis, naamlik dat dit ’n bedryf as ’n geldlener beoefen het, terwyl dit voldoende sou wees om aan te dui dat dit ’n bedryf, enige bedryf, beoefen het. Hierdeur het die belastingbetaler ’n risiko geloop om die geskil op die vraag van die beoefening van ’n bedryf te verloor, maar het eintlik die saak verloor omdat daar nie bewys is dat die rente-uitgawes aangegaan was in die voortbrenging van inkomste nie. Alhoewel die bedoeling om ’n wins te maak nie ’n vereiste vir die beoefening van ’n bedryf is nie, ontken die gebrek daaraan die doel van die voortbrenging van inkomste. ’n Direkte skakel tussen die uitgawe en die voortbrenging van inkomste word steeds vereis. Indien daardie skakel nie bestaan nie, of gebreek is, is die uitgawe nie aftrekbaar nie. Dit is ook die geval waar die uitgawe, soos in casu, bedoel is om belastingvrye inkomste voort te bring.

Die Suid Afrikaanse Inkomste Diens se voorneme om die praktyk te staak om rente-aftrekkings toe te laat op geleende geld wat teen ’n hoër of laer rentekoers herleen word, beklemtoon die belang van artikel 24J van die wet en die nakoming van die reëls daarvan.

1 *Introduction*

The deductibility of interest for tax purposes continues to be one of the moot issues in the South African courts. This is partly due to the complexity of the provisions

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relating to interest and the fact that taxpayers derive considerable financial benefit from being able to deduct interest expenditure. The ability to deduct interest reduces the taxable income of a taxpayer. On 9 January 2024, the Gauteng division of the high court sitting in Johannesburg considered the deductibility of interest incurred by a taxpayer in *Unitrans Holdings v Commissioner for the South African Revenue Services* ((A3094/2022) 2024 ZAGPJHC 3 (9 Jan 2024)). At issue was the trade and production of income requirements of section 24J of the Income Tax Act 58 of 1962 ("the act", and any reference to sections in this note refers to the act, unless otherwise stated). This note considers the requirements of deductibility of interest against the facts of the *Unitrans* case to determine whether the trade and production of income requirements were properly applied. The note also considers the impact of the change in the practice of the South African Revenue Service ("SARS") with regard to the deductibility of interest as well as the impact that group taxation could have on the deductibility of interest.

2 *The law*

As a general matter, interest expenditure is deductible in terms of section 11(a) read with section 23(g). Due to the specificity of section 24J and the stricter requirements of section 11(a) read with section 23(g), taxpayers generally apply section 24J to the treatment of interest. Section 24J is a timing provision in relation to the accrual and incurral of interest. The section determines when a borrower incurs interest and can thus deduct such interest in the determination of its taxable income. It also regulates the timing of the accrual of interest in respect of the lender, as to when the lender should include the interest in its gross income (Legwaila "Tax planning using interest – an organised chaos for those interested" 2022 *PELJ* 1 6). It spreads the interest over a period or term of the instrument by compounding the interest over fixed periods using a predetermined rate, referred to as the yield to maturity (Stiglingh *Silke: South African Income Tax* (2023) 515).

Section 24J(2) provides as follows:

> "(2) Where any person is the issuer in relation to an instrument during any year of assessment, such person shall for the purposes of this Act be deemed to have incurred an amount of interest during such year of assessment, which is equal to –
> (a) the sum of all accrual amounts in relation to all accrual periods falling, whether in whole or in part, within such year of assessment in respect of such instrument; or
> (b) an amount determined in accordance with an alternative method in relation to such year of assessment in respect of such instrument,
> which must be deducted from the income of that person derived from carrying on any trade, if that amount is incurred in the production of the income."

The term "trade", which is central to the dispute between the parties, is defined in section 1 of the act as follows:

> "'trade' includes every profession, trade, business, employment, calling, occupation or venture, including the letting of any property and the use or 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."

Two issues that had to be decided in the *Unitrans* case were (1) whether the taxpayer had been carrying on any trade; and (2) whether the interest was incurred in the production of income.

