REPORTABLE

IN THE TAX COURT
(HELD AT JOHANNESBURG)

Case No. 11691

In the matter between:

A	**Appellant**
And	
THE COMMISSIONER FOR THE SOUTH AFRICAN REVENUE SERVICE	**Respondent**

JUDGMENT

Judgment delivered on 24 April 2007

C.J. CLAASSEN J

INTRODUCTION

[1] This case concerns the problem, frequently experienced in Tax Law disputes, of deciding whether a certain expenditure was of a capital or income producing nature. In the present case the expenditure consisted of the payment of interest.

[2] The appellant, the taxpayer, contended that the payment of interest was an expenditure in the production of income and therefore deductible in terms of section 11(a) and section 23(g) of the Income Tax Act, No. 56 of 1962 (hereinafter referred to as "the Act"). The respondent contended that the interest paid by the appellant fell foul of the provisions of the aforesaid two sub-sections and could, therefore, not be deducted from the appellant's taxable income.

[3] Section 11(a) of the Act reads as follows:

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

[4] It is common cause that the above section must be read with its negatively worded counterpart found in section 23(g) which provides:

> "No deductions shall in any case be made in respect of the following matters, namely –
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> (g) any monies, claimed as a deduction from income derived from trade, to the extent to which such monies were not laid out or expended for the purposes of trade".

[5] Section 11(a) provides positively for what may, and section 23(g) negatively for what may not, be deducted in the determination of a taxpayer's taxable income. A deduction claimed must therefore satisfy both sub-sections.[1]

[6] It is common cause that appellant bears the onus to show that an amount included in an assessment is not taxable.[2] It has been held that what is required of the taxpayer to discharge this onus is affirmative evidence that satisfies a court upon a preponderance of probability that the amount is deductible or alternatively not taxable.[3]

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[1] See **CIR vs Nemojin (Pty) Ltd** 1983 4 SA 935 (A) at 946 F – 947 F.

[2] See section 82 of the Act which provides as follows:

> "The burden of proof that any amount is exempt from or not liable to any tax chargeable under this Act or is subject to any deduction, abatement or set-off in terms of this Act, shall be upon the person claiming such exemption, non-liability, deduction, abatement or set-off, and upon the hearing of any appeal from a decision of the Commissioner, the decision shall not be reversed or altered unless it is shown by the appellant that that decision is wrong."

[3] See **CIR vs Goodrick** 1942 OPD 1 at 20 (12 SATC 279 at 296).

BACKGROUND FACTS

[7] It is common cause that three doctors conducted a gynaecology and obstetric medical practice in partnership at X. Dr. A testified that he and his partners were convinced by reading various newspaper articles that they stood to gain by having the partnership incorporated. The benefits which they intended to gain were testified to by Dr. A as follows:

1. The main asset of a medical practice was lodged in its patients who frequented the practice, which in the present instance amounted to approximately 8000 patients. These patients frequenting the practice, constituted its goodwill. In a partnership such goodwill constituted an unrealisable asset. Once incorporated, the goodwill would appear on the financial statements of the company owning the practice, as an intangible asset. Such asset will then make it possible for the company to utilise it for purposes of raising finance and/or selling shares in the company to joining practitioners, something which was not possible in conducting the practice as a partnership.

2. Upon the resignation of a partner or the acquisition of a new partner, the existing partnership had to be dissolved and a new one had to be formed with the concomitant problems relating to debts incurred by the "old" partners and the "new" partners' liability therefore. In the case of a company, this problem did not arise as the company retained continuity of its existence irrespective of the amount of participating practitioners in its business of conducting the medical practice.

3. The income tax to be paid by the company on the fees received from patients would be less than the income tax payable by the individual practitioners when practising in partnership with one another.

4. They were led to believe that the practitioners, as shareholders and/or directors of the company, would be entitled to unemployment insurance fund benefits in their capacities as employees of the company, which benefit was not available to them as individual partners in a partnership.

[8] The evidence of Dr. A in regard to the aforesaid intention of the partners to have themselves incorporated, could not and was not seriously disputed by the respondent. In fact respondent called no evidence to counter the evidence of Dr. A in this regard.

[9] The only witnesses who testified were called by the appellant, being Mr. B, the appellant's accountant and auditor and Dr. A. The respondent closed its case without calling any witnesses to testify.

[10] In order to obtain the benefit of incorporation, the appellant was incorporated and it then purchased the business of the partnership i.e. the medical practice, in terms of a written agreement of sale concluded on 30 October 1996. The relevant provisions of the agreement of sale[4] read as follows:

"1. **SALE**

The SELLERS sell to the PURCHASER as a going concern, with effect from the commencement of business on 1 November 1996 (the EFFECTIVE DATE), the Gynaecological and Obstetric Practice conducted by the SELLERS.

2. **ASSETS COMPRISING THE SALE**

The sale comprises the following assets of the PRACTICE:

2.1. The Fixed Assets at Net Book Value as at the EFFECTIVE DATE, comprising furniture, office equipment and medical equipment.

[4] See pages 333 – 335 of the dossier.

