WITS THE SCHOOL OF ACCOUNTANCY

UNIVERSITY OF THE WITWATERSRAND

A RESEARCH REPORT SUBMITTED TO THE FACULTY OF COMMERCE, LAW AND MANAGEMENT IN PARTIAL FULFILMENT OF THE REQUIREMENT FOR THE DEGREE OF MASTER OF COMMERCE (SPECIALISING IN TAXATION)

THE TAXATION OF INTEREST IN SOUTH AFRICA

MTHETHO MHLAFU

JUNE 2023

Abstract

This research report comprehensively explores the tax treatment of interest in South Africa, assessing its nuances and complexities from multiple perspectives. The study begins by defining interest within various contexts, then examines interest as a tax-deductible expenditure under South African law, supported by key court cases. The investigation extends to the practical implications of interest taxation, focusing on the nature and purpose of the loan and its relation to income production. Furthermore, the report delves into the insights from classical economists and their relevance to contemporary tax laws, specifically critiquing the South African Supreme Court of Appeal's decision in the *Brummeria* case. The report concludes with an exploration of international tax standards regarding interest, emphasizing the need for harmonious interplay between domestic tax laws and international tax treaties.

Key words: Interest, Interest Deductibility, Classical Economists, OECD, General deduction, *Brummeria* Case, International Tax Standards, Tax Treaties, General Tax Equation.

Declaration

I declare that this research report is my own unaided work. It is submitted in partial fulfilment for the degree of Master of Commerce (specialising in Taxation) at the University of the Witwatersrand, Johannesburg. It has not been submitted before for any other degree of examination in any other university.

Mthetho Mhlafu

June 2023

Glossary of Terms and Abbreviations

(A)	Appellate Division of the Supreme Court of South Africa.
(C)	Cape Provincial Division of the High Court of South Africa.
(SRAD)	Appellate Division of the High Court, Southern Rhodesia.
(T)	Transvaal Provincial Division of the High Court of South Africa.
AC	Amounts of Capital Nature.
AD	Reports of the Appellate Division of the Supreme Court of South Africa.
All ER	All England Law Reports.
All SA	All South African Law Reports.
AT	Total Amounts.
C: SARS	Commissioner of South African Revenue Service.
CIR	Commissioner for Inland Revenue.
Classical economists	Economists that came up with a body of work on market theories and economic growth which emerged during the 18th and 19th centuries.
COT	Commissioner of Taxes.
CPD	Reports of the Cape Provincial Division of the Supreme Court of South Africa.
FCA	Federal Court of Appeal.
IG	Gross Income.
IN	Necessities of Life.
IT	Taxable Income.
ITC	Income Tax Case.
JTLR	Juta Times Law Reports.
Jurisdiction	The power, right, or authority to interpret and apply tax laws or decisions.
KBI	Kommissaris van Binnelandse Inkomste.
NCD	Negotiable Certificates of Deposit.

OECD	Organization for Economic Cooperation and Development.
OECD Model Tax Convention	A model income tax treaty sponsored by the OECD on which the most bilateral income tax treaties are patterned and which is updated by the OECD Committee on Fiscal Affairs from time to time.
r.IT	Tax Payable.
SARS	South African Revenue Service.
SATC	South African Tax Cases.
SCA	Supreme Court of Appeal.
SIR	Secretary for Inland Revenue.
Tax Avoidance	It involves using legal methods of arranging one's affairs to pay less tax.
Tax Planning	Arrangement of a person's business and /or private affairs to minimize tax liability.
TCC	Tax Court of Canada.
U.S	United States.
UK	United Kingdom.
UN Model Tax Convention	A model tax convention sponsored by the United Nations that is based on the OECD Model Treaty, with some modifications made to reflect the interest of developing countries.
WLD	Reports of the Witwatersrand Local Division of the Supreme Court of South Africa.

Table of Contents

Chapter 1: Introduction

The tax treatment of interest has led to many disputes which the courts have had to decide[1]. The interest component within the business financial statements can potentially be a significant and material figure – in 2021 it is estimated that global corporate debt increased by USD 1.3 trillion[2]. The business fraternity will ordinarily seek to exploit any tax arbitrage emanating from this treatment and this has resulted in courts being called upon to adjudicate on many matters[3].

As an exposition of fundamental principles, the report commences with a definition of interest[4] and expand on types of interest[5]. The South African Revenue Service has been largely concerned for over a decade about the excessive interest tax deductions emanating from transactions that do not appear to have a plausible commercial reason[6]. In fact, this is not a domestic issue only. The OECD is of the view that it is a way of eroding base profits of many countries, and it has issued many discussion papers around this subject matter over the years[7]. The tax authorities therefore advocate for a limitation on the amount of interest that can be deducted[8].

As mentioned above the problem created by financing arrangements that appear to have little or no legitimate business reasons have led to specific discussions about the clear and causal

---

[1] Rudd, R. (2019) "The tax treatment of interest in kind: the Brummeria case revisited?," *SA Mercantile Law Journal*, 31(3), pp. 435–455. Available at: https://journals.co.za/content/journal/10520/EJC-1fda500a47.

[2] Bahceli, Y. (2021) *Corporate net debt seen rising as companies spend pandemic cash piles*. Available at: https://www.reuters.com/business/finance/corporate-net-debt-seen-rising-companies-spend-pandemic-cash-piles-2021-07-06/ (Accessed: June 1, 2023).

[3] For example: *Producer v COT* 1948(4) SA 230,15 SATC 405; *Financier v COT* 1950(3) SA 293,17 SATC 34; *Cactus Investments (Pty) Ltd v CIR* 1999(1)SA 315(SCA) 61 SATC 191; *Standard Bank of South Africa Ltd, CIR* 1985(4) SA 485(A), 47 SATC 179; *CSARS v BP South Africa(Pty)Ltd* 2006(5) SA 559(SCA), 68 SATC 229; *Shapiro v CIR* 1928 NPD 436, 4 SATC 29; *Natal Laeveld Boerdery(Edms) Bpk v KBI* 1998(1) SA639(A), 60 SATC 81.

[4] *Schulze v S W Bensted (Surveyor of Taxes)* 7 TC 33; *Riches v Westminster Bank Ltd* [1947] 1 All ER 469; *Cactus Investments (Pty) Ltd v CIR* [1999] 1 All SA 345 (A), 61 SATC 43; Notes on South African Tax (2007) page 77.

[5] *Tobacco Father v COT* 1951 (1) SA 150 (SR), 17 SATC 395; ITC 610 (1945) 14 SATC 377;

ITC 792 (1954) 20 SATC 98*; Johnstone & Co Ltd, W F v CIR* 1951 (2) SA 283 (A), 17 SATC 235.

[6] See National Treasury issued discussion paper for Reviewing the Tax Treatment of Excessive Debt Financing, Interest Deductions and Other Financial Payments, 26 February 2020. Available at: https://www.treasury.gov.za/public%20comments/Reviewing%20the%20Tax%20Treatment%20of%20Excessive%20Debt%20Financing,%20Interest%20Deductions%20and%20Other%20Financial%20Payments.pdf (Accessed 15 June 2023).

[7] OECD. (2016) *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 – 2016 Update*. Available at: https://www.oecd.org/tax/beps/limiting-base-erosion-involving-interest-deductions-and-other-financial-payments-action-4-2016-update-9789264268333-en.htm (accessed 5 June 2023)

[8] Refer to: s23M; s23N; s23K; s24J; s24O; s31 and s45-47 of the Income Tax Act No. 58 of 1962

relationship between the interest on money borrowed and on what the money is being expended[9]. It is apparent that the measurement of value of interest and related time of accrual for tax purposes is important, and this is what makes the administration of tax systems generally complex[10].

This report will debate the common law principles; the prescribed legislative requirements; the international treaty requirements and the related court judgments associated with the tax treatment of interest.

1.1. The Research Problem

1.1.1. The statement of the problem

The research report will examine how the tax treatment of interest with specific reference to its measurement and time of accrual and whether the current tax principles laid out are consistent with the economic considerations.

1.1.2. The Sub-problems

To answer the main research, question the following sub-problems and associated sub-questions will be addressed:

1. **Sub-Problem 1: Establishing a common definition of interest:**
    a. How is interest defined in different sources such as dictionaries, legal statutes, court cases, international organizations, and classical economists?
    b. What are the key variations in the definition of interest based on legal, economic, and international perspectives?
    c. How does the definition of interest in South African tax law (section 24J of the Income Tax Act) encompass various aspects of interest accrual and incurral?
2. **Sub-Problem 2: Is there consistent treatment of interest as a tax-deductible expenditure in South Africa?**
    a. What are the implications of treating interest as a tax-deductible expenditure for businesses, investors, and individuals in South Africa?
    b. How does the South African Income Tax Act interpret terms such as "trade" and "actually incurred" in relation to the deductibility of interest?

---

[9] *CIR v Standard Bank of South Africa Ltd* 1985(4) SA 485(A) 47 SATC 255

[10] ENSAfrica.com. (2022) *Interest Deductibility in South Africa*. Available at: https://www.ensafrica.com/uploads/newsarticles/0_ensafrica%20interest%20deductibility%20in%20south%20africa.pdf (Accessed on 04 June 2023).

   c. How does the timing of interest expenditure "incurred" impact its deductibility?
   d. What is the distinction between capital and revenue expenditure, and how does it affect the deductibility of interest?

3. **Sub-Problem 3: The potential complexities surrounding the taxation of interest expenses in South Africa**
   a. How is the deductibility of interest determined based on the nature and purpose of the loan?
   b. What role does case law play in interpreting the tax treatment of interest, particularly in distinguishing between capital and revenue loans?
   c. What are the conditions and exceptions related to section 24J of the South African Income Tax Act, which governs the taxation of interest?
   d. How do specific loan scenarios, such as loans for purchasing shares or paying dividends, impact the tax treatment of interest?
4. **Sub-Problem 4: Exploring the Tax Treatment of Interest from the Perspective of Classical Economists**
   a. What historical context and contributions do classical economists such as Adam Smith, John Stuart Mill, and David Ricardo provide to the taxation of interest?
   b. How does the application of the general tax equation to the *Brummeria* case align or deviate from the views of classical economists?
   c. How do classical economists' perspectives address the determination of monetary value, inclusion of capital amounts in gross income, deductions for the necessities of life, and the notion of taxable income?
   d. How can classical economic theories be reconciled with modern tax systems, and what implications does this have for the taxation of interest?
5. **Sub-Problem 5: The International tax considerations or standards on treatment of interest**
   a. What are the implications of the OECD Model Tax Convention and the UN Model Tax Convention on the taxation of cross-border interest transactions?
   b. How does the distinction between capital and revenue interest impact tax systems, and what are the perspectives on interest deductibility?
   c. What tensions exist between residence-based and source-based taxation in the international context, particularly considering the needs of developing nations?
   d. How do South Africa's tax laws and tax treaties influence the tax treatment of interest for residents and non-residents?

1.2. *The Research Methodology*

The research method adopted is of a qualitative, interpretive nature, bases on a detailed interpretation and analysis of amongst other things, case law. An extensive literature review and analysis will be undertaken that includes the following sources– Books; Cases; Electronic databases; Electronic resources; internet; Journals; Magazine articles; Publications; Statutes.

1.3. *Chapter Outline*

Chapter 2: The Definition of Interest

This chapter provides an exploration of what constitutes 'interest' from multiple perspectives including dictionary definitions, the Income Tax Act, textbook descriptions, court rulings, Tax Treaties, and historical classical economic theories. The chapter begins by defining interest as a charge for borrowed money and delves deeper into its implementation in the market and business settings. It critically examines the absence of a clear definition of interest in section 1 of the Income Tax Act and how this has led to various interpretations in legal and financial sectors. The chapter further discusses several court rulings that have attempted to define interest and introduces the Organisation for Economic Co-operation and Development's definition for international considerations. The chapter also explores the classical economists' view of interest as a reward for the use of capital. This comprehensive examination of 'interest' serves as a foundation for the forthcoming chapters that discuss tax applications related to interest.

Chapter 3: Interest Incurred as Tax Deductible Expenditure

This chapter provides a thorough investigation into the treatment of interest as a tax-deductible expense, emphasizing its implications on businesses, investors, and individuals. The chapter scrutinizes relevant sections of the South African Income Tax Act, particularly section 11 and its necessity for the person claiming the deduction to be conducting a "trade." Various court cases are explored to clarify the concept of "trade" and "actually incurred" expenditure. The chapter also distinguishes between capital and revenue expenditure in relation to tax deduction, providing clarity on the tax deductibility of interest. It further elaborates on the implications of section 24J of the Act on interest from investments and other financing arrangements. The significance of the timing of the accrual and incurral of interest is discussed, along with the taxation of interest received by a resident from global investments. The chapter offers an extensive overview of the complexities surrounding interest as a tax-deductible expenditure, offering insights into the legislative and legal nuances.

Chapter 4: Practical Considerations relating to the Taxation of Interest

Chapter 4 provides a comprehensive analysis of the complexities involved in taxing interest expenses, focusing on the implications for businesses, within the South African context. It first explains the nuances of interest deductibility, covering different types of interest: notional, pre-production, and general loans, and the concept of 'excessive' interest. The chapter extensively uses case law to interpret whether an expenditure is capital or revenue nature, which is crucial for deductibility. A key legislative focus is section 24J of the South African Income Tax Act, which regulates the taxation of interest. Case law examples are used to illustrate how courts have handled various loan scenarios, including loans for purchasing shares, paying dividends, and domestic purposes. The chapter provides a detailed analysis of tax treatment of interest for specific loan purposes, highlighting the necessity of establishing a clear link between the interest expense and income generation for deductibility. It concludes by discussing the concept of qualifying and non-qualifying interest, and their tax treatment, as per section 24J, along with the examination of specific types of interest: notional, pre-production, and excessive interest. The chapter emphasizes the need to balance business interests with fair taxation principles.

Chapter 5: Exploring the Tax Treatment of Interest from the Perspective of Classical Economists

Chapter 5 delves into the taxation of interest and examines the relevance of classical economists' perspectives on this subject. It begins by discussing the historical context of taxation and introduces influential classical economists such as Montesquieu, Adam Smith, Jeremy Bentham, Thomas Paine, David Ricardo, and John Stuart Mill. The chapter then focuses on Adam Smith's maxim of equality, emphasizing the principle that individuals should contribute to the government in proportion to their abilities and revenue enjoyed under the state's protection. It further explores the derivation of the general tax equation from classical economists' principles and analyses each component of the equation in relation to a specific legal case, *Commissioner, South African Revenue Service v Brummeria Renaissance (Pty) Ltd & Others*. The chapter critically examines the deviations between the classical economists' views and the outcome of the legal case, addressing topics such as the inclusion of interest-free loans in gross income, deductions for the necessities of life, taxation of capital amounts, and the notion of taxable income. The chapter concludes by discussing the decision of the Supreme Court of Appeal (SCA) in the *Brummeria* case and the ensuing debates among scholars regarding the court's approach and alternative interpretations based on charging provisions and recharacterization. Overall, the chapter provides a comprehensive analysis of the taxation of interest from the perspective of classical economists and its application in a real-world legal case.

Chapter 6: The International tax considerations or standards on treatment of interest

Chapter 6 of the research report touches on the complex and evolving landscape of international tax considerations and standards regarding the treatment of interest income. It begins by discussing the two primary international models, the OECD Model Tax Convention and the UN Model Tax Convention, which provide structure and guidance for global tax laws. The chapter examines the perspectives of these models on interest taxation, including articles on interest, non-discrimination, and mutual agreement procedures. It explores the nature and characterization of interest, analysing the arguments for and against distinguishing between capital and revenue interest. The chapter also delves into the taxation of interest from international sources, considering the contrasting approaches of residence-based and source-based taxation. Furthermore, it investigates the deductibility of interest and its implications for investment decisions and tax systems. The classical economists' perspective on international tax laws related to interest is explored, emphasizing the principles of taxation according to ability to pay and tax neutrality. Finally, the chapter touches upon the judicial perspective and case law, highlighting key issues such as payment characterization, source rules, and treaty interpretation in cases involving interest income.

Chapter 7: Conclusion

In this final chapter, the research report's key findings are consolidated, illustrating the intricate nature of interest taxation within the South African context. It reiterates the importance of understanding the varying definitions of interest, the factors determining tax deductibility, and the practical implications from a national and international perspective. Further, it emphasizes that tax treatment of interest is complex and multifaceted, heavily influenced by a multitude of sources like national laws, court cases, international standards, and economic theories. Suggestions for future research areas, including the implications of tax treatment on South Africa's economic growth, comparative studies with other countries, and further exploration of classical economic perspectives, are presented. The chapter concludes by asserting the need for ongoing research to ensure the tax system remains fair, efficient, and conducive to economic growth.

Chapter 2: The Definition of interest

What is Interest? This chapter set out the definition and types of interest to establish a base from which the tax applications can be imputed. It will discuss the definitions ascribed to the word 'interest' by amongst others; the dictionary definitions; Income Tax Act; textbooks; courts[11]; tax treaties; historical classical economists and any other relevant statutory Act.

Mirriam Webster[12] defines interest as "a charge for borrowed money generally a percentage of the amount borrowed, the profit in goods or money that is made on invested capital". It represents the additional amount charged by a lender to a borrower in return for the use of funds. When individuals or businesses seek financial assistance, they typically borrow money from banks, financial institutions, or other lenders. The lender charges interest as a form of compensation for the risk assumed and the opportunity cost of lending money. The borrower is obligated to repay the original amount borrowed, known as the principal, along with the accrued interest, resulting in the total cost of borrowing. Interest rates can vary based on factors such as the creditworthiness of the borrower, prevailing market conditions, and the duration of the loan.

Interestingly, section 1 of the Income Tax Act[13] does not define what interest is. This issue may be viewed as an open door to interpretation, and it is therefore of no surprise that the courts have been invited to provide guidance and interpretation on what interest is. The legislature sought in 1995, through the introduction of s 24J of the Act, to clarify what interest is. Section 24J of the South African Income Tax Act defines "interest" to include the gross amount of any interest or related finance charges, discount or premium payable or receivable in terms of or in respect of a financial arrangement.