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3 *The* Unitrans *case*

The taxpayer traded as an investment and holding company performing treasury function for the Unitrans group of companies. The treasury function included the provision of loan funding and cash management (par 1). The salient fact is that the taxpayer borrowed money from its shareholder, and on-lent that money to its subsidiaries at a rate less than the borrowing cost. For the 2011 income tax return the taxpayer declared that it earned interest of about R34 million and claimed about R68 million as a deduction on interest paid to its shareholder. Importantly, the taxpayer also declared that during the relevant period, it did not enter into any transactions as contemplated by section 24J of the act (par 2). SARS disallowed the interest claimed in terms of section 24J(2) on the basis that the interest was not incurred in the conduct of any trade and was not incurred in the production of income. SARS allowed interest expenditure to the extent of the income earned by the taxpayer from the investment income, *ie* R34 million. Thus, the disallowed amount was the difference between the interest income earned by the taxpayer from its subsidiaries and the interest expenditure incurred by it in its 2011 year of assessment (par 9).

The taxpayer objected to this assessment, and SARS disallowed the objection, whereupon the taxpayer appealed to the tax court. In the tax court, SARS denied that the taxpayer conducted trade as a money lender. SARS also disputed that the expenditure claimed by the taxpayer was closely linked to its income earning operations as a money lender. It argued that the purpose of the expenditure was not to produce income but to further the interest of the subsidiaries. Therefore, SARS's case was that the expenditure was not incurred in the production of the taxpayer's income (par 5).

On the other hand, the taxpayer pleaded that it incurred interest on funds borrowed from group companies with a view to making loans to group companies in the course of its lending trade and in the production of income in the form of interest to be earned from the loans to group companies. Apart from the lending trade, the taxpayer did not identify any other trade (par 6).

The tax court (per Bam J) dismissed the taxpayer's appeal with costs and confirmed the assessment issued by SARS on 28 April 2015, thus rejecting the taxpayer's assertion that the interest expense of R68 million was deductible in terms of section 24J(2) of the act (par 7). The high court was called upon to decide what it considered a crystalised question of whether the expense was incurred in the production of income derived from carrying on any trade.

The high court held that the taxpayer had satisfied the requirement of trade but that the interest was not incurred in the production of income (par 4). I shall analyse the court's decision in relation to these aspects differently.

4 *Trade*

4.1 Court decision

The bone of contention in this case with regard to whether the trade requirement was met or not was mainly that the taxpayer argued an issue that the taxpayer did not plead, which is neither here nor there for the purposes of this note.

Substantial evidence was adduced to prove that the taxpayer satisfied this requirement. The taxpayer stated that it performed a treasury function for the Unitrans Group of Companies and that such function included the provision of loan funding and cash management. The taxpayer's wholly owned subsidiaries had a cash management arrangement with Standard Bank, whereby the group's bank

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accounts were balanced to zero on a daily basis (par 1). If the group's net position ended up in overdraft, the taxpayer would borrow funds from Standard Bank on a call loan and if the group was in a positive cash position, the taxpayer would pay back the call loan. At some point in the 2011 tax year, the taxpayer had cash resources of R347 million available, which according to the taxpayer demonstrated the fact that its dealings with its wholly owned subsidiaries and with the bank were not only inter-related, but actively managed on a daily basis (par 1).

Mr Emslie, who appeared on behalf of the taxpayer, correctly argued that if interest is incurred in the production of income (which is not limited to interest income), it can be deducted from the income derived from carrying on any trade, which is not limited to the trade of "moneylending". The court agreed with this line of contention, holding that it appears to be a trite enough principle (par 14).

Holding that the taxpayer satisfied the trade requirement of section 24J, the court stated as follows (par 28):

> "In sum, the taxpayer's case in this appeal is that, as part of its business and its trade as an investment holding company, it lent and advanced funds only to its own subsidiaries, of which it was the holding company. This, so the argument is concluded, places the taxpayer in the same position as the taxpayer in *Tiger Oats*, which means, as was held by the SCA in that case, that the interest incurred should be deducted from the taxpayer's income during the 2011 tax year of assessment. Moreover, furthering the interests of its subsidiaries was also the furtherance of the taxpayer's own interests because it was the holding company of the subsidiaries, so its own interests were fully aligned with those of its subsidiaries."

4.2 Comment

Section 24J does not require that a taxpayer be carrying on any particular trade for the section to apply. It specifically states that an amount must be deducted "from the income of that person derived from carrying on *any* trade, if that amount is incurred in the production of the income" (my emphasis). There is also no requirement that the amount be deductible only to the extent that the amount is laid out for purposes of trade, as the general limitation provision of section 23(g) applies. The court in *ITC 770* (19 SATC 216) held that the definition of trade should be construed widely and that the definition is intended to embrace every profitable activity (at 217).