This definition applies irrespective of whether such amount is calculated with reference to a fixed rate of interest or a variable rate of interest, or whether it is payable or receivable as a lump sum or in unequal instalments during the term of the financial arrangement. However, this definition primarily deals with the treatment of the timing of incurral and accrual of interest. This topic will be discussed extensively in Chapter 3 of this report.

---

[11] Definition of interest is laid out in *Schulze v S W Bensted (Surveyor of Taxes)* 7 TC 30-33; *Riches v Westminster Bank* Ltd [1947] 1 All ER 469; *Cactus Investments (Pty) Ltd v CIR* [1999] 1 All SA 345 (A), 61 SATC 43

Types of interest are discussed in *Tobacco Father v COT* 1951 (1) SA 150 (SR), 17 SATC 395; ITC 610 (1945) 14 SATC 377; ITC 792 (1954) 20 SATC 98; *Johnstone & Co Ltd, W F v CIR* 1951 (2) SA 283 (A), 17 SATC 235.

[12] https://www.merriam-webster.com (Accessed: May 17, 2023)

[13] Section 1(1) of the Income Tax Act No. 68 1962

The courts made several pronouncements or rulings on what constitutes interest. In *Schulze v S W Bensted (Surveyor of Taxes)*[14] interest was described as consideration paid for the use of money, or as “the creditor’s share of the profit which the borrower or debtor is presumed to make from the use of the money”. In *Riches v Westminster Bank*[15], Lord Wright described the essential nature of interest in a manner broadly applicable to all payments received for the use of money, stating that the:

> *“…essence of interest is that it is a payment which becomes due because the creditor has not had his money at the due date. It may also be regarded as either representing the profit he might have made if he had the use of the money or loss suffered because he had not had that use. The general idea is that he is entitled to compensation for that deprivation”.*

In the case of *Cactus Investments (Pty) Ltd v Commissioner for Inland Revenue*[16], the court defined interest as compensation to the lender for the use of money. The court distinguished between loans of consumption, and not for consumption. As the case dealt with the former, the court stated the common law principles relating to loans of this kind could be used as a basis to find an answer to their problem, and in this case the interest cannot be compensation to the lender for the use of their money. The court also stated that after making the funds available to the borrower, the lender has an unconditional right to receive the interest on the due date.

The Organisation for Economic Co-operation and Development (“OECD”) through its Model Tax Convention on Income and on Capital[17] publication defines interest in paragraph 3 of Article 11 as income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor’s profits and in particular, income from government securities, bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures. This definition is particularly important for international considerations which will be discussed at length in Chapter 5 of this report.

Section 24J of the Act definition closely resembles that of the OECD above in that it describes interest to include *‘the gross amounts of any interest or similar finance charges, discount or premium payable or receivable in terms of or in respect of a financial arrangement; amount (or portion thereof) payable by a borrower to the lender in terms of any lending arrangement as represents compensation for any amount to which the lender would, but for such lending arrangement, have been entitled; and absolute value of the difference between all amounts*

[14] *Schulze v S W Bensted (Surveyor of Taxes)* 7 TC 33
[15] *Riches v Westminster Bank Ltd* [1947] 1 All ER 469
[16] *Cactus Investments (Pty) Ltd v CIR* [1999] 1 All SA 345 (A), 61 SATC 43
[17] OECD. (2017). Model Tax Convention on Income and on Capital: Condensed Version 2017.

receivable and payable by a person in terms of a sale and leaseback arrangements throughout the full term of such arrangement, to which such person is a party.'

The definition of "interest" in section 24J seems to be elusive and recursive, as it includes the term "interest" without assigning a clear meaning to it[18]. To complicate matters, the Act does not define "interest" anywhere else. In situations like this, legal professionals typically resort to a fundamental principle of statutory interpretation known as the "literal approach"[19]. According to this principle, if a term in a legislation isn't given a specific meaning, it must be interpreted based on its common, everyday meaning, unless such an interpretation leads to a blatant absurdity that the Legislature could not have intended.

To discern the everyday meaning of a word, courts often rely on dictionaries. For instance, the Shorter Oxford English Dictionary (Sixth Edition) defines "interest" as "money paid for the use of money or for the forbearance of a debt". This definition aligns with how courts generally interpret "interest" under common law—as "compensation for the use of money lent"[20].

Considering the classical economists view, interest is defined as a reward for the use of capital. The rate of interest is determined by the demand and supply of capital. The supply of capital is a positive function of the rate of interest, while the demand for capital is a negative function of the rate of interest. The classical theory of interest can be attributed to several economists who contributed to the field, however, one of the key contributors was Eugen von Böhm-Bawerk.

In "Capital and Interest"[21] he considers that the interest rate reflects the relationship between time preferences and the productivity of capital. Time preference refers to individuals' preference for immediate consumption over future consumption, while the productivity of capital refers to the additional value that can be generated by investing capital in productive ventures. Böhm-Bawerk argued that interest rates emerge as a result of the temporal preference for present goods over future goods and the role of capital in enhancing productivity.

---

[18] Rudd, R. (2019) "The tax treatment of interest in kind: the Brummeria case revisited?," *SA Mercantile Law Journal*, 31(3), pp. 435–455. Available at: https://journals.co.za/content/journal/10520/EJC-1fda500a47.

[19] Matlala, M. (2016) *What is "interest" anyway? section 24J and interest deductions*. Available at: https://www.thesait.org.za/news/257024/What-is-interest-anyway-section-24J-and-interest-deductions-.htm#:~:text=Section%2024J%20of%20the%20Act,in%20relation%20to%20such%20credit. (Accessed: May 17, 2023).

[20] *Commissioner for Inland Revenue v Cactus Investments (Pty) Ltd* 59 SATC 1

[21] Boehm-Bawerk, E. von (1957) *Capital and Interest: A Critical History of Economic Theory*. Augsburg, Germany: Kelley & Millman (His Capital and Interest, pt. 1). Available at: https://books.google.co.za/books?id=530qDwAAQBAJ (Accessed: March 21, 2023).

2.1. Interest Incurred as Tax Deductible Expenditure

Interest is a common feature in many financial dealings around the world. It's not just important for the people and businesses directly involved in these transactions, but also for the wider world of tax rules and regulations. One key area where this comes into play is when interest is treated as a tax deductible expense. This topic is important for businesses, investors, and everyday people who pay taxes.[22]

Tax deductions are a major part of how income tax is calculated, and they can have a big impact on how much tax a person or business has to pay. When expenses can be deducted from income, it can reduce the overall tax liability, encouraging more economic activity and shaping the economy as a whole. Interest, from simple loan interest to more complex forms like notional or pre-production interest, often falls into this category.

But to really understand how interest can be used as a tax deduction, a closer look at the tax laws that govern it needs to be taken. This is especially true in places with complicated tax rules, like South Africa.[23] In this chapter, the subject of interest as a tax-deductible expense, with a focus on section 11 of the South African Income Tax Act, will be discussed.

2.2. The discussion of Trade Requirement

As a preamble to section 11[24], which lays an important requirement that should be adhered to by the taxpayer before claiming any expenditure as a deduction, the person claiming the deduction must be carrying on a trade. In dealing with this topic, it is important for one to discuss the trade requirement as stated in the preamble to section 11 and the requirements of section 11*(a)*[25]. The trade requirement and section 11*(a)* requirements are important in the discussion of this topic as they set out the basic requirements that should be satisfied before the deductibility of any

[22] Reviewing the Tax Treatment of Excessive Debt Financing, Interest Deductions and Other Financial Payments, National Treasury, 26 February 2020

[23] An analysis of ways in which the South African Tax System could be simplified, Gail Young, January 2021

[24] Income Tax No.58 of 1962 as well as this court judgment in ITC 1429 (1982) 50 SATC 402

[25] Income Tax No.58 of 1962

expenditure is allowed. The term 'trade'[26] is defined in the Act and must be constructed to the elements of profitability[27] and cessation of business[28].

'Trade' is given a very wide meaning by the Act and includes *inter alia* 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, or any design or any trade mark, or any copyright, or any other property which is of a similar nature[29].

The notion that a wider meaning must be applied to term trade is further postulated in *Burgess* case[30], SARS contended that the taxpayer's scheme did not constitute a trade, the taxpayer in fact sought to only gain a tax benefit from the venture. The court did not agree with SARS, it held that the person who had laid out money to obtain a bank guarantee with the hope of making a profit had in fact engaged in a 'venture'. The motive for carrying on a trade was not relevant, the term 'trade' sought to cover every profitable activity. [31]

In *Stephan v CIR*[32], the court considered the continuity of activities as a test to determine whether the taxpayer had carried on a trade when engaged in a single venture. In this case the court accepted that the taxpayer's venture entailed carrying on a trade. It must be noted that SARS may disallow certain once off or single investments as not carrying on a trade. For an example overseeing a single rent producing property.

The continuity and profit motives are not the requirements for a carrying on a trade test, they are indicators, as such each case ought to be decided on its own merits, in *De Beers Holdings (Pty) Ltd v CIR*[33], the court stated that the '*attainment of a profit is not necessarily the hallmark of a trading transaction. A trader may for commercial reasons be compelled to resell goods at a loss'*.

The Commissioner of South African Revenue Service (*C:SARS*) will require that an interest expenditure be incurred while carrying on a trade as defined for it to be deductible. In one case

[26] s1(1) Income Tax Act No.58 of 1962

[27] The following cases have reference: *De Beers Holdings (Pty) Ltd v CIR* 1984 (3) SA 286 (T), 46 SATC 47; ITC 1675 (1998) 62 SATC 219; ITC 1292 (1979) 41 SATC 163 and ITC 1592 (1994) 57 SATC 247.

[28] Refer to the following court cases: ITC 1171 (1971) 34 SATC 80; ITC 729 (1951) 18 SATC 96 and ITC 1627 (1997) 60 SATC 26.

[29] s1(1) Income Tax Act No.58 of 1962

[30] *Burgess v CIR,* 1993(4) SA 161 (A), 55 SATC 185, 1993 Taxpayer 153

[31] Stinglingh, M. *et al.* (2020) *Silke: South African Income Tax 2020*. 2020th edn. Edited by M. Stinglingh. South Africa: LexisNexis.,p.117

[32] *Stephan v CIR* 1919 WLD1,32 SATC 54

[33] *De Beers Holdings (Pty) Ltd v CIR* 1986(1) SA 8 (A), 47 SATC 229, 1986 Taxpayer 8

the taxpayer entered into a venturing arrangement by borrowing money at certain rate of interest with a specific purpose of making a profit by lending it out at a higher interest rate. The court held that the intention to carry on a trade inter alia was the decisive factor and not the results of a taxpayer having made a profit[34]. It would therefore follow that 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.

It is the SARS practice[35] to accept the deduction of interest incurred on borrowed funds in order to lend it on at higher interest rate. The overarching principle of this practice is such that the taxpayer may not be allowed an interest deduction over and above the interest income from a particular trade. This Practice Note which has been in existence for over 30 years[36] has had its fair share of contentious deliberations which have ultimately landed in the Constitutional Court[37].

The issue of the closeness or direct link of the purpose of borrowing the funds and that of lending it out has come under close scrutiny, the classic example being that of a parent company borrowing funds to on lend to a loss making subsidiary. The issue in this case is whether the parent company incurred this expenditure for the purposes of trade or not, SARS would argue the latter. It is suggested as was the case in *Solaglass Finance* case[38], that if a parent company is able to illustrate that the activity is a normal treasury function that it undertakes, the requirement of profit making will not be a determinant meaning that the subsidiary could be a loss making undertaking. The SARS is in the process of repealing the Practice Note 31, but the taxpayers may apply the practice pending the drafting of the new legislation as per the Constitutional Court ruling. There does seem to be some contention as to real benefit for taxpayers contesting the application of this practice note, which in the greater scheme is arguably in taxpayers favour[39].

The SARS practice note, and court judgment would serve as a guideline of probable treatment of this requirement which has a bearing on deductibility of interest.

---

[34] ITC 1429 50 SATC 40

[35] Practice Note 31 Income Tax Act No.58 of 1962

[36] Brincker, E. (2023) *The repeal of Practice Note 31 and the impact on the deductibility of interest*, *Special Edition Budget Speech Alert*. Available at: https://www.cliffedekkerhofmeyr.com/en/news/publications/2023/Practice/Tax/special-budget-alert-22-february-The-repeal-of-Practice-Note-31-and-the-impact-on-the-deductibility-of-interest-.html (Accessed: May 20, 2023).

[37] *Marshall v CSARS 2018* 80 SATC 400

[38] *Solaglass Finance Co (Pty) Ltd v CIR* 1991(2) SA 257 (A), 53 SATC 1, 1991 Taxpayer 5.

[39] Brincker, E. (2015) *The Deduction of Interest*, *News & Press: TaxTalk*. Available at: https://www.thesait.org.za/news/242362/The-Deduction-of-Interest-.htm (Accessed: May 2, 2023).

2.2.1. *Profit requirement*

As mentioned above the trade requirement is imperative in deciding whether any expenditure is deductible however this requirement does not necessarily entail that the taxpayer must be making profit. This inclusion of profit as part of the consideration if interest expense may be deductible has been debated by the Courts.

In *De Beer's Holdings (Pty) Ltd v CIR*[40] it was stated that a taxpayer may elect to trade for some other commercial advantage for his business or he may be compelled to sell at a loss. The expropriation of farms in Zimbabwe by war veterans for example would serve as an example.

In ITC 1675[41] the taxpayer was denied an interest claim on an investment fund that was intended to produce interest income. The facts of this case were that the taxpayer's investment became irrecoverable therefore the accrued interest was never received by the taxpayer. The taxpayer also appears to have failed in his tax returns submission to include accrued interest to date and claim a deduction for bad debt[42] for an amount equal to accrued interest yet to be included in the income. The court held that therefore no income from trade from which to deduct the interest incurred.

It is worth noting that the *CSARS* contention contrary to the practice set out in Practice Note 31 (discussed above) that the interest was not deductible as it was not laid out or expended for the purpose of trade, even though the money borrowed was lent out to earn interest. The court issued a warning point on this matter, as no ruling was required that it cannot be safely assumed that CSARS will consider himself bound by his own practice notes and that the issuing of practice notes departing from the provisions of the Act cannot be a good policy.

In ITC 1292[43] the court, in ruling against the taxpayer, held:

i. *"A prerequisite of deductibility of expenditure is that there must be a real hope, based not on fanciful expectation but on reasonable possibility of earning a profit;*

ii. *That in the present instance no such real hope existed; and*

iii. *That therefore no portion of the aforementioned sums of R2905 and R3205 was deductible"*

[40] *De Beers Holdings (Pty) Ltd v CIR* [1985] 47 SATC 229

[41] ITC 1675 62 SATC 219

[42] s 11*(i)* Income Tax Act No.58 of 1962

[43] ITC 1292 41 SATC 163

The ruling above really entails that the taxpayer will be required to show that the carrying on a trade was bona fide and that it was not some unreasonable fishing expedition with no “real hope” of making a profit.

In ITC 1592[44] the taxpayer had bought property with investment and letting intentions. The taxpayer after consulting experts (Bureau for Economic Research) anticipated breaking even within five years. The economic situation however worsened after five years and therefore the taxpayer incurred losses and the Receiver denied the taxpayer deductions based on the premise that the investment was not bona fide. The court held that the anticipated loss was not itself sufficient to warrant a denial of losses incurred, furthermore that the taxpayer had relevant documentary proof of intentions to conduct a sound business.

In summary, the interpretation of expenditure deductibility in trade has evolved through judicial rulings, emphasizing the importance of bona fide trade intention over absolute profitability. Notably, in Practice Note 31, there's a deviation from the CSARS' stance, highlighting the need for caution. Case laws such as ITC 1292 and ITC 1592 reaffirm the need for a "real hope" of profit and the validity of incurred losses under unexpected economic downturns. These insights underscore the intricacies involved in determining the deductibility of trade expenditure.

2.2.2. *Cessation of trade*

In ITC 1171[45], the taxpayer, a director and employee of various companies also carried on a general dealer’s business. In order to finance this business he borrowed sums of money at interest from various sources from time to time. When the general dealer’ business failed to prosper, he closed it down and all trading operations ceased at the end of October 1966.

As the matter of common cause prior to the cessation of the business the taxpayer had been claiming interest in respect of various loans on the premise that they were had been incurred in the production of income and expended wholly and exclusively for the purposes of trade[46] and was deductible. The taxpayer sought to deduct interest incurred on the same loans in subsequent years, this after having ceased trading from his other income in the form of director’s fees, salary and commission. The Secretary as was known back then disallowed all the interest deduction claimed by the taxpayer after a he had ceased trading.

---

[44] ITC 1592 57 SATC 247

[45] ITC 1171 34 SATC 80 1973 Taxpayer 36

[46] Note now s23*(g)*

Judge Watermeyer upheld that decision:

i. *"In determining whether the expenditure was incurred in the production of income' the purpose of the act entailing the expenditure had to examined.*

ii. *In casu, the act entailing the interest expenditure was not the initial borrowing of the money but the taxpayer's decision from day to day to retain the use of money.*

iii. *Once the taxpayer had ceased trading as a general dealer, his election to retain the use of the money was no longer made for the purpose of earning income, either in the general dealer' s business or from any other source.*

iv. *Accordingly, the interest expenditure incurred after the taxpayer had ceased trading as a general dealer was not incurred in the production of income and was therefore not deductible.*

v. *The appeal was dismissed with costs"*

In ITC 729[47] the taxpayer in that case was a director of a company carrying on a trade of merchants. The taxpayer had prior to sale the business of partnership undertaken to pay pensions to certain retired employees for their lifetime. Upon the sale of the business to the company, the acquirer did not take up the obligation to pay these pensions and therefore the obligation remained with the partners. The court held that these pensions payable after the cessation of the trade by the partnership were deductible based on the premise that these obligations were incurred for the purpose of trade.

In ITC 1627[48] the taxpayer undertook to develop a township therefore borrowed moneys in order facilitate this project. The loans had not been fully paid up by the time the last stand in township had been sold he therefore continued paying the loans and interest incurred thereon after such time. The taxpayer sought to deduct the interest paid against his salary from the professional firm which he was working for.

The *CSARS* disallowed the interest on the basis that the interest could only be allowed against township income and not against the taxpayer's salary.

Judge Labe J ruled in favour of the taxpayer in this case stating that had continued trading by virtue of his employment and that it was unnecessary for the courts decide whether trading ceases when the active was no longer carried on and that the view that trading perhaps only ceases when

[47] 1951 18 SATC 96

[48] 60 SATC 26

all the debts of a business have been paid and all the sums due to it have been collected was debatable.

A Special Board Decision no.124 the court upholds the principle that interest should only be deductible if relates to the discharge of a liability assumed during the normal course of carrying on an enterprise.

The deductions from the principles laid down on the above cases are that should the taxpayer's obligations be terminable after cessation of business then based on the merits of the case in point it would not be deductible. It therefore follows that should the expenses relate to obligations incurred during the carrying on of the business operations they would be deductible.

It appears also from the above cases that interest incurred on money involuntarily spent as a result of some misfortune would be deductible and interest on money voluntarily spent not deductible[49].

2.3. The General deduction s11(a)

It was important in 2.2 above to deal with the trade requirement, as a preamble, as it aptly sets the scene for the deduction of interest on money borrowed in relation to section 11*(a)*, known as "General Deduction" of the Income Tax Act.

For any expenditure to be deductible in terms of the Income Tax Act such expenditure must first satisfy the requirements of section 11*(a)*[50] of the Income Tax Act. Section 11*(a)* allows the deduction of (1)any expenditure or a loss that is (2) actually incurred[51] (3) in the production of income[52], provided such expenditure and losses are (4) not of a capital nature[53].

[49] ITC 1727 2001 64 SATC 275

[50] Also known as the General Deduction Formula.

[51]Refer to the following court cases: *Caltex Oil (SA) Ltd v SIR* 1975 (1) SA 665 (A), 37 SATC 1; ITC 1495 (1990) 53 SATC 216; *Nasionale Pers Bpk v KBI* 1986 (3) SA 549 (A) 48 SATC 55 and *Golden Dumps (Pty) Ltd, CIR v* 1993 (4) SA 110 (A), 55 SATC 198

[52] The following cases amongst others have laid some principles regarding the treatment of this element:

Nemojim Pty (Ltd) v CIR 1983 (4) SA 935 (A), 45 SATC 241; *Producer v COT* 1948 SR 62, 15 SATC 405; *Financier v COT 1*950 SR 69, 17 SATC 34; *Allied Building Society, CIR v* 1963 (4) SA 1 (A), 25 SATC 343; *Standard Bank of SA Ltd, CIR v* 1985 (4) SA 428 (A),47 SATC 179; ITC 484 (1941) 11 SATC 351; ITC 572 (1944) 13 SATC 461; ITC 1764 (2004) 66 SATC 93; *CSARS v BP Southern Africa (Pty) Ltd* 2006 (5) SA 559 (SCA) and *Drakensberg Garden Hotel (Pty) Ltd, CIR v* 1960 (2) SA 475 (A).

[53] The following cases refer to some pertinent issues of this requirement: *New State Areas Ltd v CIR* 1946 AD 610, 14 SATC 155; ITC 1124 (1968) 31 SATC 53; *Hilewitz, CIR v* (1996) 60 SATC 86;

ITC 968 (1962) 24 SATC 726 and *Guardian Assurance Holdings (SA) Ltd, SIR v* 1976 (4) SA 522 (A), 38 SATC 11.

Prior to introduction of s24J[54] in 2004 this section was the overriding section when determining the deductibility of interest and therefore principles derived from its application remain a pivotal part of this determination. The general deduction formula does not explicitly mention that in order for an expenditure to be deductible, it must be incurred during the year of assessment. The courts have upheld held this view,[55] which may be contrasted with the s11A provisions. In order to ascertain whether an expenditure or loss is of capital nature or not, its revenue nature must be ascertained.

Each of these four requirements are to be considered in detail below, using the common law judgments by the courts.

2.3.1. *Expenditure and losses*

Interpreting the phrase "(1) any expenditure or a loss" within Section 11*(a)* of the South African Income Tax Act indeed presents a rich area of debate. A major point of contention often centers around what exactly constitutes "expenditure" and "loss", and whether certain financial outlays can be properly categorized as such.

In the context of tax, an "expenditure" typically refers to amounts that have been paid out or the value of resources that have been used up in the course of conducting a business or trade. However, what exactly can be considered as a deductible "expenditure" can be a point of dispute. For instance, in the case of *CIR v Nemojim (Pty) Ltd* (1983) 45 SATC 241, the court held that the word “expenditure” in section 11*(a)* does not include a contingent liability. Therefore, it would seem that for an expense to be deductible, it must represent an actual outflow of resources, rather than merely a potential or future obligation.

Similarly, "loss" typically refers to a decrease in economic benefits during the accounting period in the form of outflows, depletions of assets or incurrences of liabilities. A key area of debate would be how to measure and recognize such losses. The courts have ventilated when such losses can be included, for example in ITC 1242 (1975) 37 SATC 306, which dealt with a theft were the principle was that where the theft was inseparable from, or a necessary ingredient of, the carrying on of a particular business, the loss is deductible. However, the courts have not defined the word “losses” itself[56].

---

[54] Income Tax Act of 1962

[55] *Concentra (Pty) Ltd v CIR* 1942 CPD 509, 12 SATC 95.

[56] Stinglingh, M. *et al.* (2020) *Silke: South African Income Tax 2020*. 2020th edn. Edited by M. Stinglingh. South Africa: LexisNexis., page 119

In conclusion, the interpretation of "any expenditure or a loss" within Section 11*(a)* of the South African Income Tax Act remains a contentious issue, with debates centering around the specific categorization of 'expenditure' and 'loss'. The complexity is amplified by varying court interpretations and a lack of clear-cut definition, and the debate continues to evolve as each case presents unique circumstances that may further refine or challenge existing interpretations.

2.3.2. *Actually incurred*

The following discussion delves into the critical nuances of the phrase 'expenditure actually incurred' in the context of S11(a), illustrating how it impacts the deductibility of expenditure for tax purposes, and considering the distinction between 'actually incurred' and 'necessarily incurred', a differentiation that broadens the scope of expenditure deductibility.

In considering the second part of S11(a), as long as the taxpayer can prove that interest liability has been incurred the expenditure is deemed to have been actually incurred. It is not necessary for the taxpayer to prove that interest expenditure has necessarily been incurred.

In the case of *Port Elizabeth Electric Tramway Co Ltd v CIR*[57], Watermeyer AJP in paragraph 244 stated:

> *"Taking these in turn, the words of the statute are 'actually incurred', not 'necessarily incurred' The use of the word 'actually' as contrasted with the word 'necessarily' may widen the field of deductible expenditure. For instance, one man may conduct his business inefficiently or extravagantly, actually incurring expenses which another man does not incur; such expenses therefore are not 'necessary' but they are actually incurred and therefore deductible. But expenses 'actually incurred' cannot mean 'actually paid'. So long as the liability to pay them actually has been incurred they may be deductible. For instance, a trader may at the end of the income tax year owe money for stocks purchased in the course of the year or for services rendered to him. He has not paid such liabilities but they are deductible."*

This is correct in the sense that if the requirement was necessarily incurred an objective test would be required to determine if it was objectively required of the taxpayer to incur the expenditure in question. Therefore, the taxpayer would be required to prove that it was necessarily required by their business that they incur the expenditure in question.

While a requirement "during the year of assessment" has not been mentioned in section 11*(a)*, the courts have held that the expenditure that the taxpayer claims as a deduction, must be incurred during the year in which it is claimed.

---

[57] *Port Elizabeth Electric Tramway Co Ltd* v CIR 1936 CPD 241, 8 SATC13

In *Sub Nigel Ltd v CIR*[58] it was said that for the whole scheme of the Act shows that, as the tax payer is assessed for income tax for a period of one year no expenditure incurred in a year previous to the particular tax year can be deducted. This was again reiterated in *Concentra (Pty) Ltd v CIR*[59] the taxpayer company claimed as a deduction certain expenditure relating to directors' expenses which had arisen in earlier years. The court held that the expenditure should have been claimed in the years in which it arose, and that, by not doing so, the company had forfeited its right to claim a deduction in terms of section 11*(a)*.

In ITC 1496[60], the taxpayer entered into a farming partnership as part of a 'plantation scheme'. At the heart of the scheme lay the idea that interest due over a lengthy period in the future could, by being settled immediately by way of promissory notes, be deducted immediately.

Judge Melamet J, held in handing down the judgement:

i. *"The liability to pay interest is conditional upon the loan being in existence and the accrued interest being unpaid at the time stipulated for the payment of interest and the holder of the promissory note being able to establish his or her title to thereto. The loan could have been discharged for some or other reason and its continued existence at the time it is sought to recover accrued unpaid interest is a prerequisite to the right to claim such interest.*

ii. *It may or may not become payable.*

iii. *It matters not how unlikely the fulfilment of the condition is.*

iv. *Although the promissory note might evidence a contractual liability to pay interest at some future date, the actual liability so to pay is only incurred as and when interest accrues on the outstanding loan.*

v. *...Interest is an expense to compensate the lender for the time period during which the money is lent out to a second party. It cannot be incurred prior to the time during which the money is used. It is incurred and accrues from day to day."*

Similar to the above is ITC 1121[61] when a bank claimed a deduction for all interest reflected on the negotiable certificates of a deposit (NCDs) it had issued even though most of it was only payable in instalments at fixed dates in future years of assessment. The court held that, although the NCDs

---

[58] 1948 (4) SA 580 15 SATC 381
[59]1942 CPD 509 12 SATC 95
[60] 1990 53 SATC 229
[61] 1968 30 SATC 171

evidenced a contractual liability to pay interest, the actual liability payable was only incurred when interest accrued on outstanding loans.

The period in which interest liability is incurred is important, as shown in *Caltex Oil (SA) Ltd v SIR*[62] where it was held that 'expenditure actually incurred' does not mean expenditure actually paid during the year of assessment, but means all expenditure for which liability has been incurred during the year of assessment, whether the liability has been discharged during that year or not. It is in the tax year in which the liability for the expenditure is incurred and not in the tax year in which it is actually paid (if it is paid in a subsequent year), that the expenditure is actually incurred for the purposes of s 11*(a)*.

Other than the requirements of s 24J incurral of interest, it is clear in terms of this requirement that for interest expenditure to be deductible the interest must have been incurred in the year of assessment in which it is claimed. It may therefore not be accumulated from year to year and only to deducted in a subsequent year in which income is earned. To be discussed later in the topic is the timing of interest deduction resulting from arrangements such as borrowing money to purchase shares and to pay dividends (see 3.2 below).

The courts, through the case of *National Pers BPK v KBI*[63], have clarified that a liability is deemed 'incurred' when a legal obligation towards an expenditure becomes certain. If the obligation is still undecided at the tax year's end, reliant on a future event that may or may not happen, the expenditure is not seen as 'actually incurred'. An unpaid expense only counts as a liability once the taxpayer has received goods or services and thus owes the supplier money, as the supplier has fulfilled their part of the deal. This logic, however, may not apply to interest liability, which typically becomes due after the provision of loan capital.

The determination of whether an expense has been incurred often hinges on the obligations specified in a contract. As shown in the case of ITC 1495[64], a provision for accrued leave wasn't deductible because the employee's contract didn't grant them the right to payment in lieu of leave. According to the contract, the employees were entitled to leave or leave accrual, not the monetary equivalent.

In ITC 1444[65], the taxpayer claimed a deduction in respect of the expense of imported raw materials to be delivered at a later date. Because of the volatile nature of the supply of the material, it was the practice of the taxpayer to enter into contracts for the future supply of the material. The

---

[62] 1975 (1) SA 665 (A), 37 SATC 1

[63] 1986(3) SA 549 (A) 48 SATC 55

[64] 53 SATC 216

[65] 1989 51 SATC 35

court held that, because of the bilateral nature of a sale contract which created reciprocal obligations, payment was conditional on performance by the seller and therefore no "absolute and unqualified liability" arose until such time. As a result, the expenditure claimed as a deduction did not represent "expenditure actually incurred". The expense would only be incurred once the seller delivered the materials to the buyer.

It was held in *CIR v Golden Dumps (Pty) Ltd*[66] that where a taxpayer genuinely disputes liability for an amount and the dispute is the subject of litigation, the expenditure in respect of that amount is not 'actually incurred' until the court declares that the tax payer is indeed liable for the amount.

In conclusion, the interpretation of 'expenditure actually incurred' under S11(a) shapes the scope of expenditure deductibility. The legal precedents illustrate that the incurred liability, rather than the payment of expenditure, guides this interpretation. Furthermore, the presence of contractual obligations and the timing of the liability play critical roles in determining the incurred expenditure. This underscores the complexity of tax regulations and the necessity for detailed understanding when handling tax-related matters.

2.3.3. *In the production of income*

To determine whether the expenditure is incurred in the production of income or not it is necessary to look at the purpose of the expenditure and determine whether there is a close connectivity between the interest expenditure and the income-earning operations of the taxpayer[67].

In the case of *Port Elizabeth Electric Tramway Co Ltd v CIR*[68], Watermeyer AJP's interpretation of the phrase "in the production of the income" was that it meant that the expenditure must be closely connected to the income-producing operations of the taxpayer. He said that income is produced by the performance of a series of acts and attendant expenses are deductible if they are part of those acts or a necessary concomitant of them[1]. He also said that expenses that are too remote from the income-producing operations are not deductible. This interpretation has been criticized as being too mechanical and contrived[69].

[66] 1993 (4) SA 110 (A) 55 SATC 198

[67] *CIR v Nemojim (Pty) Ltd* 1983 45 SATC 241

[68] *Port Elizabeth Electric Tramway Co Ltd v CIR* 1936 CPD 241, 8 SATC13

[69] Goldswain, G.K. and Swart, O. (2015) "The Port Elizabeth Electric Tramway case: Is the meaning ascribed to the phrase 'In the production of the income' by Watermeyer AJP in the Port Elizabeth Electric Tramway case still religiously followed today?," *Southern African Business Review*, 19, pp. 71–96. Available at: https://doi.org/10.25159/1998-8125/5791.

In *COT v Rendle*[70], the Appellate Division of the High Court of Rhodesia held that the deductibility of fortuitous expenditure depends on whether the chance or risk of its being incurred is sufficiently closely connected with the taxpayer's business operations. The taxpayer must show that the risk of the mishap which gives rise to the expenditure was inseparable from or a necessary incident of the carrying on of the particular business.

In the case of *Producer v COT*[71], the taxpayer borrowed money for use in the business, but later invested in shares which did not produce taxable income. The court held that whether in fact, the money did produce income or not was irrelevant.

Financier v COT[72] reiterates this principle, where the taxpayer carried on a business as a moneylender by discounting bills and making loans, and invested some of its funds in the shares of various companies. In its 1948 year of assessment the taxpayer sought to deduct an amount of £2550, being interest paid on money borrowed. The Commissioner disallowed £956 of this amount on the basis that it represented that portion of the interest relating to the portion of the loans used by the taxpayer for investment in shares, from which no taxable income was derived. The amount of £956 was an estimated amount based on the ratio of the amounts invested by the taxpayer not producing taxable income to the total current assets including such investments.

The court held in favour of the taxpayer based on the purpose for which the moneys were borrowed and that it not relevant as to whether or not the money yielded income. Judge Trendgold, in arriving at the decision for that court case, stated two general principles:

i. *"A specific sum of money borrowed and applied with a purpose not to produce income and not directly connected with any income-earning part of the taxpayer's business will result in the disallowance of the interest relating to it, since that interest is not incurred in the production of income.*

ii. *Where a taxpayer borrows money for use in the income producing business such interest will be deductible even if subsequently, for legitimate business purposes, the taxpayer invests that money in such a way that it does not produce taxable income. The ultimate use of the money is relevant only if it can be used to establish that the funds were not raised at the time of the borrowing to produce income."*

---

[70] COT v Rendle 1965 (1) SA 59 (SRAD), 26 SATC 326, 1964 Taxpayer 225

[71] 1948 SR 62, 15 SATC 405

[72] 1950 SR 69, 17 SATC 34

It is therefore clear that the ultimate use or destination of the funds borrowed is not necessarily the decisive factor in determining the deductibility of interest, it merely throws a light upon the purpose for which the money was borrowed.

In *CIR v Allied Building Society*,[73] a permanent building society, accepted, as a matter of the ordinary course of business, all money offered to it in respect of the shares, savings, or fixed deposits. The taxpayer had always been able to utilise in its business all the money offered to it by prospective shareholders and depositors. The taxpayer used the funds to grant loans on security of urban immovable property and to make advances against the security of deposits or shares in itself. It also derived income by way of interest on advances and loans made by it, interest on government, municipal and other stock, interest on deposits with bankers and local authorities, dividends on *National Finance Corporation* stock, rents, valuation, and inspection fees, commissions and sundry receipts.

At all material time, the total interest bearing assets exceeded total borrowed funds which interest was being paid on. In the taxpayer's assets, certain non-income earning properties were included which the Commissioner denied the interest deduction that related to that portion.

The court held that the acquisition of non-revenue producing properties was purely incidental to the business of borrowing money in order to earn investment income. The court further laid the argument that should the taxpayer have opted to let some of the borrowed funds lie idle, the Commissioner would not be afforded sufficient grounds to reduce the interest amount deductible and that the *true criterion of deductibility* was the purpose for which the permanent building society borrowed the amount.

Essentially, the *vital enquiry* in determining whether an expenditure is in the production of income or not appears to be the purpose of borrowing.