4.2.1 Trade requires a positive step, not a merely passive role

It was submitted by counsel for SARS that the carrying on of a trade involves an "active step", which means that something more is required than a mere watching over existing investments that are not income producing and are not intended or expected to be so (par 41). The main thrust of the taxpayer's argument was that the interest sought to be deducted by it was in fact incurred by it not in its trade as a moneylender, but more in its capacity as an investment holding company (par 25). The issue here was that if it could not be proven that the taxpayer was conducting a trade as moneylender, then the taxpayer would potentially fail to prove the section 24J(2) trade requirement. It was not required that the taxpayer be conducting the trade of a moneylender. Any trade would suffice. And that is the gist of section 24J, the main difference between section 24J and the general deductions formula in section 11(a) read with the limitations clause in section 23(g).

The taxpayer relied on *Commissioner, South African Revenue Service v Tiger Oats Ltd* ((108/2002) 2003 ZASCA 43 (15 May 2003), 2003 2 All SA 604 (SCA), 65 SATC 281 (the *Tiger Oats* case)) as authority for the proposition that a holding

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company carrying on business as an investment holding company and making interest-free or low-interest loans to its subsidiaries in whose management it is intimately involved, is a company carrying on a business and therefore carrying on a "trade", as defined, for income tax purposes (par 22). Unfortunately for the taxpayer, the business structure and transactions in this case did not bear much similarity to the facts in the *Unitrans* case.

The main differences were that in the *Unitrans* case, the taxpayer had no employees or fixed assets but paid for management services provided for its operating subsidiaries and associated companies. It made loans to subsidiaries and associated companies, and not to anyone else. The loans were funded by share capital and reserves and some with surplus cash. The loans were shareholder loans and typically did not bear interest. Where interest was charged, the rate of interest was invariably lower than the rate at which the subsidiary would be able to borrow from outside sources.

In the *Tiger Oats* case, the taxpayer was more involved in the business of the subsidiaries. In addition to paying management fees, it shared directors with subsidiaries and paid those director's fees. The court in the *Tiger Oats* case held that "this shows that the respondent is actively involved in the operations of the subsidiaries and associated companies and is not simply a passive investor in them, equatable with a member of the public who invests in listed shares on the stock exchange" (par 36 – per Marais JA).

4.2.2 Is profit a requirement for trade?

It is clear from the facts of the *Unitrans* case that the taxpayer made no profit from the activities undertaken, or at the very least to the extent that such activities were for the benefit of its subsidiaries. But did the taxpayer have to make a profit in order for it to satisfy the trade requirement? Cases that deal with the requirement of "in the production of the income" have mostly been decided in respect of section 11(a) of the act, which requires that for expenditure and losses to be deductible, such expenditure and losses should be incurred in the production of the income.

In *De Beers Holdings (Pty) Ltd v CIR* (1986 1 SA 8 (A)), the court emphasised that the absence of a profit does not necessarily exclude a transaction from being part of a taxpayer's trade, and thus, a non-profitable transaction would still satisfy the trade requirement. It should be shown on the facts that a taxpayer was still trading, regardless of the lack of profit, or lack of intention to make a profit from the particular transaction (see Olivier "Assessed losses: a note on the trade and income requirements" 2009 *Stell LR* 387 388). The court held that such moneys could well be expended on grounds of commercial expediency or in order to indirectly facilitate the taxpayer's trade. For example, where a trader normally carries on the business of buying and selling goods at a profit, then as a general rule, a transaction entered into with a purpose of not making a profit, or in fact registering a loss, must be shown to have been closely connected with the pursuit of the taxpayer's trade. It should be shown to have been so connected that despite a profit motive it is still expended for the taxpayer's trade. And this, the court said, would need an explanation from the taxpayer, unless facts speak for themselves (36-37).

In *ITC 734* (18 SATC 202), a farmer who took his wife with him on a trip to buy a bull in Switzerland and then proceeded to treat themselves to a holiday was held to not have satisfied the trade requirement in relation to the trip. The expense for the whole trip was disallowed because at that time there was no apportionment in relation to the trade requirement. In *ITC 1404* (48 SATC 1) the court held that where

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there is no reasonable possibility of making a profit, a court might be entitled to infer that the purpose of the expenditure was not trade. The court found that in that case, the taxpayer considered that while he might not make a profit in the short-term, he would be able to show a profit in the long term. The court found that the act did not seek to disallow an expense where the taxpayer incurred losses in the hope of future profits.

While continuity is a pointer towards the carrying on of a trade, it is not a prerequisite. The degree of activities required vary from case to case. In *Burgess v CIR* (1993 4 SA 161 (A)), the taxpayer incurred interest on a loan obtained to be used to invest in a single policy. The court held that this constituted trade, regardless of the fact that it was a single transaction, because the investment entailed a risk and an intention to make a profit. The court cautioned, however, that the mere existence of a risk element does not mean that trade is carried on.

In *ITC 1292* (41 SATC 163), the court assumed that a trade could be conducted only if a real hope to make a profit existed and that such hope must not be based on fanciful expectations but on a reasonable possibility (165). Olivier expresses a view that insisting on a reasonable prospect of generating a profit may be too stringent and that, at most, the possibility of generating a profit can be one of the facts to take into account to determine whether a trade was conducted (Olivier "The 'trade' requirement for income tax purposes: a reappraisal (*CSARS v Smith* 65 SATC 6)" 2009:10 *Journal of Economic and Financial Sciences* 189 191).

In the end, the test as to whether a trade is carried out is to be determined based on objective and subjective factors. The objective test requires that the facts speak for themselves. The subjective test is dependent on the taxpayer's *ipse dixit*, which in what seems like a circular reasoning, needs to be backed up by facts.

4.2.3 Any trade and not "for purposes of trade"

A clear and unequivocal distinction should be made between the requirement of trade in section 24J and in 23(g). This is pertinent here because the taxpayer, in seeking to adduce evidence to the effect that it was a moneylender, tended to steer beyond the requirement for 24J towards 23(g). Section 24J merely requires that there be a trade that is being carried on – not any particular trade, but any trade. The only connection, if any, between the trade and the interest expenditure is the existence of the trade. The section does not require anything more. Section 23(g) on the other hand prohibits deductions of expenditure from income derived from trade to the extent to which such moneys are not laid out or expended for purposes of trade. In this regard I hasten to mention that section 23(g) does not apply to interest expenditure deductible in terms of section 24J based on the application of the *generalia specialibus non derogant* rule. Section 23(g) links the expenditure with the trade in that the expenditure should be laid out for purposes of trade. In this regard, the purpose of the expenditure needs to be examined and linked to the trade, in that it should further the trade of the taxpayer, meaning that the expenditure cannot be irrelevant to the trade. No such requirement exists for section 23(g). Be that as it may, in this regard the British court in *Vodafone Cellular Limited v Shaw (Inspector of Taxes)* (1997 STC 734) stated that the words for "the purposes of the trade" do not mean for the purposes of the taxpayer or for the benefit of the taxpayer.

What the taxpayer needed to prove in the *Unitrans* case was that it was conducting a trade, any trade. The fact that trade requires some active step dictates that a trade needs to be identified and the activities of the taxpayer needs to be in pursuance of that trade. This is what led the taxpayer to lead evidence of activities that it

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undertook as an investment management entity. As the court succinctly concluded, "[t]he simple point is that the fact that the taxpayer was not a moneylender, as defined by the authorities, does not necessarily mean that it was not conducting a trade as envisaged by the said section".

5 *Production of income*

5.1 Court decision

It is trite that expenditure incurred to generate exempt income is not deductible (see *Commissioner for SARS v Van der Westhuizen* 2001 2 All SA 297 (C); *Natal Laeveld Boerdery BK v Kommissaris van Binnelandse Inkomste* 1998 1 All SA 5 (A); *CIR v Ticktin Timbers CC* (1997) 59 SATC 260 (C); *Commissioner: South African Revenue Service v Scribante Construction (Pty) Limited* 2000 JOL 7409 (E), 62 SATC 443).

The key *ratio decidendi* in this case, however, was that, in its evidence, the taxpayer did not adduce any evidence as to why it considers the expense claimed to be in the production of income. The taxpayer also did not challenge SARS's evidence that the expense was not incurred in the production of income (56). This, based on the principles, made it clear that the taxpayer did not meet the requirements of section 24J(2) of the act and was therefore not entitled to the interest deduction claimed. What further supported the conclusion that the taxpayer was not entitled to a section 24J(2) deduction was the fact that it declared in its tax returns that it did not enter into any transactions as contemplated in section 24J of the act (par 56).

The court found that based on the evidence before the tax court, it could safely conclude that the nature of the transaction was that the taxpayer borrowed funds to enable its group companies to improve their future financial income-earning capabilities by not charging interest. This therefore meant that the intention of the taxpayer was never to earn any income. The taxpayer was not pursuing its self-interest but was subjugating its profitmaking potential to the interests of the group companies (par 57).