The purpose test is elaborated further in *Standard Bank of SA Ltd* case[74], where the taxpayer, a commercial bank, borrowed money at a low interest rate by way of customer's deposits and in turn advanced these deposits in various ways to earn interest and other forms of compensation for the use of money. The taxpayer, as a matter of normal business course, used some of these moneys to buy shares which earned dividends. In terms of s10 (1) *(k)* of the Act such moneys would constitute exempt income, and hence the Commissioner disallowed a portion of the bank's interest relating to this exempt income. The court held that the immediate purpose was to obtain

[73] 1963(4) SA 1 (A), 25 SATC 343

[74] 1985 (4) SA 485 (A),47 SATC 179

floating capital. Therefore there was no close connection between the certain proportion of interest and the dividends it received[75] to warrant a denial of full interest expenditure deduction.

The contrasting case to this one above is that of a director (ITC 484)[76] who borrowed a *specific* sum of money and lent it out to his company, interest free. The court excluded the purpose of producing income and simply looked at the facts of the case which clearly indicated that the purpose was not produce income.

The discussion between general loans vs will be elaborated on further in 3.2 below.

There are instances where the taxpayer gets involved in costly arrangements as in ITC 572[77] where the taxpayer issued debentures as consideration for assets still to be used in its business, while using its surplus funds to make interest free loans to its shareholders. The court held that the fact that the arrangement might be expensive to the company, it does not alter the purpose for which the funds were borrowed, and hence held that the interest should be deductible.

This appears to be a contentious point and will be discussed further later in this research as the financial position could be used as a test for the true criterion for borrowing[78].

In *CIR v Drakensburg Garden Hotels (Pty) Ltd*[79] a company acquired shares in another company owning the premises which it had leased out in the course of carrying on its business. Its purpose in acquiring the shares was to obtain absolute control of its premises in order to ensure security of tenure and hence the continuation of its income. It was held that the purpose of borrowing the money was not to produce exempt dividend income, but to ensure the continuance of business profits. The key tool that worked in favour of the taxpayer was the ability to show a link between the interest payment and the production of income.

In conclusion, the purpose of borrowing rather than the final use of borrowed funds plays a significant role in determining the deductibility of interest expenditure in tax matters. Courts have consistently ruled that if the intention at the time of borrowing is to generate income, interest is deductible even if funds are later invested in non-income producing avenues. However, if funds are borrowed explicitly for non-income producing purposes, the corresponding interest is non-deductible.

[75] s 23*(f)*

[76] 1941 11 SATC 351

[77] 1944 13 SATC 461

[78] See TC 1764 (2004) 66 SATC 93

[79] 1960 (2) SA 475 (A), 23 SATC 251

On the other hand, costly or seemingly inefficient financial strategies do not preclude interest deduction if the borrowing's purpose aligns with income generation. Nevertheless, a clear link between the interest expense and income production is critical to uphold such deductions, underscoring the significance of the purpose test in this legal context.

2.3.4. *Not of a capital nature*

Determining whether interest is capital or revenue in nature is crucial because under section 11(a), capital expenses can't be deducted from income. An expenditure that is made with 'a view to bringing into existence an advantage for the enduring benefit of a trade'[80] would probably not qualify for a deduction, since such expenditure is considered to be of a capital nature.

For instance, in the case of ITC 1124[81], a taxpayer aimed to control two timber milling companies by purchasing shares with a loan. This move was to ensure a steady timber supply for an associated company. However, this expense was not allowed as a deduction, not because it was a capital expense, but because it didn't have a close enough connection to income generation.

In another case, *CIR v Hillewitz*, the taxpayer had to cover losses due to suretyships given to a company's creditors. The company, where the taxpayer was a director, shareholder, and employee, later went into liquidation. The court ruled these losses as capital in nature, thus not deductible, since the suretyships were crucial for the company's financial sustainability and continued business operations.

In ITC 968[82], a taxpayer who retired from a partnership was given promissory notes for his share of the partnership capital. He sold these notes to raise cash for a loan. However, the court ruled that the loss from this sale was a capital loss and thus not deductible.

On the other hand, if an expense is not capital, it's considered revenue as no halfway house exists[83]. Sometimes, it's possible to divide an expense into capital and revenue components, as in the *SIR v Guardian Assurance Holdings* case[84]. The company initially planned to issue shares privately, but decided on a public issue hoping to earn interest from oversubscriptions. The company estimated that part of the floatation expenses was due to this decision and was deductible as it was tied to earning interest. Although SARS claimed these expenses were capital

[80] *New State Areas Ltd v CIR* 1946 AD 610, 14 SATC 155

[81] 1968 31 SATC 53

[82] 1962 24 SATC726

[83] *Pyott v CIR* 1945 13 SATC 121 126

[84] 1976 (4) SA 522 (A), 38 SATC 11

in nature and thus not deductible, the court disagreed, ruling that these expenses could be apportioned and the portion related to earning interest was not capital in nature.

In ITC 1604[85] the taxpayer did not contemplate earning dividends or obtaining a capital distribution. His purpose was to secure his income and to increase it and he succeeded in showing that he earned increased income. The acquisition of the interest in the corporation, therefore, was closely connected to the earning of income by way of an increased salary and a substantial executive bonus. The interest expenditure was held to be in the production of income. The taxpayer was able to show that the main purpose of incurring loan expenditure was for the purposes of income producing.

On the other hand in ITC 1126[86] the court indicated that the purchase price was paid to acquire the shares which gave the taxpayer control of the company. Such expenditure was held to be of a capital nature in that the control acquired by the taxpayer can be likened to the acquisition of the income earning structure. If one looks the closeness of the connection test between the income earning asset and the income earning activities of the taxpayer in this case one can see that the control for the company was the purpose for the acquisition of the shares. This was an intention to acquire a capital asset therefore the interest on the loan that was acquired to execute this capital intention followed the character of the transaction.

In conclusion, discerning whether interest is capital or revenue in nature, significantly impacts tax deductions under section 11(a). These cases demonstrate how complex this process can be and how court decisions hinge on the specific circumstances and intent behind each financial action.

2.4. The application of s24J charging provision on interest on investment income and other financing arrangements

The s24J charging section, was first introduced in 1995, this section included in the Act after the Commissioner realised at the time, that despite the anti-avoidance provisions s8E and s8F resulted in funding mismatches and unexpected deferrals[87]. Thereby resulting in tax losing economical relevance of some investment and funding transactions. When s24J was first introduced it was aimed at giving clarity as to what interest means as indicated above the courts leading to this event as well as providing guidance as to the time of accrual or incurrence of interest.

---

[85] 1995 58 SATC 263

[86] 1968 31 SATC 111

[87] s8E and s8F of Income Tax Act No.58 of 1962 serve as examples of a hybrid instrument.

Since its introduction the section has evolved into a stand-alone charging provision. Its regarded as highly a complex section and while a technical application of this section is not being provided here, the timing of interest incurral and accrual from both the borrower and lender perspective should still be considered. It will also investigate instances where s24J becomes applicable. In arriving at the amount of incurral or accrual the components of the calculation which include the 'yield to maturity' are considered.

Chapter 3: Practical Considerations relating to the Taxation of Interest

The taxation of interest expenses has profound implications for businesses, impacting cash flows, profitability, and, ultimately, growth potential. Consequently, effective tax planning requires a thorough understanding of the principles and guidelines for determining whether interest expenses are deductible or not. This chapter delves into the intricacies of these principles as they apply to various real-world scenarios, providing a comprehensive exploration of the tax treatment of different types of interest expenses.

The chapter explores a range of interest types, specifically focusing on notional interest, pre-production interest, and interest on general loans, each of which presents its own unique challenges and considerations in the context of tax law. Moreover, the issue of 'excessive' interest and how tax authorities and courts have approached such cases will be delved into.

Further, specific loan scenarios commonly encountered in business, such as loans for purchasing shares, loans to pay dividends, and loans for domestic purposes, will be considered. By examining these scenarios, it is intended there be some explanation of the complexities inherent in tax law and how various factors, including the purpose of the loan, its direct and indirect effects on income generation, and the relationship between the borrower and lender, can influence tax outcomes.

The chapter then draws upon case law, offering an analysis of court decisions and their implications on the tax treatment of interest expenses. These case studies provide valuable insight into how courts evaluate whether an expenditure is of a capital or revenue nature, an essential distinction in determining whether an expense can be deducted under section 11(a) of the law.

3.1. The tax treatment of interest on general loans

In South Africa, as in many countries around the world, the tax treatment of interest on general loans - loans obtained for the purposes of running a business or generating revenue - is of concern to taxpayers and tax planners alike. First and foremost, the concept of revenue versus capital nature is crucial to understand, as highlighted in 2.3.42.3.4 above. In tax law, expenses of a revenue nature are typically deductible, while those of a capital nature are not. A revenue expenditure generally refers to an expense incurred in the ordinary course of business or trade. In contrast, a capital expenditure often relates to an investment or asset that will benefit the business over a more extended period, such as property or equipment. The crux is in determining the nature of the interest expenditure on a general loan: is it an expense incurred in the course of generating income (revenue) or an investment in an income-producing asset (capital)?

Section 24J of the South African Income Tax Act provides some guidance in this area. This provision is centred on the taxation of interest. According to section 24J, 'interest' includes not only interest in the ordinary sense but also discounts, finance charges, or premiums that are paid in connection with a financial instrument. Essentially, section 24J seeks to even out the tax treatment of financial instruments, ensuring that any interest income accrued is taxable and any interest expenditure is deductible. The stipulation, however, is that the interest must have been 'incurred in the production of the income.' In other words, there must be a direct link between the interest expenditure and income generation.

Relevant case law offers further illumination on these principles[88]. In *Burman v CIR*[89], the taxpayer had acquired shares in property companies and advanced moneys to them on loan account to be used by them as working capital to pay for properties purchased by them, his intention being to make a profit by selling the shares and disposing of his loan accounts to the purchasers of the shares. The companies went insolvent and the taxpayer accordingly suffered a loss. As the share capital of the companies was minimal, the loss was mainly incurred in respect of the loan accounts. The taxpayer claimed his loss on the loan accounts as a deduction on the basis that it, like his shares, was trading stock and therefore of revenue in nature.

The CSARS disallowed the deduction and the taxpayer's appeal was dismissed on the grounds that the loss was of fixed nature rather than of floating capital and was therefore of capital nature and that the fact that the 'taxpayer had intended that the loan accounts be disposed of together with the shares of the company did not mean that the loans were a component of the taxpayer's interest in the company.'

Similarly, in *Stone v SIR*[90] , the taxpayer advanced on sum of money to one individual named Kasmai to enable him to fulfil the contractual obligation of supplying goods in the normal course of carrying on a trade. The taxpayer suffered losses as it turned out that Kasmai had committed fraud and therefore the loans had become irrecoverable. The taxpayer sought to deduct from his income losses he incurred as a result of this arrangement.

---

[88] See the following: *Burman v CIR* 1991 (1) SA 533 (A), 53 SATC 63; *Stone v CIR* 1974 (3) SA 584 (A), 36 SATC 117; *Sentra-Oes Koöperatief Bpk v KBI* 1995 (3) SA 197 (A), 57 SATC 109;

Solaglass Finance Company (Pty) Ltd v CIR 1991 (2) SA 257 (A), 53 SATC 1 and

Atlantic Refining Company of Africa (Pty) Ltd v CIR 1957 (2) SA 330 (A),21 SATC 203.

[89] 1991 (1) SA 533 (A), 53 SATC 63

[90] 1974 (3) SA 584 (A), 36 SATC 117

The court dismissed his appeal on the grounds that the taxpayer was not in the business of money lending and therefore loans advanced to Kasmai were occasional or once off loans and therefore were of capital rather than the floating nature.

Again, in *Sentra-Oes Kooperatief v KBI*[91], the court held that a R5 million loss incurred by the taxpayer, a short term insurer to farmers was not deductible as the taxpayer was not a banker or involved in money lending business and therefore the loss was of capital nature.

Building further on these precedents, in *Solaglass Finance Co v CIR*[92] the taxpayer in this case sought to claim a deduction of R4 545 922 for a loss incurred on the disposal of a debt in the 1978 year of assessment and a deduction of R55 153 in respect of the loss incurred on irrecoverable loans in its 1979 year of assessment. The court held in this case against the taxpayer that the loans made were not only made with the view of earning a profit in the form of interest, but also with the view of providing a benefit to other companies within the group. The losses could therefore not be regarded as representing moneys laid out or expended wholly and exclusively for the purposes of the taxpayer's trade[93] and were therefore not deductible.

In *Atlantic Refining Co v CIR*[94] the taxpayer, a supplier of petrol and petroleum products had entered into some form of restraint of trade contracts with its competitors. To induce the competitors to enter into these forms of contracts the taxpayer offered them low or interest fee loans. Some of these loans became irrecoverable and the taxpayer suffered losses as a result and sought to deduct these losses from gross income under the premise that they had been circulating capital. The court held that the purpose of the taxpayer in entering into these loan arrangements was to have an enduring benefit of retaining its competitors as their sources of income and that the taxpayer was not a money lender and therefore was not deductible.

Across these, the courts have consistently denied tax deductions for losses on loans on the grounds that they were capital in nature, not revenue. The courts noted that the taxpayers in these cases were not in the business of money lending, and the loans, therefore, were not part of their ordinary income-generating operations. Instead, these loans were more akin to investments - they were of a capital nature.

This does not mean, however, that interest on general loans is never deductible. If a taxpayer can demonstrate that a loan was obtained in the course of, and for the purposes of, producing income

---

91 1995 (3) SA 197 (A), 57 SATC 109

92 1991 (2) SA 257 (A), 53 SATC 1

93 Note now provision of s 23*(g)*

94 1957 (2) SA 330 (A), 21 SATC 203

- in other words, if the loan is of a revenue nature - then the interest on that loan may be deductible under section 24J.

3.2. The tax treatment of interest on specific loans

In deciding whether an interest on money borrowed is deductible or not often a taxpayer would in certain circumstances borrow a specific sum of money and apply it to an identifiable purpose. In this particular instance the purpose of the expenditure and what it actually affects can be readily determined and identified. A clear and close causal connection can be traced and it is an imperative consideration in determining the deductibility of interest expenditure.

In the world of business, understanding the tax implications associated with loans is crucial to informed decision-making and financial planning. Focusing on the South African context, the tax treatment of interest on loans undertaken for distinct purposes: purchasing shares[95], paying dividends[96], and addressing domestic needs is then considered. For each, key aspects such as the revenue vs capital nature of these expenses, the types of interest, relevant case law, and the critical elements of section 24J of the South African Income Tax Act is considered.

3.2.1. *Interest incurred from the Purchase of Shares*

When discussing the tax treatment of interest on loans procured to purchase shares, it's essential to consider the borrowing entity's nature of operations.

Section 11*(a)* of the South African Income Tax Act stipulates that to be deductible, an expense must be incurred in the production of income. Interest on loans is an expense, but dividends, which are usually derived from shares, aren't considered taxable income. Hence, it's generally accepted that the interest on loans taken to buy shares can't be deducted from the company's taxable income.

However, an exception exists. When a company trades shares and holds the shares as trading stock, the interest on loans taken to acquire those shares could potentially be considered a trading

---

[95] The following cases serve as reference: ITC 1694 (1999) 63 SATC 127 aka *Mpande Foodliner CC (MF) v CSARS, 2000 (11) JTLR 331, 63 SATC 46* T (Pty) Ltd; ITC1602 (1995) 58 SATC 205; *Natal Laeveld Boerdery (Edms) Bpk v KBI* 1998 (1) SA 639 (SCA),60 SATC 81; *CIR v Shapiro* 1928 NPD 436, 4 SATC 29; ITC 1428 (1985) 50 SATC 34 *and CIR v Drakensberg Garden Hotel (Pty) Ltd* 1960 (2) SA 475 (A).

[96] Cases to be considered include: *CSARS v Van der Westhuizen* 2001 63 SATC 191; *CSARS v 121 Castle Street Cape Town CC* 2002 (1) SA 198 (C) 63 SATC 185*; CSARS v BP South Africa (Pty) Ltd* 2006 (4) SA 195 (C) 68 SATC 229 (SCA*); Ticktin Timbers CC v CIR* [1999] 4 All SA 192 (A) 61 SATC 399; *CSARS v Scribante Construction (Pty) Ltd* 2001 (2) SA 601 (E) 62 SATC 443 and *CIR v Elma Investments CC* (CPD) 1996 58 SATC 295.

expense. This means it could be deducted from taxable income, provided the company can prove the loan was necessary for the income-generating operations.

The case law does offer further clarity on this matter: in ITC 1602[97] the taxpayer wanted to increase the farming activities but the other remaining members in the close corporation would not oblige. In an effort to buy them out of the close corporation the taxpayer raised a loan and used it to purchase the interest of the outgoing members. The taxpayer then sought to deduct interest incurred on this loan from the income. The court held that to the extent loan used to acquire the interest of outgoing members on its own did not increase the income-producing capacity of the company but to the extent that the loan was used to settle loan accounts of existing members it would be deductible.

In ITC 1694 (aka *Mpande Foodliner*)[98] the taxpayer in this case was permitted to deduct interest on a loan that was raised in order to enable him to purchase 50% of his brother's share of a close corporation carrying on fishing business. The taxpayer showed the court that from the date on which his shareholding increased to 100%, he withdrew the full profit as a salary compared to 50% that was previously withdrawn. The court held that the taxpayer did not have the intention of earning dividends from his shareholding and that upon acquisition of additional 50% he earned twice an amount he would have earned had he not bought his brother's share.

In *Natal Laeveld Boerdery (Edms) Bpk v KBI*[99] a dispute between the two existing members erupted and the two members agreed that the one member would purchase the other's shareholding. The purchase of shares is to be financed by the corporation's mortgage.

The court held in this case that the primary purpose of borrowing by the corporation was to resolve irreconcilable differences of opinion and to enable the remaining member to acquire shares of the outgoing member. It further stated the fact the corporation would ultimately earn additional income without interference was best as a secondary objective. The court therefore disallowed the deduction.