The court found that this was supported by SARS's contention that the taxpayer structured its affairs so that it would never earn any income, and, in the process, it would not make any profit (par 58). SARS contended that it was never the taxpayer's intention to borrow money at a higher rate than it charged. It intended to provide cheaper funding to group companies than what they could procure in the market. Not only did it not have any intention to earn income, it structured its affairs so that it would never earn any income but would pay expenses incurred on benefits reaped by group companies. Based on the foregoing, the court concluded that the requirements for the deduction of the interest expenditure to be allowed as a tax deduction were therefore not met, and SARS was correct in disallowing the interest expenditure as a deduction in terms of section 24J(2) (par 59).

Applying the principles laid out in previous cases to the facts in the *Unitrans* case, the court expressed that it cannot be said with any conviction that the interest expenditure was incurred in the production of income whilst the taxpayer was conducting its trade as an investment holding company (par 54). Moreover, an in-depth examination and a proper interpretation of the annual financial statements of the taxpayer revealed that the loan was used to acquire a subsidiary from one of the group companies. The court was principally persuaded by the fact that the loan equated exactly to the cost of acquiring the business of Unitrans Limited, and that there was an element of unproductive interest which is not deductible in terms of the act (par 54).

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It was conceded on behalf of the taxpayer that the purpose of borrowing money from group companies was to on-lend to group companies where group companies require assistance to salvage their business and therefore that the purpose of the loan was to benefit the group companies (par 55). The court found therefore that the intention was not for the taxpayer to earn an income but to help the group companies to increase their earning capacity. This was evidenced by the fact that the taxpayer charged interest that was less than the interest paid on borrowed funds. The court summed up that the simple point was that the purpose of the loan was not to finance the income producing operations of the taxpayer but to benefit the group companies (par 55).

5.2 Comment

5.2.1 Closeness of the connection

Whether expenditure has been incurred in the production of income is determined by examining the act which produces the income and then judging whether the attendant expenditure can be said to be sufficiently close to that act to be regarded as having been incurred in the production of income. Expenditure is regarded as being incurred in the production of income if it is an inevitable concomitant of the taxpayer's income-producing operations (*Joffe & Co (Pty) Ltd v Commissioner for Inland Revenue* 1946 AD 157). 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 (*Port Elizabeth Electric Tramway Co v CIR* 1936 CPD 241 246).

What influenced the court in its decision was that as an investment entity, conducting investment trade, the taxpayer's trade yielded exempt income, and as such, it would not be entitled to deduct interest in terms of section 24J(2). The loan in investment activities produced unproductive interest and exempt income in the form of dividends. The court also placed weight on the fact that, on its own version, the taxpayer did not, in 2011, conduct any trade which provided financial and secretarial services to its subsidiaries. It was conceded on behalf of the taxpayer that in 2011 the taxpayer did not provide these services (par 40).

In *Producer v Commissioner of Taxes* (1948 4 SA 230 (SR)) the taxpayer company lent money to a subsidiary in respect of which it charged interest and then converted part of the loan to the subsidiary into equity. Its claim on the loan account against the subsidiary was set off against the shares issued to the subsidiary. Thus, when the money was borrowed by the taxpayer company, the purpose was certainly to produce income. At some stage the money was used to produce dividends, and the commissioner disallowed the part that was used to subscribe for equity (par 52). In that case, the court held that if a taxpayer borrows a specific sum of money and applies that sum to a purpose unproductive of income, and not directly connected with the income earning part of his business, then the interest paid on the borrowed money cannot be deducted as expenditure incurred in the production of income (par 52 and 53).

5.2.2 Specific purpose *v* general purpose

The court alluded to the difference between instances where interest is incurred on a loan taken for a specific purpose versus instances where the loan is taken

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for a general purpose. The court referred to *Commissioner for Inland Revenue v Standard Bank of SA Ltd* (1985 4 SA 485 (A)), a case in which the taxpayer, a bank, sought to deduct interest on money deposited by its customers. The taxpayer had used the money to earn tax-free dividends on preference shares. The court in that case held that as all the money from depositors went into a general pool, it could not be said for which specific purpose the money was borrowed, so one had to look at the general purpose of the bank, which was to borrow money at one interest rate and on-lend it at a higher interest rate, the general purpose being to produce income (par 51).

The taxpayer abandoned its argument that it was in the business of moneylending, which it originally raised to prove that it was carrying on a trade. If the taxpayer had continued with the argument, and succeeded to prove that it was in the business of moneylending, the point could have been carried over to change the considerations with regard to the production of income requirement. Taking the approach of the decision in the *Standard Bank* case, the focus would not have been on whether the loans to subsidiaries were made at lower or higher rates than the rate the loan was obtained by the taxpayer. The focus would have been on the general purpose of a moneylender, which, like that of the bank in *Standard Bank*, is to borrow money and on-lend it (see the *Standard Bank* case par 51).

The court did not find that, applying these principles in the *Standard Bank* and the *Producer* cases, the taxpayer's general purpose as an investment entity was to borrow money and lend it out at a higher interest rate and generate profit. This is clear from the fact that the taxpayer did not generate interest income from the loans to group companies. As a result, the interest incurred on the lending of the money by the taxpayer to on-lend is not deductible. This, in my view, correctly torpedoed the taxpayer's case with regard to the production of income.

The taxpayer could not even demonstrate that the benefit to the subsidiaries would circle back and somehow benefit itself, the taxpayer, in any way, albeit indirectly, other than that it would generate or increase the amount of dividends received by the taxpayer. The taxpayer in this case would fail regardless of whether you test the interest on the basis of the general business of the taxpayer or the specific purpose for which the loan was taken. The general business of an investment entity is not to borrow and on-lend, let alone at a loss.

5.2.3 Direct link between expenditure and production of income

A link needs to be shown between expenditure and the production of income. In *ITC 224* (6 SATC 156) interest was held to be not deductible because it was not incurred for purposes of facilitating the company's business but to assist a third party. In that case the taxpayer borrowed money at interest to lend to a purchaser of shares in the taxpayer. This loan was to enable the purchaser to pay for the purchase of the shares. In that case, a direct link between the taxpayer's production of income and the purchase of the shares could not be established.

In *Commissioner for The South African Revenue Service v Spur Group (Pty) Ltd* ((320/2020) 2021 ZASCA 145 (15 Oct 2021)), the taxpayer was a wholly owned subsidiary of the group's holding company ("holding company case"). The group adopted and implemented a share incentive scheme, the purpose of which was to incentivise key managerial staff of the taxpayer by providing them with an indirect interest in the listed shares of the holding company. A discretionary trust was created with the holding company as its sole beneficiary. The trust acquired a shelf company in which employees of the taxpayer were offered ordinary shares at par value in

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proportions determined by the holding company. The taxpayer contributed about R48 million to the trust which the trust used to subscribe for the holding company's preference shares. The shelf company thereafter applied the funding received from the preference share issue to purchase shares of the holding company. The employees, as shareholders of the shelf company, became entitled to the incremental value of the holding company shares by virtue of the shelf company's investment in the holding company.

A few years later when the shares of the holding company shares had appreciated in value to the extent that the investment significantly exceeded the preference share liability, the shelf company redeemed some of the preference shares and paid out R22,5 million to the trust, leaving the employees as the only shareholders of the shelf company. The shelf company sold some of the shares in the holding company and paid a dividend to the employees. The taxpayer's contribution of R48 million was not repaid by the trust. The preference share dividends of R22,5 million received by the trust vested in the holding company as sole beneficiary. After termination of the scheme the shelf company was de-registered. The taxpayer sought to deduct the R48 million that was contributed to the trust as expenditure incurred in the production of the taxpayer's income.

The court reiterated the basic principles of the production of income requirement: firstly, that the taxpayer must show an adequate closeness between the expenditure and the production of income by first determining the purpose of the taxpayer in incurring the expenditure in question and whether the purpose was to produce income. Secondly, it should be determined whether a close nexus or link exists between the expenditure and the ultimate production of income (par 27). The supreme court of appeal disallowed the deduction of the expenditure on the basis that it was not directly and closely connected to the production of income on two main grounds, firstly that the contribution of R48 million by the taxpayer to the trust was central to the scheme (par 30). However, the participants did not benefit directly, and even indirectly for that matter, from the making of the contribution. The second reason for the disallowance was that the contribution did not itself serve to incentivise the participants because it was an amount that would never accrue to the participants. Instead, it was for the benefit of the holding company as the beneficiary of the trust. In that case, the court considered that the link between the expenditure and the production of income was severed by the benefit to the holding company against evidence to the effect that the intention was to incentivise employees, and indeed some employees testified to have been incentivised by payments that were made. The fact that the payments were not made directly from the R48 million contribution should not have been fatal to the production of income purpose of the expenditure (see Legwaila "The supreme court of appeal limits the deduction of expenditure incurred in the production of the income: *The Commissioner for the South African Revenue Service v Spur Group (Pty) Ltd* [2021] ZASCA 145" 2023 *Speculum Juris* 397 403-404.