In *Sallies Ltd v CSARS*[100] the taxpayer sought to deduct the interest incurred on certain loans to acquire share capital of another company. Immediately thereafter the taxpayer entered into a marketing agreement with that subsidiary and was paid marketing fees. The taxpayer decision to deduct the interest on the loan was based on the premise that it had produced income in the form of marketing fees. The CSARS disallowed the interest deduction in terms of s 11*(a)*, read with s

[97] 1995 58 SATC 205

[98] 1999 63 SATC 127, 2000 (4) SA 1048 (T), 63 SATC 191

[99] 1998 (1) SA 639 (SCA), 60 SATC 81

[100] 2007 WLD, 70 SATC 39

23*(f)* and s 23*(g)*, on the basis that it was for the acquisition of share capital and that the marketing agreement was incidental to the true purpose of obtaining an investment in the subsidiary.

The court held that the purpose of borrowing had to be determined at the time of borrowing, should there be multiple purposes, the dominant intention had to be determined. The taxpayer failed to show the causal link between the incurring of interest and the earning of marketing fees. The court therefore denied the taxpayer a deduction based on the capital nature of the expenditure.

In *CIR v Shapiro*[101] the taxpayer's purchase of shares in a company was a condition of appointment as a managing director. In order to pay for shares in a company from which he derived a salary and commission, the taxpayer borrowed certain moneys on which he had to pay interest annually. He claimed that the interest should be allowed as a deduction against the salary and commission received by him from the company. It was held by the court that that the salary and commission were not produced by his shareholding in the company but by the exercise of his duties in the office held by him as manager. Consequently, the interest paid on the money borrowed to buy the shares had not been productive of his income.

In ITC 1428[102] the taxpayer was promoted to the directorship of a company. But in order to become a director and in terms of his service agreement, he was compelled to acquire shares in the company. To do so, he had to raise finance by way of an overdraft and pay interest on that overdraft. The taxpayer sought to deduct the amount of interest. The taxpayer indicated that the purchase of shares was directly linked to his salary. Evidence was led in this case by the managing director that if the taxpayer had been unable to fund the purchase of shares in the firm he would have been regarded as having breached his service agreement and as being in jeopardy of dismissal. The taxpayer further testified that his salary had, during that year increased.

The court in this case held that the purpose of his acquisition of shares was to obtain the emoluments attaching to his directorship, and that there was a sufficiently close link between his payment of interest and his earning of income to permit the deduction of interest as an expenditure incurred in the production of income.

In *Drakensburg Garden Hotel*[103], the company borrowed money in order to acquire the shares of another company. This was done in order to obtain absolute control of hired premises from which it derived rent and business profits, thereby ensuring continuance of its income. It was held that

[101] 1928 NPD 436, 4 SATC 29

[102] 1985, 50 SATC 34

[103] 1960 (2) SA 475, 23 SATC 294

the income from which to deduct the interest was not the dividend income flowing from the shareholding (which was exempt income) but the other income derived from rent and business profits. It was held in this case that, the closeness of the connection between the payment of interest and the production of the taxpayer's income was sufficient to warrant its deduction.

Examining tax deductibility cases related to loan interest in the South African context, comparisons and contrasts between the decisions of ITC 1428, *Shapiro's* case, and *CIR v Drakensburg Garden Hotel (Pty) Ltd* can be drawn. In the Shapiro case, interest payments from the purchase of shares did not warrant deduction as they lacked sufficient connection with income generation, differing from ITC 1428, where the taxpayer had to buy shares to improve his status and income through increased salary and bonuses. Comparatively, the *Drakensburg Garden Hotel* case set a precedent that interest on loans used to buy shares to sustain and boost income from trading or business operations is deductible.

The aforementioned cases underline the principle of considering the purpose of expenditure and its impacts for it to be deductible in income production. Let's elucidate this with a hypothetical scenario: Firm A, which has an initial bank credit of R500,000.00 and an overdraft facility of R100,000.00, decides to use these funds to buy preference shares. However, it's crucial to note that interest on loans solely taken to fund preferential shares subscription is non-deductible.

After purchasing the shares, Firm A, left with no working capital, takes a loan, intending to support its income-earning expenditure. Despite having initial working capital, the firm's decision to invest in non-income generating activities led to the need for borrowing, inevitably attracting loan interest.

The crux of the matter becomes whether this interest expenditure was incurred in income production, influencing its deductibility. In an actual scenario, the taxpayer would argue that the loan was taken to secure working capital, not for preference shares acquisition. For interest to be deductible, it must be demonstrated that it was spent in income production, as outlined by section 11*(a)* and section 23*(g)* of the Income Tax Act and further reinforced in the *Producer and Financier* case.

However, it's worth noting that Firm A had fully paid for the preference shares before obtaining the loan, thus using the entire loan proceeds for working capital, as it had no funds due to previous investment in preference shares. Unless an ulterior motive, like a tax benefit, exists, the principle suggests that the incurred interest expenditure, which was closely tied to income-generating operations, should be deductible.

These cases underscore the need to consider the intent behind the loan. If it's established that the loan was taken to enhance the company's income-producing capability directly, the interest expense could be considered deductible.

In the context of the above, it becomes evident that the tax treatment of such interest expenses hinges heavily on the revenue (income generating) versus capital (investment) nature of the expense, the purpose of the loan, and how it relates to the company's income-producing activities.

3.2.2. *Interest incurred on loans raised to pay dividends*

At first glance, the tax treatment of interest on loans procured to pay dividends seems fairly clear. As per section 10(1)*(k)* of the Income Tax Act, dividends are exempt from tax, meaning the interest paid on loans taken to pay dividends doesn't meet the "incurred in the production of income" criterion of section 11*(a)*, and so can't be deducted.

However, relevant case law suggests a different perspective: in *CIR v Van der Westhuizen*[104] the taxpayer (*Ben*, the farmer), had been a lone worker and undertook to acquire his brother's fifty percent share in the close corporation. As a lone worker on the farm he could indicate that his annual salary was equivalent to the full profits of the close corporation and that the purpose of borrowing funds was to increase his earnings and not to earn dividends. The court held in favour of the taxpayer that indeed the link between the expenditure and income earned by the taxpayer was clear.

In contrast to the *Van der Westhuizen's* case above, in *CSARS v 121 Castle Street Cape Town CC*[105], the taxpayer in this case owned a property which was sought after by a firm of architects. The corporation borrowed money which was advanced to new members in order to facilitate their acquisition of the interest of the former members. The corporation then made repairs and improvements to the building resulting in the firm of architects, in the form of another close corporation becoming tenants of the corporation at substantially increased rentals.

It was held that the money borrowed by the taxpayer had not been used for the production of income and its capacity to produce income had not been increased by the transaction. Therefore, the only result of the arrangement was to burden the taxpayer with a liability to pay interest with a consequent reduction in its net income. Essentially the taxpayer had a dual purpose when incurring the interest expenditure, namely:

i. *"To enhance its income producing capacity by securing accommodation in its property for the close corporation owning the architectural practice*

ii. *To assist the new members with their purchase of existing member's interest."*

---

[104] 2001 63 SATC 191

[105] 2002 (1) SA 198 (C), 63 SATC 185

Based on s 23*(g)* court held that an apportionment of interest will need to be made.

In *CSARS v BP South Africa (Pty) Ltd*[106] dividends were declared by the companies and the dividends or portion thereof was loaned back by the company at interest. A key factor considered by the courts in the above cases was whether the two transactions (dividends declared and the loan back to the company) were interdependent and that neither was intended to exist without the other. The fact that the companies had surplus funds available was one of the facts considered in determining the interdependence and the purpose of the loan.

In *Ticktin Timbers CC v CIR*[107]*, the* taxpayer, a close corporation, had declared dividends to its sole member, *Dr Ticktin*, but the dividends were not paid to him and, instead, they had been credited to the loan account of that member in the books of the CC. Interest had been charged on the loan and the appellant contended that the loan funds had been used in its business and that the interest on such funds, had, therefore, been incurred in the production of income and was deductible in terms of section 11 *(a)* of the Act.

The court in the above case held inter alia as follows;

i. *"that it was quite clear that the relevant transactions, namely, the making of the distribution on the one hand and the making of the loan, on the other, were not intended to be separate and unconnected transactions; they were plainly interdependent and neither was intended to exist without the other.*

ii. *A company or a corporation is not obliged to pay a dividend or make a distribution respectively, irrespective of the financial circumstances in which it finds itself. If after doing so, it will have resources to enable it to continue its income earning activities without having to borrow simultaneously an equivalent amount, no problem arises; when it will not, but nevertheless pays a dividend or makes a distribution and simultaneously raises a loan in exactly the same amount, it becomes a question of whether or not the purpose of the loan was to enable a dividend to be paid or the distribution to be made or to provide the entity with liquid funds required to enable it to pursue its income earning operation."*

Similar to *BPSA*'s case, in *Scribante Construction (Pty) Ltd*[108]case, a taxpayer had sufficient funds in hand to pay dividends without having to borrow, but for good business elected not to physically pay the dividend but rather credit it to the shareholder's loan account. The court found out that

[106]2006 68 SATC 229

[107] 1999 61 SATC 399

[108] 2002 62 SATC 443

the 'borrowing' was to enable the taxpayer to earn income rather than to pay dividends. Based on the specific facts the interest paid on the loan was therefore held to be deductible.

In *CIR v Elma Investments CC*[109], the taxpayer paid its two members an amount by way of distribution of unappropriated profits. The distribution was made on a footing that it would be immediately lent back to the close corporation, as an interest bearing loan. The court held that the scheme created additional expenditure for the corporation instead of additional income. Therefore, the loan had been raised not for the purpose of producing income but rather to create an interest bearing loan.

These judgments articulate that a deduction could be possible if there's a clear interrelation between the loan and the income-earning operations of the entity. In other words, if it's proven that the loan wasn't merely taken to pay dividends but was also aimed at generating income, the interest could potentially be deductible.

3.2.3. *Interest Paid on a Loan Incurred for Domestic Purposes*

In the case of loans used for domestic or personal purposes, the deductibility of the interest paid on these loans is generally not allowed by the South African tax code. This is because these expenses don't satisfy section 11*(a)* of the Income Tax Act's requirement of being incurred in the production of income.

In *X v The Commissioner for the South African Revenue Service*[110]*,* the taxpayer, identified as *Mr. X*, was a qualified solicitor working for a law firm, *Y Attorneys*. *Mr. X* was remunerated at the same level as an equity partner and thus had to help with the firm's ongoing working capital requirements. He did this by maintaining a credit balance on his loan account (Firm Loan Account), the interest on which constituted taxable income for him. The funds paid towards the Firm Loan Account and were deducted from *Mr. X*'s monthly remuneration[111].

In addition, *Mr. X* had purchased a property secured by a mortgage bond access facility (Home Loan), which he had drawn on to fund various expenses. He claimed in his income tax returns for the years 2010, 2011, and 2012 that certain interest incurred on the mortgage bond was incurred

[109] 1996 58 SATC 295

[110] Case No: 13791 & 13792 https://www.sars.gov.za/wp-content/uploads/Legal/Judgments/TC/LAPD-DRJ-TC-2016-11-TCIT-13791-and-13792-WC-13-December-2016.pdf

[111] Botha, L. (2017) *An interest(ing) case: Section 11(a) of the Income Tax Act and the deductibility of interest expenses on home loans, Tax and Exchange Control Alert*. Available at: https://www.cliffedekkerhofmeyr.com/en/news/publications/2017/Tax/tax-and-exchange-control-alert-17-march-an-interest-ing-case-section-11-a-of-the-income-tax-act-and-the-deductibility-of-interest-expenses-on-home-loans.html (Accessed: May 3, 2023).

in the production of interest income received from the law firm. However, the South African Revenue Service (SARS) disallowed these deductions, leading to this case[112].

The key issue of the case was whether *Mr. X* could deduct a portion of the interest incurred on the Home Loan from the interest income earned on the Firm Loan Account. This depended on whether the interest was incurred in the production of income, as specified by s 11*(a)* of the Income Tax Act.

In its judgment, the court referenced Practice Note 31 (PN 31), which allowed for the deduction of expenditure incurred in the production of interest income, even if the person did not carry on trade as a moneylender. The court found that *Mr. X*'s case was aligned with the scenario described in PN 31, as the interest earned on his Firm Loan Account was akin to interest earned on capital or surplus funds invested.

The court observed that *Mr. X*'s intent was to earn interest income by maintaining a credit balance in his Firm Loan Account, which was funded by his remuneration. Consequently, the court found that the taxpayer's remuneration was, in essence, borrowed money that was invested at a higher rate of interest than the rate of interest that the Home Loan was borrowed at. In this context, the court found that the interest on the Home Loan had been incurred in the production of the taxpayer's income.

However, the court found that *Mr. X*'s use of the Home Loan to fund various expenses indicated that the Home Loan was not used exclusively for the production of income. The court found that a portion of the interest on the Home Loan was not deductible as it was not used solely in the production of income.

Such cases demonstrate the thin line between personal and income-generating expenses. It underscores the necessity of being able to demonstrate a clear connection between the loan and the production of income.

3.2.4. *Section 24J of the South African Income Tax Act*

When discussing the tax treatment of interest, it's vital to consider section 24J of the South African Income Tax Act. This section outlines the rules for the taxation of interest, primarily pertaining to business or investment activities.

---

[112] Botha, L. (2017) *An interest(ing) case: Section 11(a) of the Income Tax Act and the deductibility of interest expenses on home loans, Tax and Exchange Control Alert*. Available at: https://www.cliffedekkerhofmeyr.com/en/news/publications/2017/Tax/tax-and-exchange-control-alert-17-march-an-interest-ing-case-section-11-a-of-the-income-tax-act-and-the-deductibility-of-interest-expenses-on-home-loans.html (Accessed: May 3, 2023).

Section 24J primarily covers two types of interest: "qualifying interest," typically derived from business operations, and "non-qualifying interest," not considered as part of a business operation. The distinction is critical as the tax treatment varies between the two.

In the case of qualifying interest, it's usually deductible, provided it meets the section 11*(a)* criteria. Non-qualifying interest, however, is usually not deductible, unless it can be linked to the production of income. Importantly, this section does not typically apply to interest paid on a loan for domestic or personal purposes, reinforcing the limitation on deductibility in these cases.

In conclusion, understanding the tax landscape in South Africa can be a complex endeavour due to its dynamic nature and the intricacies associated with different types of loans and interest expenses, and section 24J is no exception as evidenced by arguments for its application, or against application[113]. The deductibility of interest is contingent on numerous factors, such as the purpose of the loan, the type of interest, and its relationship with the income-generating activities of the entity.

3.3. Considering the Type of Interest

The type of interest is also a key consideration in evaluating the tax treatment of interest. Notional interest is an opportunity cost of interest not earned for an example if a taxpayer decides to place his R200 000 in his business instead of investing it in a bank, he is not allowed to deduct the interest that he would have earned by investing in a bank[114].

Pre-production interest is an interest incurred on a loan to acquire certain assets before those assets are brought into use. In CSARS point of view that interest expenditure is not allowed as a deduction because of s11*(a)* trade requirement. However the s11A[115] specifically allows the deduction of such expenditure prior to the commencement of trade, provided that:

i. interest is not allowable as a deduction
ii. interest must have been actually incurred by the taxpayer
iii. the loan must have been used towards the acquisition, installation, erection or construction of those assets
iv. the underlying assets must be used in the taxpayer' trade
v. interest must have been incurred prior to those assets being brought into use.

[113] Rudd, R. (2019) "The tax treatment of interest in kind: the Brummeria case revisited?," *SA Mercantile Law Journal*, 31(3), pp. 435–455. Available at: https://journals.co.za/content/journal/10520/EJC-1fda500a47.

[114] s 23*(h)*

[115] s11A of the Act

If all of the above mentioned requirements are met the total accumulated pre-production interest is to be deducted in full in the tax year in which that asset is brought into use.

The interest expenditure can be disallowed to the extent that it is excessive. This disallowance can be constructed on the grounds of trade requirement[116] or that the expenditure is not actually incurred in the production of income[117] or abuses resulting from certain international transactions[118]. While the trade requirement is explored in 2.2 above, it needs to be considered further what would be deemed excessive.

In *Tobacco Father v COT,*[119] the Commissioner of Taxes disallowed the deduction of a wage paid by a father to his son for managing two of the father's tobacco farms. The Commissioner's contention was that the amount was not a *bona fide* wage and was therefore excessive. The court held in this case that in establishing whether the son's services are excessive or not, the test that may be applied is to ask what the "fair rate of wage in the tobacco industry." The father was able to show that the wage paid to the son compared to the open-market and was not excessive hence deduction was allowed.

In contrast, in ITC 610[120] the court had to decide whether the remuneration paid to the directors of the company was excessive or not, the following considerations were taken into account:

i. the relation of directors award to profits and turnover
ii. what an independent employer would pay
iii. how the current remuneration compared with that awarded in the past years
iv. the possible motive of reduction of excess profits.

Taking the above factors into consideration the court held that the remunerations to the directors were unjustifiable and indeed excessive.

Applying these court judgment considerations to interest, it should therefore be borne in mind that an excessive interest will not be deemed to be in the production of income, and therefore will not be allowed, as it will be construed to be laid out for purposes other than that of a trade.

[116] s 23*(g)*
[117] s 11(a)
[118] s 31
[119] 1951 SR, 17 SATC 395
[120] 1945 14 SATC 377

Chapter 4: Exploring the Classical Economists' Perspective on the Tax Treatment of Interest

This chapter aims to discuss the relevance of the classical economists'[121] views on taxation principles that have transcended centuries and without doubt they are not to be ignored, even in this modern age. This chapter explores the taxation of interest with reference to the case of *Commissioner, South African Revenue Service v Brummeria Renaissance (Pty) Ltd & Others* 2007 6 SCA 601[122], contrasting the case with the classical economists' taxation principles. A brief discussion summarises the derivation of the classical economists' tax equation and applies this to the facts of the case in point. Disparities between the classic economists' tax views and outcomes of the SCA judgment are debated.