One sees the trend of disallowing deductions where there is another person or entity that benefits from the expenditure in the *Unitrans* case as well. The question is whether it is rational to expect that expenditure would only be in the production of income if it benefits only the taxpayer, or it directly results in the production of income of the taxpayer. Expenditure that indirectly but ultimately produces the income of the taxpayer is suspect. Expenditure whose purpose is to produce the income of the taxpayer, but also in effect benefits other parties, is both suspect and cannot be apportioned.

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6 *Total reliance on section 24J – Practice Note 31*

Section 11(a) requires that a taxpayer should be carrying on a trade and incur the interest expenditure in the production of income in order to qualify for a deduction of interest. In determining whether a person is carrying on a trade, the commissioner considers, *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. Thus, 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 profit-making venture (SARS "Practice Note: No 31" – 3 October 1994 "Income Tax: interest paid on moneys borrowed" https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-PrN-2012-21-Income-Tax-Practice-Note-31-of-1994.pdf (23-01-2024)).

SARS considered 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. In practice SARS generally allowed the deduction of expenditure incurred in the production of income even though the receipt or accrual of the income does not constitute the carrying on of a trade. This practice of SARS is set out in Practice Note No 31 (SARS "Practice Note: No 31" – 3-10- 1994 Income Tax: Interest paid on moneys borrowed https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-PrN-2012-21-Income-Tax-Practice-Note-31-of-1994.pdf (23-01-2024). Although Practice Note 31 provides that the practice set out therein will be followed by SARS, the Practice Note is not binding in terms of South African law. https://taxfaculty.ac.za/news/read/general-rules-regarding-interest-deductibility:~:text=Section%2024J(2)%20provides%20that,in%20relation%20to%20all%20accrual (26-01-2024). The Practice Note acknowledges that it has been SARS's practice to allow expenditure incurred in the production of the interest to the extent that it does not exceed such income. This practice is also applied in cases where funds are borrowed at a certain rate of interest and invested at a lower rate. The practice note concedes that, strictly in terms of the law, there is no justification for the deduction; however, this practice has developed over the years and is followed by SARS.

During November 2022, SARS announced its intention to withdraw Practice Note 31 SARS for years of assessment commencing on or after 1 March 2024 (SARS "Withdrawal of Practice Notes 31 of 1994 and 37 of 1995" https://www.sars.gov.za/wp-content/uploads/Legal/Drafts/Legal-LPrep-Draft-2022-67-Withdrawal-of-Practice-Notes-31-of-1994-and-37-of-1995-effective-1-March-2023-15-November-2022.pdf (23-01-2024) and SARS "Postponement of withdrawal of Practice Notes 31 and 37 https://www.sars.gov.za/wp-content/uploads/Legal/Drafts/Legal-LPrep-Draft-2023-04-Postponement-of-Withdrawal-of-Practice-Notes-31-and-37-22-February-2023.pdf (25-01- 2024). According to SARS this was because there has been increasing abuse of the concession provided for in PN 31 where taxpayers have relied on the PN as a means to structure transactions or undertake transactions in order to obtain a deduction of interest or expenditure incurred. These are deductions which would not otherwise have been allowed as a deduction under the act. According to SARS the development of tax legislation has resulted in the reclassification of certain income streams to interest. This reclassification has further allowed taxpayers the deduction under the Practice Note against the reclassified income. SARS states:

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"[t]ransactions are structured to maximise the deduction of interest or other expenditure incurred using [the Practice Note] whilst there is no corresponding inclusion in gross income for the recipient. This is achieved where the transactions are concluded with either exempt or non-resident taxpayers" SARS "Withdrawal of Practice Notes 31 of 1994 and 37 of 1995" (https://www.sars.gov.za/wp-content/uploads/Legal/Drafts/Legal-LPrep-Draft-2022-67-Withdrawal-of-Practice-Notes-31-of-1994-and-37-of-1995-effective-1-March-2023-15-November-2022.pdf (23-01-2024)).

Practice Note 31 bridges the gap between the strict requirements of section 11(a) and the more lenient requirements of section 24J. While the Practice Note is not binding, its withdrawal will mean that taxpayers would rely more and more on the strict requirements of section 24J or 11(a) to obtain interest deductions.

7 *Attributes of group taxation*

Group taxation has been proposed as a solution to most of the challenges that corporates face in South Africa (see Koekemoer *A Proposed Group Tax System for South Africa* (2018 thesis Univ Pretoria) https://repository.up.ac.za/handle/2263/71705 (25-01-2024)). Its introduction could have a positive impact in the deductibility of expenses in general and interest expenditure in particular.

Group taxation is classifiable into three systems: fiscal unity, group contribution and group relief. Under the fiscal unity system the company group is treated as a single business entity for tax purposes. This system recognises the companies as a single business undertaking of a single or group of shareholders divided into separate business units for corporate law and governance purposes. The group pools the profits and losses of the group members and files a joint and consolidated tax return (Rohatgi *Basic International Taxation* (2005) 256). The group contribution system, also referred to as the intra-group contribution system, involves the contribution by profit-making companies in the group to one or more loss-making companies within the same group (see Legwaila "Intermediary holding companies and group taxation" 2010 *Obiter* 308 318). In the group relief system, a loss-making company surrenders its current losses to the profitable companies in the group. The transferee company will then be able to use the transferred losses to offset against its taxable profits (see Rohatgi 257; Legwaila 318; see "Payments for loss transfers under the group relief system — the GST angle" http://www.lawgazette.com.sg/2003-8/Aug03-col.htm (25-01-2024)).

The most popular system and one that is touted for South Africa is the fiscal unity system. The Dutch fiscal unity regime allows the group companies to pool their profits and losses and to transfer the assets within the group without a capital gains tax liability (Rohatgi 191; Legwaila 320). The Austrian system allows the holding company to pool income and expenses and consolidate their taxable income (Ruehlmann "Austria, extensive tax reform" 2005 *European Legal Developments Bulletin* 11). The German system is similar to the Austrian system, but also allows loss and profit transfers between the group companies (see Oestreicher and Koch "The determinants of opting for the German group taxation regime with regard to taxes on corporate profits" 2009 *Review of Managerial Science* https://link.springer.com/article/10.1007/s11846-009-0036-3 (25-01-2024)); Baker McKenzie "Germany: pitfalls of the income tax grouping 'Organschaft' – proper implementation of profit and loss transfer agreements" 2023 https://www.lexology.com/library/detail.aspx?g=c33c472f-b8cd-4fcb-8422-0d97221e87df (25-01-2024)).

From a broader point of view, it seems anti-business not to allow a company to deduct expenses that it incurs in order to assist its subsidiaries to generate more

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profits and generate more dividends to itself. Unfortunately, rules applicable to deductibility are strict. If the law does not allow for an item of expenditure to be deductible, rules of logic cannot be applied to change that position. This would require a policy change. While the fiscal unity system would allow group companies to pool profits and losses, expenses incurred by one member of the group for the production of the income of other members of the group, as in the *Unitrans* case, would be deductible, as the deductibility provisions would change focus, and look at the production of the income of the group as a whole.

8 *Conclusion*

The *Unitrans* case highlights some important factors in the rules governing deductibility of interest. Firstly, trade is a widely defined term and is interpreted widely. As a result, genuine business activities would qualify as trade. There is no requirement that profit should be made in the trade, or that there is an intention to make a profit from the particular item of expenditure sought to be deducted. For purposes of section 24J, a taxpayer need not box itself into any particular trade. Any trade suffices.

It is harder for a taxpayer to prove that an item of expenditure was incurred in the production of income than it is to prove that it is carrying on a trade. And more and more, courts find that where there is no direct link between the expenditure and the production of income, or that the expenditure benefits persons other than the taxpayer, the production of income requirement is not met.

The withdrawal by SARS of its practice of allowing the deduction of expenditure incurred in the production of income even though the receipt or accrual of the income does not constitute the carrying on of a trade, places more focus on the application of the provisions of section 24J. Along with these developments, a more liberal and business friendly approach would be facilitated by the introduction of group taxation in the form of fiscal unity.

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"A VERITABLE CESSPOOL OF LAWLESSNESS": UPHOLDING IMPARTIALITY AND DECORUM IN SOUTH AFRICAN JUDGMENTS

Mogoai v City of Tshwane Metropolitan Municipality (120856/2023) 2023 ZAGPPHC 1994 (4 Dec 2023)

SAMEVATTING

"A VERITABLE CESSPOOL OF LAWLESSNESS": HANDHAWING VAN ONPARTYDIGHEID EN DEKORUM IN SUID-AFRIKAANSE REGSPRAAK

Die onpartydige beslegting van geskille deur die regbank is 'n grondliggende kenmerk van 'n legitieme en beskaafde regsisteem. Hierdie beginsel is onheuglik tot die Suid-Afrikaanse reg en ontspruit uit die Romeins-Hollandse stelreël *nemo iudex in sua causa potest* (niemand is geskik om as 'n regter in hul eie saak op te tree nie). Sedert 1996 word regterlike onpartydigheid deur die grondwet onderskryf wat, tesame met die gemenereg en 'n ryk regspraak, regterlike onpartydigheid reël.

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