The taxation treatment of interest has always been a subject of much debate and contention, and it is therefore not surprising that over the years the courts have been approached to provide clarity on how it should be taxed. The courts have in the past delivered judgments in this area with varying degrees of application of the law and to some extent with contradictions, thereby creating some controversy[123]. The judgment in *Brummeria's* case[124] appears to exacerbate this narrative, at least when assessing the response from many in the tax fraternity[125].

It is often very important to 'go back to the drawing board' in attempting to unpack what seems to be a repetitive conundrum which *Brummeria*'s case exposed. The point from which to venture into in this case would be going back to the history[126] of taxation itself. It is therefore in this context that this article will consider the views of the classical economists on taxation and apply them to the relevant case in point. The deductions from this comparison will critically analyze to ascertain to what extent, if at all, did the Supreme Court of Appeal decision in *Brummeria*'s case deviate from the views of the renowned classical economists.

---

[121] Montesquieu (1748); Adam Smith (1776); Jeremy Bentham (1748-1832); Thomas Paine (1791); David Ricardo (1817) and John Stuart Mill (1848).

[122] *Commissioner, South African Revenue Service v Brummeria Renaissance (Pty) Ltd & Others* 2007 6 SCA 601.

[123] Rudd, R. (2019) "The tax treatment of interest in kind: the Brummeria case revisited?," *SA Mercantile Law Journal*, 31(3), pp. 435–455. Available at: https://journals.co.za/content/journal/10520/EJC-1fda500a47.

[124] *Commissioner, South African Revenue Service v Brummeria Renaissance (Pty) Ltd & Others* 2007 6 SCA 601

[125] Cohen, S.B. (2009) "Does Brummeria sweep clean? A US tax-law perspective," *South African Law Journal*, 126(3), pp. 489–504. Available at: https://journals.co.za/content/ju_salj/126/3/EJC53885.

126 Hayek, F. (1960) "v.(1960) The Constitution of Liberty," *Chicago: University of Chicago* [Preprint].

4.1. Consideration of the Classical Economics Historical Context

As mentioned above, the historic context is critical in analysing the constituent components of taxation. The following classical economists, amongst others, provide us with valuable lessons from which to make reference to, namely; Montesquieu (1748); Adam Smith (1776); Jeremy Bentham (1748-1832); Thomas Paine (1791); Davido Ricardo (1817) and John Stuart Mill (1848). These writers were influential in government tax policies and contributed immensely to modelling the Income Tax Act[127].

A particular focus in this article will be on the contributions made by Adam Smith's first of four maxims[128] in embedding the principles of taxation, namely the Canon of Equality which stipulates:

> *"The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in* ***proportion to their respective abilities****; that is, in* ***proportion to revenue*** *which they respectively* ***enjoy under the protection of the state****. In the observation or neglect of this maxim consists, what is called the equality or inequality of taxation"*[129].

John Stuart Mill later in (1848) sought to expand further on this first canon as he deemed the remaining three canons as self-explanatory[130]. It is primarily from these bases that the classical formula for the general tax equation was derived.

4.2. The General Tax Equation

A breakdown of the constituent components of the classical general tax equation[131] is made in a tabular format below as well as reference the key contributors towards its derivative.

ITEM	AMOUNT	CONTRIBUTORS
Total Amounts Received (A_T)	XX	Adam Smith[132]

[127] Vivian, R.W. (2006) "Equality and personal income tax--the classical economists and the KATZ commission," *South African journal of economics*, 74(1), pp. 79--109.

[128] These were later named the four canons of taxations as inspired by the Church Law

[129] Smith, A. (1776) *An Inquiry into the Nature and Causes of the Wealth of Nations*. Edited by S.M. Soares. London: MetaLibri Digital Library. Available at: http://metalibri.wikidot.com/title:an-inquiry-into-the-nature-and-causes-of-the-wealth-of., section V.II.II.

[130] Mill, J.S. (1965) *Principles of political economy*. London: Longmans, Green and Company.

[131] Wits Public Finance Lecture 3 by Robert William Vivian, September 2020

[132] Smith, A. (1776) *An Inquiry into the Nature and Causes of the Wealth of Nations*. Edited by S.M. Soares. London: MetaLibri Digital Library. Available at: http://metalibri.wikidot.com/title:an-inquiry-into-the-nature-and-causes-of-the-wealth-of., See Chapter V.II.II.

ITEM	AMOUNT	CONTRIBUTORS
		John Mill[133] David Hume[134]
Less: Amounts of Capital Nature (A_C)	(XX)	Adam Smith[132] David Ricardo[135]
Amounts from Non-Country Source	(XX)	Adam Smith[136] John Mill[133] Montesquieu[137]
Gross Income (I_G)[138]	**XX**	Classical economists aligned to s1 of Income Tax Act.
Less: Deductions [Necessities of Life (I_N)]	(XX)	Plato Montesquieu[137] Adam Smith[132] John Mill[133] Lady Hicks[139] Jeremy Bentham(1748-1832)
Taxable Income (I_T)[140]	**XX**	John Mill[133]
Tax Payable[141]	**$r.I_T$**	Montesquieu[137] John Mill[133] Friederich von Hayek[142]

133 Mill, J. S. (1965)

134 Hume, D. (1752) *Political Discourses*. Edinburgh: A. Kincaid & A. Donaldson.

135 Ricardo, D. (1821) *On the Principles of the Political Economy, and Taxation*. London: John Murray, Albemarle-Street. See pages 105-106.

136 Smith, A. (1776: V.II.II)

137 Montesquieu, C. de S. and Nugent, T. (1949) *The Spirit of the Laws, Hafner library of classics 9*. New York, NY: Hafner Press.

138 The Gross income (I_G) is therefore the remaining balance after deducting the Capital income and other states revenue from the taxpayer's total income.

139 Hicks, U. (1968) *Public Finance*. 3ed edn. New York: James Nisbet & Co Ltd.

140 The Taxable Income is therefore what remains after deducting from Gross Income the Necessities of Life

141 Tax payable was measured at a particular percentage rate. This was once set at 2% on taxable income.

142 Hayek, F. (1960) "v.(1960) The Constitution of Liberty," *Chicago: University of Chicago* [Preprint].

4.3. Application of the general tax equation to the facts of the Bummeria case

4.3.1. *Total Amounts (AT)*

The court held in *Brummeria*'s case that the 'amount' can be measured at notional value and not necessarily at actual amount and therefore the word 'amount' must be given a wider meaning. This effectively meant that the right to use the loan interest free has monetary value. The test to ascertain whether the receipt or the accrual has a monetary value must be an objective one[143]. In applying the amount to be included in gross income the court allowed the Commissioner to determine the value of the right given up by the tenants in exchange for the lifelong occupation right over the property, and that this must therefore be made using the life expectancy of the tenants factoring cancellation clauses as well as present value of the interest free loan amount at the weighted-average prime overdraft rate, the result of which will be a 93,1% inclusion to gross income[144]. This calculation is seemingly complex and arguably may be in contrast to Adam Smith's fourth Canon of Economy[145].

In terms of the classical economists, the right to interest by *Brummeria Group* as result of a loan advanced by the occupants can be likened to what Mill terms *the equality of sacrifice:*[146]

> *"It means apportioning the contribution of each person towards the expenses of government, so that he shall feel neither nor less inconvenience from his share of the payment than every other person experiences from his"*

However, as David Hume[147] identified:

> *"Every man, to be sure, is desirous of pushing off from himself the burden of any tax, which is imposed, and of laying it upon others: But as every man has the same inclination, and is upon the defensive; no set of men can be supposed to prevail altogether in this contest."*

In the context of a government, this translates into a phenomenon that person with political power will attempt to use this to shift the tax burden from themselves to others using their

---

143 SARS (2012) "Interpretation Note 58 (Issue 2): The Brummeria Case and the Right to Use Loan Capital Interest Free." South African Revenue Service. Available at: https://www.sars.gov.za/AllDocs/LegalDoclib/Notes/LAPD-IntR-IN-2012-58%20-%20Brummeria%20Case%20Right%20Use%20Loan%20Capital%20Interest%20Free.pdf (Accessed: October 23, 2020).

144 Interpretation Note no.58 Issue 2 of Income Tax Act 58 of 1962

145 Smith, A. (1776: V.II. Part 3)

146 Mill, J. S. (1965: 155)

147 Hume, D. (1752) *Political Discourses*. Edinburgh: A. Kincaid & A. Donaldson.

political power and therefore the burden of taxation cannot be objectively determined but rather lies in vested interests of different persons[148].

In the *Brummeria's case* the court did not consider that: (1) the right to interest must be matched against the tenants right for life occupation; and (2), that in ascertaining whether that right had a monetary value, subjective tests and not objective tests ought to be made as dictated by the classical economists. In this light, in terms of this component of the tax equation, one may argue that an amount has not accrued.

Mill's view is that the inequality of tax results when government makes a distinction of persons or classes in whatever sacrifices it requires of them to make to it, in this regard every person ought to bear their share of tax burden[149]. Therefore, by not considering the right of occupation given to the tenants infringes on this proposition.

4.3.2. *Amounts of Capital Nature (AC)*

The loan advanced to the *Brummeria Group* was accepted to be of capital in nature and therefore was not subjected to inclusion in gross income by the Commissioner and the court. This is consistent with the view of Adam Smith and David Ricardo[150] that the amount to be taxed must be of revenue nature. It is also accepted that given the enduring nature of the loan advanced by the tenants in that, it is linked to lifelong occupancy in the property the floating versus fixed nature of this advance loan was not questioned. It must therefore be deducted from the total income received by the *Brummeria Group*. Mill states[151]:

> *"In addition to the preceding rules, another general rule of taxation is sometimes laid down, that it should fall on income and not on capital. That taxation should not encroach upon the amount of the national capital, is indeed of the greatest importance; but this encroachment, when it occurs, is not so much a consequence of any particular mode of taxation, as of its excessive amount. Over- taxation carried to a sufficient a sufficient extent is quite capable of ruining the most industrious community".*

[148] Vivian, R. and Mushai, A. (2017) "Introduction of the Marginal Tax Rate System - A Continuation of a History of Constitutional Failures." (Work in Progress).

[149] Mill, J. S. (1965: V. II.2)

[150] He argues that by encroaching on capital the state would be diminishing its capacity to reproduce and therefore reduce its revenue due to distressed industry.

[151] Mill, J. S. (1965: V.II.7)

4.3.3. *Amounts from Non-Country Source*

The group of companies in this case were all South African resident companies and therefore the courts in arriving at its decision would have considered the residency of the companies and funders (tenants) to ascertain its origin. In this regard it is generally accepted that it falls within the ambit of s1 definition of Gross Income[152].

In terms of the classical economists view on this component of the equation, the protection by the state as enjoyed by its citizen must be funded by its citizen. Mill argues that it does not always follow that a *quid pro quo* relationship between the taxes and benefits persists, in fact that the role of the state is more than to just a mere protection of the persons and property[153]. Montesquieu alerted the government that having more than one taxing authority for the same person will force that person to 'flee'[154].

The classical economists' approach for this part of the equation yields the same outcomes as that of the court, but for different reasons, as the source-based system would be applicable, rather than a residence-based approach.

4.3.4. *Gross Income (IG)*

This is the result of the three components discussed above. The definition of the s1 gross income might be aligned to the classical economists' formulation, but the outcomes reached in this case would have been different due to differing constituent views between the two. It must be observed further that the fact that the value of a right to interest that accrues in the first year of assessment *only* gets determined in the second year of assessment, is inconsistent with Adam Smith's Canon of Certainty and Convenience[155].

4.3.5. *Necessities of Life (IN)*

The case facts in this case are that the lenders (tenants) give the right to the borrowers (*Brummeria Group)* to make use of the loans interest free in exchange for occupational right for life over the property provided by the borrower. As indicated above the court was not seized with the tax consequences of the tenants and therefore in arriving at its decision, it only dealt with the borrower's point of view.

---

[152] s 1 of Income Tax Act 58 of 1962

[153] Mill, J. S. (1965: V.II; p.155-156)

[154] Montesquieu, C. et al (1949: XIII.1)

[155] Smith, A. (1776: V.II. Part 3)

The classical economists general view is that in attaining equality of taxation consideration should be given to a person's respective ability to bear the tax burden[156] and not what the government wishes to receive from its citizens as this can never be enough[157]. The person's ability to advance any tax dues must be considered in relation to their necessities-of-life. Mill describes the necessities-of-life to include requisitions of life and health and immunity from bodily pain essentially without over-indulging[158]. He further quotes Jeremy Bentham (1748-1832) as follows:

> *"The mode of adjusting these inequalities of pressure, which seems to be the most equitable, is that recommended by Bentham, of leaving a certain minimum of income, sufficient to provide for the necessities-of-life, untaxed. Suppose 50l [i.e. £50] a year to be sufficient to provide the number of persons ordinarily supported from a single income, with the requisites of life and health and with protection against habitual bodily suffering, but not with indulgence. This then should be made the minimum, and incomes exceeding it should pay taxes not upon the whole amount but upon the surplus."*

It follows from Mill's position above that a single indiscriminate blanket amount as deduction for the necessities-of-life by each person needed to support each household[159]. This stance is also later affirmed by Lady Hicks in 1968[160]. This principle actually dates as far back as ancient Athens time where Plato (1424-347BC) mentioned that 'payment for common meals ought to be excluded from tax calculations[161]

The facts of the case, the court appears to have simply looked at the *Brummeria Group*'s ability to pay for the right on interest free loan instead of evaluating its necessity. The court did not consider the fact that the right on interest free loan ought to be matched to the right advanced to the pensioners especially given the fact that the right to shelter and protection is a fundamental Constitutional right. The taxes levied, whether direct or indirect against *Brummeria's Group* would ultimately be borne by the individuals and not the companies[162]. In applying the Adam Smith's maxim that the tax liability ought to be assessed in proportion to their respective abilities, it is submitted that the court did not fairly assess the merits of the case in this context.

---

[156] Adam Smith, (1776: V.II.II); Mill, J. S. (1965: V.II.3; XIII.1)

[157] Montesquieu, C et al (1949: XIII.1;7)

[158] Mill, J. S. (1965: V.II.3)

[159] Popescu, L. (2019) "Evolution of Concepts Regarding Taxation and Taxation Systems," *Ovidius University Annals, Economic Sciences Series*, 19(2), pp. 861–868.

[160] Vivian, R. W. (2006: p.85)

[161] Vivian, R. W. (2006: p.85)

[162] Vivian, R. W. (2006: p79)

4.3.6. *Taxable Income (IT)*

The remainder after deducting the necessities-of-life from the gross income is coined taxable income. This taxable income will then be subjected to a rate of taxation which classical economists argued that it should not be a graduated or progressive tax system[163].

It is common cause that in South Africa a progressive tax system is being utilized and therefore outcomes of the court would have resulted in the graduated tax net capturing revenues of *Brummeria Group* despite reservations by the classical economists[164].

4.3.7. *Tax Payable (r.IT)*

The progressive tax system implies imposition of higher taxes for those that have more wealth. The classical economists contend that this imposition is not necessarily achieving the equality of taxation[165]. The economists assert because of the insatiable nature of the governments, the taxpayers will continue in this vicious cycle of incurring additional tax burden until they have no more to give[166]. They further state by limiting the rates at which tax is levied on income taxes it would soften the impact of the indirect taxes of which Value Added Tax[167] serves as an illustration[168].

4.4. *Discussion of the decision of the SCA on the Brummeria case*

4.4.1. *Background of the Case*

An overview of the *Brummeria* case is provided as context to the subsequent discussions of the decisions taken:[169]

> *This case is about three companies Brummeria Renaissance (Pty) Ltd, Palms Renaissance (Pty) Ltd and Randpoort Renaissance (Pty) Ltd developed retirement villages. The companies obtained interest-free loans in order to build units in exchange for granting life occupation*

---

[163] Vivian, R. W. (2006: p.87)

[164] Mill, J. S. (1965: V.II.3)

[165] Note that Thomas Paine (1792) advocated for the progressive tax system.

[166]Montesquieu, C et al (1949:13.7), Mill, J. S. (1965: V.II.3), Mill, J. S. (1965: V.III.5)

[167] Value-Added Tax Act 89 of 1991

[168] Vivian, R. W. (2006: p.88)

[169] SCA. (2007) *Media Summary – Judgment Delivered In The Supreme Court Of Appeal*. Available at: https://www.supremecourtofappeal.org.za/images/judgments/2007/sca07-099ms.pdf (Accessed: 18 October 2020).

rights of the units to the lenders. The Commissioner, SARS assessed the companies to tax, contending that the right to use the loans interest-free had a money value and therefore formed part of the companies' taxable income. The Commissioner's contention was dismissed by the Johannesburg Tax Court but upheld on appeal.

4.4.2. *Decision*

The courts essentially held the following in delivering its judgment:[170]

> *"Held, that although the actual receipt of the loan capital did not result in receipts of amounts for the purpose of the definition of gross income, the right to retain the loan capital without paying interest had a money value and, accordingly, the value of such right had to be included in the companies' gross income for the years in which such rights accrued to the companies. In the modern commercial world, a right to retain and use loan capital for a period of time, interest free, was a valuable right. (Paragraphs [9] and [12] at 605I and 607C - D.)*
>
> *Held, further, that it did not follow that if a receipt or accrual could not be turned into money, it had no money value. The question could not be whether an individual taxpayer was in a position to turn a receipt or accrual into money. The test was objective, not subjective. The fact that a right could not be transferred, ceded or alienated, did not negate the money value of that right. (Paragraphs [15] and [19] at 609F - G and 611E - F.)*
>
> *Held, further, that once the Commissioner had changed the entire basis of the assessment in the further revised assessments pursuant to an objection by the first respondent, he had allowed the first respondent's objection to the revised assessments in full as contemplated in s 81(5). Therefore, because no fraud, misdescription or non-disclosure was relied upon he was precluded by the provisions of s 79(1), read with s 81(5), of the Act from raising the assessments against the first respondent which he did in the further revised assessments. (Paragraph [27] at 613I - J.) Appeal upheld, except in this respect in regard to the first respondent."*

4.4.3. *Discussion of the decision taken*

The decision of the SCA in this case has been widely regarded as contentious[171] for a number of reasons. At the outset it must be mentioned that the court did not consider the tax consequences of the individuals that advanced the loans to the group of companies and admittedly it was not a matter before it.

---

[170]*Commissioner, South African Revenue Service v Brummeria Renaissance (Pty) Ltd & Others* 2007 6 SCA 601

[171] Cohen, S.B. (2009) "Does Brummeria sweep clean? A US tax-law perspective," *South African Law Journal*, 126(3), pp. 489–504. Available at: https://journals.co.za/content/ju_salj/126/3/EJC53885.

Its common cause in this case that the loan capital given to the *Brummeria's Group* of companies was a receipt of a capital nature and therefore did not result in gross income inclusion. The thrust of the matter was that the right to retain this loan capital interest free had an ascertainable money value[172]. This requirement necessitated that a wider meaning[173] to the word 'amount' in the definition of gross income in s1(1) of the Act[174] be applied since in *Brummeria Group*, no amount had accrued. The court was of the view that an objective test must be applied as to whether the receipt or accrual of this right has a monetary value this essentially led to clarity being provided for contradictions in Stander's case[175]. The court explained that the ability or agility to turn value into money does not preclude it from being regarded as receipts or accruals[176].

The court simply left it to the Commissioner to ascertain the value of this forgone right to interest by the tenants in the hands of *Brummeria Group*. The rationale for including this value in gross income was that the *quid pro quo* right by *Brummeria* to the tenants is that they stood the benefit of occupying the property rental fee prompted a gross income inclusion. The Commissioner opted to use the weighted-average prime overdraft rate from the banks in computing this valuation[177].

The timing of an accrual of this right would take place only once an unconditional legal entitlement by *Brummeria* has been obtained, this would imply that the *Brummeria* would only be taxed for the right to use the interest free loan in exchange for granting a right of occupation to the tenants and once it is free to use the loan as it wishes[178].

The above derivatives from the court case have been hotly contested by many as mentioned above and alternative propositions or approaches to a SCA decision. Rudd[179] argues that by applying the charging provisions of s24J[180] to the present case that a different outcome to that of the court would have been arrived at. He is of the view the court's omission of occupation right, in fact constitutes interest in terms of s24J(10) of this charging provision. It therefore follows that *Brummeria* would be entitled to an interest deduction for this occupation right in terms of

---

[172] Refer to Felix Schuh and Genn cases

[173] See Lategan and People Stores cases

[174] Income Tax Act 58 of 1962

[175] *Stander v Commissioner for Inland Revenue* 1997 (3) SA 617 (C)

[176] See *Cactus Investments and People Stores* cases

[177] SARS (2012) "Interpretation Note 58 (Issue 2): The Brummeria Case and the Right to Use Loan Capital Interest Free." South African Revenue Service. Available at: https://www.sars.gov.za/AllDocs/LegalDoclib/Notes/LAPD-IntR-IN-2012-58%20-%20Brummeria%20Case%20Right%20Use%20Loan%20Capital%20Interest%20Free.pdf (Accessed: October 23, 2020).

[178] See *Lategan, People Stores and Cactus Investments* cases

[179] Rudd, R. (2019). The tax treatment of interest in kind : the *Brummeria* case revisited? SA Mercantile Law Journal, 31(3), 435–455. https://journals.co.za/content/journal/10520/EJC-1fda500a47

[180] s 24J of the Income Tax Act 58 of 1962

s24J(2). He concludes that this omission of this ought to have yielded gross income for the tenants.

Cohen[181] uses a similar argument to that of Rudd but in the context of US Law, he is of the view that the right to use interest free loans by *Brummeria* as a result of a loan advanced by the tenants of its property simultaneously creates an obligation to the occupants of the same value to that of the right of use of interest. He contends that this is a 'recharacterization'[182] of below or free market interest rates even though the timing of the accrual of each leg might differ slightly. He is of the view that offsetting of incomes and deductions from both parties may not always be perfect and therefore this 'recharacterization' may prevent tax avoidance situation. He does give the credit for appreciating the economic benefits accruing from such arrangements and also concedes that the 'recharacterization' method may be administratively complex to apply.

In conclusion, the deviations between the outcomes of the General Tax Equation as envisaged by the classical economists and the outcomes of the decision of SCA are evident. The four maxims of taxation principles appear to have been breached in the outcomes of the SCA decision. The omission of occupants' tax position as a key role player has an adverse bearing on equality of taxation. The complex calculation of value and timing of this right of use of interest free loan may infringe canon of certainty, convenience, and economy. The courts, however, only apply and interpret the law as set out by the legislators. It is perhaps important that the legislators in addition to the recognition of the Constitutional imperatives, that it strongly considers the history lessons in setting out taxation laws.

The tax treatment of interest from the receipt and expenditure perspectives is important from business point of view as it directly impacts the results of their financing arrangements. The interest component for many entities is one major item in its financial statements therefore proper financing arrangements by taking into effect the taxation consequences is imperative.

---

[181] Cohen, S.B. (2009) "Does Brummeria sweep clean? A US tax-law perspective," *South African Law Journal*, 126(3), pp. 489–504. Available at: https://journals.co.za/content/ju_salj/126/3/EJC53885.

[182] This assumes that both legs of the deductions from both unconnected parties would not have been ordinarily prohibited.

Chapter 5: The International tax considerations or standards on treatment of interest

The international tax landscape is a complex and continually evolving arena, influenced by numerous factors such as international treaties, economic conditions, domestic tax laws, and the increasingly interconnected nature of business operations. Navigating this complicated domain, especially when it comes to the tax treatment of interest income, presents unique challenges. Two international models – the Organisation for Economic Co-operation and Development Model Tax Convention (OECD MTC) and the United Nations Model Double Taxation Convention (UN MTC) – form the backbone of global tax laws, offering structure and guidance.

This chapter will focus on the treatment of interest in relation to the requirements of the international treaties such as the OECD MTC[183] and the UN MTC[184]. The chapter will also look at interest accruing to residents from a non-country source or accruing to a non-resident person from the country. It is in this light that the pertinent issues such as the taxing rights are to be discussed and matched with the classical economists[185] view on this matter.

5.1. The OECD Model Tax Convention's Perspective on Interest

A key aspect of the international taxation on interest income is how different countries coordinate their tax policies to avoid double taxation or non-taxation of cross-border interest payments. One of the main international organizations that provides guidance on this issue is the Organisation for Economic Co-operation and Development (OECD), which consists of 38 member countries that are mostly developed economies. The OECD has developed a model tax convention that serves as a basis for bilateral tax treaties between countries. The model tax convention contains various articles that deal with the taxation of interest income, such as:

Article 11: Interest. This article provides that interest arising in one country and paid to a resident of another country may be taxed in both countries, but the tax charged in the source country shall not exceed 10% of the gross amount of the interest. However, some exceptions apply, such as when the recipient of the interest is the beneficial owner of the interest and is a bank or a financial institution, or when the interest is paid by a government or a public body.

---

[183] Model income tax treaty sponsored by the OECD on which most bilateral income tax treaties are patterned and which is updated by the OECD Committee on Fiscal Affairs from time to time

[184] Model income tax treaty sponsored by the United Nations that is based on OECD Model Treaty, with some modifications made to reflect the interests of developing countries.

[185] Mill, J. S. (1965); Smith, A. (1776: V.II.II) and Montesquieu, C. de S., & Nugent, T. (1949). The Spirit of the Laws, Hafner library of classics 9. New York, NY: Hafner Press.

Article 24: Non-discrimination. This article provides that nationals and residents of one country shall not be subjected to any taxation, or any requirement connected therewith in another country that is more burdensome than the taxation or requirement to which nationals or residents of that other country in the same circumstances are or may be subjected. This article aims to prevent discrimination based on nationality, residence, or ownership of capital.

Article 25: Mutual Agreement Procedure. This article provides that if a person considers that the actions of one or both of the countries result or will result for him in taxation not in accordance with the provisions of the convention, he may present his case to the competent authority of either country. The competent authorities of both countries shall endeavour to resolve the case by mutual agreement and may consult together for the elimination of double taxation in cases not provided for in the convention.

The OECD model tax convention therefore reflects a balance between the interests of the source country and the residence country in taxing cross-border interest income. Generally, the source country has a limited right to tax interest income paid to a resident of another country, while the residence country has the primary right to tax such income. However, there are some exceptions and variations depending on the type and recipient of the interest income. For example:

1. Interest paid by a government or a public body of one country to a resident of another country is generally exempt from tax in both countries.
2. Interest paid by a resident of one country to a resident of another country who is the beneficial owner of the interest and who carries on business in the first country through a permanent establishment situated therein may be taxed in both countries, but only to the extent that it is attributable to that permanent establishment.
3. Interest paid by a resident of one country to a resident of another country who is the beneficial owner of the interest and who is related to the taxpayer may be taxed in both countries at a higher rate than 10% if such interest exceeds an arm's length amount.

The OECD model tax convention also provides for mechanisms to prevent double taxation or non-taxation of cross-border interest income, such as:

- The exemption method or the credit method for eliminating double taxation in the residence country.
- The exchange of information and assistance in the collection between the tax authorities of both countries.
- The mutual agreement procedure for resolving disputes or difficulties arising from the interpretation or application of the convention.

As a recurring theme across chapter 2 and chapter 3 above, the principles of interest definition, type, and potential deductibility is certainly not clear-cut. Therefore, in the context of cross-border transactions, these mechanisms above are used to prevent double taxation, or non-taxation of cross-border interest income are especially relevant. The differences in treatment and interpretation are worthy of further exploration.

5.2. Nature and Characterisation of Interest

As considered and deliberated in 2.3.4 above, key to understanding the tax treatment of interest is its characterization as either capital or revenue. Revenue interest arises from routine business activities like the accumulation of interest on loans provided or debts owed, and is typically subjected to tax as part of ordinary income. Capital interest, however, associated with the purchase, holding, or disposal of a capital asset, enjoys a different tax treatment, contingent on individual jurisdictional laws.

Arguments for and against the distinction between capital and revenue interest are abundant as have been highlighted above. Supporters argue that this differentiation reflects the disparate economic impacts of the two types of interest, and tax policies should thus mirror these differences. Detractors, however, believe such a distinction complicates tax systems, allows for tax planning and evasion, and results in distortions in resource allocation. These two different philosophies, as two different sides of a coin, create a very complex playing field in cross-border contexts where differential interest definitions in various jurisdictions may lead to taxation mismatches and issues of double taxation or non-taxation.

The treatment of interest in international tax treaties such as the Organization for Economic Co-operation and Development (OECD) Model Tax Convention (MTC) and the United Nations (UN) Model Tax Convention (MTC) are an important aspect of international tax law. The treatment of interest under these treaties is governed by specific provisions that aim to prevent double taxation and promote cross-border trade and investment.

5.3. Taxation of Interest from International Sources

Interest income from international sources brings up the consideration and balancing of different principles related to residence and source-based taxation. Under residence-based taxation, countries tax their residents on their global income, regardless of where it was generated. In contrast, source-based taxation involves countries taxing income that arises within their borders, regardless of the recipient's residence.

The OECD MTC generally supports residence-based taxation, primarily granting taxing rights to the recipient's country of residence to avoid the occurrence of double taxation and to facilitate the smooth flow of capital[186]. On the other hand, the UN MTC, created for the needs of developing nations in mind, often allows for source-based taxation[187]. This approach aims to protect the tax bases of countries where economic activities and value creation occur.

According to the OECD MTC, interest paid to a resident of one contracting state by a resident of the other contracting state may be taxed in the state of the recipient, but only to the extent that the interest is not related to the recipient's active business. In other words, passive interest income, such as interest received on bank deposits or bonds, may be taxed in the recipient's state of residence, while active interest income, such as interest received on a loan made in connection with a business, may not be taxed in the recipient's state of residence.

The UN MTC contains similar provisions regarding the taxation of interest. Under the UN MTC, interest paid to a resident of one contracting state by a resident of the other contracting state may be taxed in the recipient's state of residence, but only to the extent that the interest is not derived from an active business carried on in the state of the recipient.

It is possible that the difference between these two perspectives underscores the tension between capital-importing and capital-exporting nations participating in the OECD, and potentially highlights the need for balance and compromise in international tax rules.

Looking at the key consideration for South Africa, interest accruing to residents from a non-country source, or accruing to a non-resident person from South Africa, is generally subject to taxation in accordance with the domestic tax laws of the jurisdiction in which the recipient resides or the source of the income, respectively. Under South African tax law, interest received by a South African resident from a non-South African source is generally considered taxable income and must be declared in the recipient's tax return. However, South Africa has entered into numerous tax treaties with other countries to avoid double taxation of income derived from cross-border transactions, and the provisions of these treaties may affect the taxation of interest income in specific cases.

Similarly, interest paid to a non-resident person from a South African source is generally subject to withholding tax in South Africa, unless an exemption or reduction in the withholding tax rate

---

[186] Graetz, M.J. and O'Hear, M.M. (1997) "The 'Original Intent' of U.S. International Taxation," *Duke Law Journal*, 46(5), pp. 1021–1110. Available at: https://scholarship.law.duke.edu/dlj/vol46/iss5/2. Further, the OECD's commentary on Article 11 (Interest) of the OECD MTC: OECD (2014), Model Tax Convention on Income and on Capital: Commentary on Article 11 (Interest), paragraphs 1-14, OECD Publishing. This commentary indicates that the primary right to tax interest is generally given to the country of residence of the recipient.

[187] The UN's commentary on Article 11 (Interest) of the UN MTC: United Nations (2011), "Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries", United Nations, New York. The commentary on Article 11 provides for source-based taxation of interest income.

is available under South African domestic tax law or a tax treaty. The withholding tax rate may vary depending on the type of interest and the country of residency of the recipient.

5.4. Consideration of Interest Deductibility

Interest deductibility is a critical component in the tax treatment of interest and holds profound implications for investment decisions, capital structures, and the overall fairness and integrity of tax systems. Typically, interest is deductible if it's deemed an expense incurred in the process of earning income. However, the degree to which interest deductions are permitted varies significantly across the globe, which can potentially foster tax avoidance strategies.

The OECD and UN MTCs, as part of their Base Erosion and Profit Shifting (BEPS) project, recommend restrictions on interest deductions as a means of preventing profit shifting to low-tax jurisdictions[188]. Advocates of such restrictions argue that they help protect tax bases and ensure profits are taxed where economic activities and value creation occur. Conversely, critics contend that such restrictions may act as a deterrent to international trade and investment. Furthermore, these limitations could disproportionately affect corporations in sectors like infrastructure and real estate that heavily rely on debt financing.

5.5. A Possible Classical Economists' Perspective on International Tax Laws related to Interest

Classical economists argue for a tax system that does not favour certain forms of financing over others. However, achieving such neutrality proves challenging in practice due to differences in national tax laws and the potential for tax planning and evasion. The taxation of interest income and the allocation of taxing rights between jurisdictions can be viewed in light of classical economists' views on taxation.

As explored in (Chapter 4 above), the classical economists, such as Adam Smith, believe in the principle of taxation according to ability to pay, which means that taxes should be levied in proportion to an individual's ability to pay. In the context of interest income, this would mean that interest income should be taxed in the jurisdiction in which the recipient resides, as this jurisdiction is best placed to assess the recipient's ability to pay tax on the income.

However, classical economists also believe in the principle of tax neutrality, which means that taxes should not unduly influence economic decisions and that all economic activities should be taxed equally. In the context of cross-border interest income, this would suggest that interest

---

[188] OECD (2013) "Action Plan on Base Erosion and Profit Shifting." Available at: https://doi.org/10.1787/9789264202719-en (Accessed: 12 May 2023).

income should be taxed in the jurisdiction in which the source of the income is located, as this jurisdiction is best placed to ensure that all economic activities are taxed equally.

The allocation of taxing rights between jurisdictions with regard to interest income must balance these two principles. The provisions of international tax treaties, OECD MTC and the UN MTC, aim to ensure that interest income is taxed in a manner that balances the principle of taxation according to the ability to pay with the principle of tax neutrality.

5.6. Judicial Perspective and Case Law

Another dimension to the international perspective on the taxation of interest income is how courts interpret and apply tax laws and treaties in cases involving interest income. Courts have different approaches and opinions on various issues related to the taxation of interest income, such as:

1. The definition and characterization of interest income. Courts would have to determine whether a payment constitutes interest income or another type of income, such as dividends, fees, royalties, or capital gains. This may depend on factors such as the legal form, economic substance, duration, frequency, contingency, and purpose of the payment.
2. The source and residence of interest income. Courts would have to determine where interest income arises and who is entitled to it. This may depend on factors such as the place where the debt is issued, registered, secured, or paid; the place where the creditor or debtor is resident, domiciled, or incorporated; and the place where the interest income is paid or received.
3. The application and interpretation of tax treaties. Courts would have to determine whether a tax treaty applies to a case involving interest income and how to interpret the provisions of the treaty. This may depend on factors such as the scope, purpose, and context of the treaty; the meaning of terms and expressions used in the treaty; and the relevance of other sources of law or guidance, such as domestic law, international law, OECD model tax convention, commentaries, and case law.

Therefore, a review of international case law can provide some perspective on the recurring considerations in the tax treatment of interest income and expenses:

1. In Canada's *Velcro* case[189], the Tax Court ruled that payments made by *Velcro Canada* to its Dutch parent were royalty payments and not interest. This case emphasizes how

[189] *Velcro Canada Inc. v. The Queen*, 2012 TCC 57

payment characterization can significantly affect tax outcomes and the distribution of taxing rights between nations.

2. In the United States, the pivotal decision in the *Garlock* case[190] clarified that for U.S. tax purposes, the source of interest income is determined by the borrower's residence. This case illustrates the complexities surrounding source rules and the challenges they present in a globally interconnected world.
3. Canada: In *The Queen v Prévost Car Inc*[191], the Federal Court of Appeal had to decide whether interest paid by *Prévost Car Inc.*, a Canadian company, to its Dutch parent company was subject to withholding tax under Article 11 of the Canada-Netherlands tax treaty. The court held that the interest was not subject to withholding tax *because Prévost Car Inc*. was not a resident of Canada for the purposes of the treaty, but rather a resident of Sweden, where its ultimate parent company was located.
4. United Kingdom: In *HMRC v Ardmore Construction Ltd*[192], the Court of Appeal had to decide whether interest paid by *Ardmore Construction Ltd*, a UK company, to its Cypriot parent company was deductible for corporation tax purposes. The court held that the interest was not deductible because it was paid under a tax avoidance scheme that involved circular loans and artificial transactions.

In summary, the consideration of the international perspective has highlighted the intricate balance between residence-based and source-based taxation, and the challenges it presents to both capital-importing and exporting nations. Similar to the discussion in chapter 4, it has extended to the contentious subject of interest deductibility and its ramifications, along with a brief exploration of the principles of taxation from an economist's perspective. Lastly, it highlights the crucial role of court cases in applying tax laws and treaties on the multifaceted domain of global tax policy as it pertains to interest income.

---

[190] *Garlock, Inc. v. C.I.R*, 489 F.2d 197 (2d Cir. 1973)

[191] *Her Majesty The Queen V. Prévost Car Inc*, 2009 FCA 57

[192] *Ardmore Construction Ltd v Revenue and Customs Commissioners* [2018] EWCA Civ 1438

Chapter 6: Conclusion

This research report has delved into the depths of the tax treatment of interest within the South African tax framework, interpreting key legislations, analysing important court rulings, and unravelling the implications of both on businesses and individuals. The exploration ranged from national laws to international tax treaties, and from the economic principles of classical economists to practical implications for modern financial practitioners.

The report started by establishing that the definition of interest, pivotal to understanding its tax implications, is multifaceted, varying based on legal, economic, and international perspectives. This variability necessitates careful consideration when analysing tax implications or conducting further research. Key interpretations of interest were provided by section 24J of the South African Income Tax Act, court precedents, and the OECD.

Next, interest incurred as tax deductible expenditure was examined, and illuminated the nuances of treating interest as a tax-deductible expenditure, emphasizing the vital importance of timing, and the differentiation between capital and revenue expenditure. Section 24J and the legal interpretations of "trade" and "actually incurred" were identified as key determinants of whether an interest payment can be deducted from income.

In Chapter 3, the focus was on practical considerations relating to the taxation of interest. The determination of deductibility was found to depend heavily on the purpose of the loan and its relation to income-producing activities. A clear, direct causal link between the loan and income generation is crucial for deductibility, highlighting the importance of careful financial planning.

Chapter 4 took a step back to consider the classical economists' perspective on the taxation of interest. It underscored the need for a nuanced analysis of tax cases, with consideration for both objective and subjective factors. Moreover, it invited further research into the intersection of classical economic theories and modern tax systems.

Finally, the lens is widened to consider the international tax treatment of interest. It highlighted the balance between the taxing rights of the source country and the residence country in cross-border interest transactions, as well as the tension between residence-based and source-based taxation.

These explorations have led to several overarching conclusions. Firstly, the tax treatment of interest is a complex issue that requires careful interpretation of law and a deep understanding of both national and international tax standards. Secondly, the definitions and treatment of interest within the South African tax framework are influenced by a variety of sources, including national laws, court cases, international tax standards, and the perspectives of the classical economists. Thirdly, both domestic and international considerations play a significant role in the tax treatment of interest, with particular importance given to the purpose of the loan and its relation to income-generating activities.

This research report has opened many avenues for future research. One key area is the impact of the tax treatment of interest on economic growth and investment in South Africa. Further research could assess how variations in tax laws and interpretations might affect investment decisions, business growth, and economic development.

Moreover, given the globalized nature of finance, studies investigating how South Africa's tax laws and policies compare with those in other countries could provide valuable insights. Comparative analysis could identify best practices, potential improvements, and unintended consequences of existing tax policies on interest. Also, the *Brummeria* case and the classical economists' perspective highlighted the tension between the views of classical economists and modern tax systems invites further exploration. Future research could examine how principles from classical economic theories can be integrated into contemporary tax laws to enhance fairness, efficiency, and economic growth.

Additionally, research could be conducted on the implementation and effectiveness of South Africa's tax treaties in preventing double taxation and ensuring fair allocation of taxing rights in cross-border transactions.

In conclusion, the tax treatment of interest in South Africa is a complex, multifaceted topic with significant implications for businesses, individuals, and the economy. Understanding this issue requires careful interpretation of laws and a deep understanding of national and international standards. This research has provided an analysis of the current state of affairs, but there are many promising areas for further exploration. As tax laws continue to evolve in response to changes in the economy and society, continuous research and analysis will be crucial for adapting to these changes and ensuring that South Africa's tax system remains fair, efficient, and conducive to economic growth.

Chapter 7: References

7.1. Books

Boehm-Bawerk, E. von (1957) *Capital and Interest: A Critical History of Economic Theory*. Augsburg, Germany: Kelley & Millman (His Capital and Interest, pt. 1). Available at: https://books.google.co.za/books?id=53oqDwAAQBAJ (Accessed: March 21, 2023).

Hayek, F. (1960) "*v.(1960) The Constitution of Liberty,"* Chicago, USA: University of Chicago.

Hicks, U. (1968) *Public Finance*. 3ed edn. New York, USA: James Nisbet & Co Ltd.

Hume, D. (1752) *Political Discourses*. Edinburgh, UK: A. Kincaid & A. Donaldson.

Mill, J.S. (1965) *Principles of political economy*. London, UK: Longmans, Green and Company.

Montesquieu, C. de S., & Nugent, T. (1949). *The Spirit of the Laws, Hafner library of classics 9*. New York, USA: Hafner Press.

OECD (2013) "Action Plan on Base Erosion and Profit Shifting." Paris, France: OECD. Available at: https://doi.org/10.1787/9789264202719-en (Accessed: February 04, 2023).

Ricardo, D. (1821) *On the Principles of the Political Economy, and Taxation*. London, UK: John Murray, Albemarle-Street.

Smith, A. (1776) *An Inquiry into the Nature and Causes of the Wealth of Nations*. Edited by S.M. Soares. London, UK: MetaLibri Digital Library. Available at: http://metalibri.wikidot.com/title:an-inquiry-into-the-nature-and-causes-of-the-wealth-of (Accessed: February 04, 2023).

Stinglingh, M., Heerden, L. van, Koekemoer, A., Wilcocks, J. S., & Zwan, P. van der. (2020). Silke: South African Income Tax 2020 (2020th ed.; M. Stinglingh, Ed.). South Africa: LexisNexis.

Vivian, R. and Mushai, A. (2017) "Introduction of the Marginal Tax Rate System - A Continuation of a History of Constitutional Failures." (Work in Progress).

7.2. Journals and Articles

Bahceli, Y. (2021) *Corporate net debt seen rising as companies spend pandemic cash piles*. Available at: https://www.reuters.com/business/finance/corporate-net-debt-seen-rising-companies-spend-pandemic-cash-piles-2021-07-06/ (Accessed: June 1, 2023).

Botha, L. (2017) *An interest(ing) case: Section 11(a) of the Income Tax Act and the deductibility of interest expenses on home loans*, *Tax and Exchange Control Alert*. Available at: https://www.cliffedekkerhofmeyr.com/en/news/publications/2017/Tax/tax-and-exchange-control-alert-17-march-an-interest-ing-case-section-11-a-of-the-income-tax-act-and-the-deductibility-of-interest-expenses-on-home-loans.html (Accessed: May 3, 2023).

Brincker, E. (2015) *The Deduction of Interest*, *News & Press: TaxTalk*. Available at: https://www.thesait.org.za/news/242362/The-Deduction-of-Interest-.htm (Accessed: May 2, 2023).

Cohen, S.B. (2009) "Does *Brummeria* sweep clean? A US tax-law perspective," *South African Law Journal*, 126(3), pp. 489–504. Available at: https://journals.co.za/content/ju_salj/126/3/EJC53885 (Accessed: February 04, 2023).

Goldswain, G.K. and Swart, O. (2015) "*The Port Elizabeth Electric Tramway* case: Is the meaning ascribed to the phrase 'In the production of the income' by Watermeyer AJP in the Port Elizabeth Electric Tramway case still religiously followed today?," *Southern African Business Review*, 19, pp. 71–96. Available at: https://doi.org/10.25159/1998-8125/5791 (Accessed: October 15, 2022),

Graetz, M.J. and O'Hear, M.M. (1997) "The 'Original Intent' of U.S. International Taxation," *Duke Law Journal*, 46(5), pp. 1021–1110. Available at: https://scholarship.law.duke.edu/dlj/vol46/iss5/2 (Accessed: February 04, 2022).

Matlala, M. (2016) *What is "interest" anyway? section 24J and interest deductions*. Available at: https://www.thesait.org.za/news/257024/What-is-interest-anyway-section-24J-and-interest-deductions-.htm#:~:text=Section%2024J%20of%20the%20Act,in%20relation%20to%20such%20credit (Accessed: May 17, 2023).

National Treasury. (2020). *Reviewing the Tax Treatment of Excessive Debt Financing, Interest Deductions and other Financial Payments*. Available at: Reviewing the Tax Treatment of Excessive Debt Financing (Accessed 15 June 2023)

Popescu, L. (2019) "Evolution of Concepts Regarding Taxation and Taxation Systems," *Ovidius University Annals, Economic Sciences Series*, 19(2), pp. 861–868.

Rudd, R. (2019) "The tax treatment of interest in kind: the *Brummeria* case revisited?," *SA Mercantile Law Journal*, 31(3), pp. 435–455. Available at: https://journals.co.za/content/journal/10520/EJC-1fda500a47 (Accessed: October 23, 2020).

SARS (2012) “Interpretation Note 58 (Issue 2): The *Brummeria* Case and the Right to Use Loan Capital Interest Free.” South African Revenue Service. Available at: https://www.sars.gov.za/AllDocs/LegalDoclib/Notes/LAPD-IntR-IN-2012-58%20-%20*Brummeria*%20Case%20Right%20Use%20Loan%20Capital%20Interest%20Free.pdf (Accessed: October 23, 2020).

Smith, A. (1776) *An Inquiry into the Nature and Causes of the Wealth of Nations*. Edited by S.M. Soares. London: MetaLibri Digital Library. Available at: http://metalibri.wikidot.com/title:an-inquiry-into-the-nature-and-causes-of-the-wealth-of (Accessed: October 23, 2020).

Vivian, R. W. (2006). Equality and personal income tax--the classical economists and the KATZ commission. *South African Journal of Economics*, *74*(1), 79--109.

7.3. Statutes

Income Tax Act 58 of 1962

7.4. Cases

Allied Building Society, CIR v 1963 (4) SA 1 (A), 25 SATC 343

Ardmore Construction Ltd v Revenue and Customs Commissioners [2018] EWCA Civ 1438

Atlantic Refining Company of Africa (Pty) Ltd v CIR 1957 (2) SA 330 (A),21 SATC 203

BP South Africa (Pty) Ltd, C: SARS v 2006 (4) SA 195 (C),68 SATC 229 (SCA)

Burgess v CIR, 1993(4) SA 161 (A), 55 SATC 185, 1993 Taxpayer 153

Burman v CIR 1991 (1) SA 533 (A), 53 SATC 63

Cactus Investments (Pty) Ltd v CIR [1999] 1 All SA 345 (A), 61 SATC 43

Caltex Oil (SA) Ltd v SIR 1975 (1) SA 665 (A), 37 SATC 1

Case No: 13791 & 13792 Available: https://www.sars.gov.za/wp-content/uploads/Legal/Judgments/TC/LAPD-DRJ-TC-2016-11-TCIT-13791-and-13792-WC-13-December-2016.pdf (Accessed: 15 June 2023)

CIR v Cactus Investments (Pty) Ltd 1997 59 SATC 1

CIR v Drakensburg Garden Hotels (Pty) Ltd 1960 (2) SA 475 (A), 23 SATC 251

CIR v Elma Investments CC (CPD) 1996 58 SATC 295

CIR v Felix Schuh (SA) (Pty) Ltd 1994 (2) SA 801 (A)

CIR v Genn & Co (Pty) Ltd 1955 (3) SA 293 (A)

CIR v Golden Dumps (Pty) Ltd 1993 (4) SA 110 (A) 55 SATC 198

CIR v Hilewitz (1996) 60 SATC 86

CIR v People's Stores (Walvis Bay) (Pty) Ltd 1990 (2) SA 353 (A)

Concentra (Pty) Ltd v CIR 1942 CPD 509 12 SATC 95

COT v Rendle 1965 (1) SA 59 (SRAD), 26 SATC 326, 1964 Taxpayer 225

Creative Productions (Pty) Ltd, C: SARS v [1999] 2 All SA 14 (N), 61 SATC 106

CSARS v 121 Castle Street Cape Town CC 2002 (1) SA 198 (C), 63 SATC 185

CSARS v BP South Africa (Pty) Ltd 2006 68 SATC 229

CSARS v Brummeria Renaissance (Pty) Ltd & Others 2007 6 SCA 601

CSARS v Van der Westhuizen 2001 63 SATC 191

De Beers Holdings (Pty) Ltd v CIR [1985] 47 SATC 229

De Beers Holdings (Pty) Ltd, CIR v 1984 (3) SA 286 (T), 46 SATC 47

Financier v COT 1950 SR 69, 17 SATC 34

Garlock, Inc. v. C.I.R, 489 F.2d 197 (2d Cir. 1973)

Genn & Co (Pty) Ltd, CIR v 1955 (3) SA 293 (A), 20 SATC 113

Guardian Assurance Holdings (SA) Ltd, SIR v 1976 (4) SA 522 (A), 38 SATC 11

Her Majesty The Queen V. Prévost Car Inc, 2009 FCA 57

ITC 484 (1941) 11 SATC 351

ITC 572 (1944) 13 SATC 461

ITC 610 (1945) 14 SATC 377

ITC 729 (1951) 18 SATC 96

ITC 792 (1954) 20 SATC 98

ITC 968 (1962) 24 SATC 726

ITC 1121 (1968) 30 SATC 171

ITC 1124 (1968) 31 SATC 53

ITC 1126 (1968) 31 SATC 111

ITC 1242 (1975) 37 SATC 306

ITC 1171 (1971) 34 SATC 80

ITC 1292 (1979) 41 SATC 163

ITC 1428 (1985) 50 SATC 34

ITC 1429 (1982) 50 SATC 402

ITC 1444 (1989) 51 SATC 35

ITC 1495 (1990) 53 SATC 216

ITC 1496 (1990) 53 SATC 229

ITC 1592 (1994) 57 SATC 247

ITC 1602 (1995) 58 SATC 205

ITC 1604 (1995) 58 SATC 263

ITC 1627 (1997) 60 SATC 26

ITC 1634 (1997) 60 SATC 235

ITC 1675 (1998) 62 SATC 219

ITC 1694 (1999) 63 SATC 127 *aka Mpande Foodliner CC (MF) v CSARS*, 2000 (11) JTLR 331, 63 SATC 46.

ITC 1727 2001 64 SATC 275

ITC 1764 (2004) 66 SATC 93 *v BP Southern Africa (Pty) Ltd*

Johnstone & Co Ltd, W F v CIR 1951 (2) SA 283 (A), 17 SATC 235

Lategan v CIR 1926 CPD 203

Lever Bros & Unilever Ltd, CIR v 1946 AD 441, 14 SATC 1

Marshall v CSARS 2018 80 SATC 400

Mooi v SIR 1972 (1) SA 675 (A), 34 SATC 1

Nasionale Pers Bpk v KBI 1986 (3) SA 549 (A), 48 SATC 55

Natal Joint Municipal Pension Fund v Endumeni Municipality 2012 (4) SA 593 (SCA)

Natal Laeveld Boerdery (Edms) Bpk v KBI 1998 (1) SA 639 (SCA), 60 SATC 81

National Pers BPK v KBI 1986(3) SA 549 (A) 48 SATC 55

Nemojim Pty (Ltd) v CIR 1983 (4) SA 935 (A), 45 SATC 241

New State Areas Ltd v CIR 1946 AD 610, 14 SATC 155

Port Elizabeth Electric Tramway Co Ltd v CIR 1936 CPD 241, 8 SATC13

Producer v COT 1948 SR 62, 15 SATC 405

Pyott v CIR 1945 13 SATC 121 126

Riches v Westminster Bank Ltd [1947] 1 All ER 469

Schulze v S W Bensted (Surveyor of Taxes) 1915 7 TC 30-33

Riches v Westminster Bank Ltd [1947] 1 All ER 469

Sallies Ltd v CSARS (2008) 70 SATC 39 (W)

Scribante Construction (Pty) Ltd, CSARS v 2001 (2) SA 601 (E), 62 SATC 443

Sentra-Oes Koöperatief Bpk v KBI 1995 (3) SA 197 (A), 57 SATC 109

Shapiro, CIR v 1928 NPD 436, 4 SATC 29

Solaglass Finance Company (Pty) Ltd v CIR 1991 (2) SA 257 (A), 53 SATC 1

Standard Bank of SA Ltd, CIR v 1985 (4) SA 428 (A),47 SATC 179

Stander v Commissioner for Inland Revenue 1997 (3) SA 617 (C)

Stephan v CIR 1919 WLD1 32 SATC 54

Stone v SIR 1974 (3) SA 584 (A), 36 SATC 117

Sub-Nigel Ltd v CIR 1948 (4) SA 580 (A), 15 SATC 381

Ticktin Timbers CC v CIR [1999] 4 All SA 192 (A), 61 SATC 399

Tobacco Father v COT 1951 (1) SA 150 (SR), 17 SATC 395

Van der Walt, KBI v 1986 (4) SA 303 (T), 48 SATC 104

Velcro Canada Inc. v. The Queen, 2012 TCC 57

WF Johnstone v CIR 1951 (2) SA 283 (A), 17 SATC 235