2.2. Goodwill in the amount of R2 700 000 (Two million Seven Hundred Thousand Rand) which has been calculated as follows:

19 months turnover based on the 1996 Financial Statements of the Practice i.e. 19/12 x R1 729 639 = R2 738 595, rounded off to R2 700 000.

3. **LIABILITIES**

No liabilities of the SELLERS are to be taken over by the PURCHASER.

4. **PURCHASE PRICE**

The Purchase Price shall be the sum of the assets sold under Clause 2.1 plus the goodwill sold under Clause 2.2, and shall be deemed to be paid in full by crediting the SELLERS' loan accounts equally in the books of the PURCHASER with the resultant total."

[11] It is evident from the aforesaid agreement of sale that the parties intended the appellant to buy the practice consisting of the partnership's goodwill and other assets, as a going concern. The intention was to finance the purchase price of the fixed assets at nett book value by crediting the sellers' loan accounts equally. It is common cause that this was initially done.[5] Initially no interest was levied on the credit balances of the directors' loan accounts. Subsequently, however, interest on these loan accounts was levied at the rate of 15% for the financial year ending 28 February 1998[6], 21% in respect of the financial year ending 28 February 1999[7], and 21% in respect of the financial year ending 29 February 2000.[8] No interest in respect thereof was levied for the financial year ending 28 February 2001.[9]

[12] It transpired from the evidence tendered by Dr. A that one of the practitioners ran into financial difficulties approximately 4 months after the

[5] See appellant's financial statements for the period ending 28 February 1997, paragraph 4, page 137 of the dossier.
[6] See paragraph 5 of the financial statements of the appellant, page 144 of the dossier.
[7] See paragraph 5, page 155 of the dossier.
[8] See paragraph 5, page 166 of the dossier.
[9] See paragraph 6(2) on page 181 and paragraph 10.3 at page 182 of the dossier.

aforesaid agreement of sale was concluded. The doctors were then faced with the problem of obtaining finance in order to assist their colleague. A bank came up with a solution in terms whereof a medium term loan was offered in the amount of R1 350 000 to liquidate the personal debts owed to directors in the amount of R450 000 each. The loan was to be repaid by the appellant in monthly instalments, payable directly into three different 7 year loan redemption plans of R450 000 each against the security of the three directors supplying unrestricted suretyships each and an unrestricted cession of the three loan redemption plans to the bank.[10] The appellant accepted this offer and repaid portions of their loan accounts to each of the directors in three amounts of R450 000 on 28 February, 1 March and 3 March respectively.[11] These amounts were initially financed by utilizing the appellant's overdraft facilities. Subsequently such overdraft was liquidated when the bank paid the amount of R1 350 000 into the appellant's bank account on 8 March 1997.[12] The loan from the bank was reflected for the first time in the appellant's financial statements for the year ending 28 February 1998, where it was recorded that the loan bore interest at prime rate which was then 19.5%.[13] Thereafter the appellant paid interest on this loan to the bank for the year ending 28 February 1999 at the rate of 21%,[14] for the year ending 29 February 2000 at the rate of 14.5%[15] and for the year ending 28 February 2001 at the rate of 14.5%.[16]

[13] The appellant sought to deduct the interest on the loan accounts and the interest payable to the bank from its taxable income pursuant to the provisions of section 11(a) as follows:

1999 the amount of R585 888.00;

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[10] See the letter dated 24 February 1997 from the bank , pages 336 – 345 of the dossier.
[11] See pages 66 and 68 of the dossier.
[12] See page 70 of the dossier.
[13] See paragraph 6, page 144 of the dossier.
[14] See paragraph 6, page 155 of the dossier.
[15] See paragraph 6, page 166 of the dossier.
[16] See paragraph 6, page 181 of the dossier.

2000 the amount of R419 694.00 and

2001 the amount of R154 042.00.

[14] It is common cause that the respondent refused to allow these amounts in its assessment of the appellant's taxable income for the years 1999, 2000 and 2001. The respondent advanced 3 reasons for disallowing the deduction of the aforesaid interest expended during the relevant years, namely:

1. The interest incurred was not incurred in the production of income;

2. The interest incurred was not laid out or expended for purposes of trade; and

3. The interest incurred is expenditure of a capital nature.

[15] It is common cause that the respondent did not attack the scheme as being a sham or an unlawful attempt to evade the payment of tax. It is therefore necessary only to deal with the reasons as set out aforesaid for respondent's disallowing the deduction of interest. It should, however, be mentioned that initially the respondent in its letter of assessment dated 10 February 2003 advanced only a single reason for disallowing the deduction namely:

> "Die rente uitgawe is nie in die produksie van inkomste aangegaan nie en word ontsê volgens die bepalings van artikel 11(a) saamgelees met artikel 23(g) van die Inkomstebelastingwet Nr. 58 van 1962."[17]

[17] See page 309 of the dossier.

We will, however, deal with the objections as relied upon by the respondent during the trial as stated aforesaid.

THE INTEREST WAS NOT INCURRED IN THE PRODUCTION OF INCOME

[16] An expenditure is said to be incurred in the production of income when it is closely related to the act which produces such income. Thus it was held in **Port Elizabeth Electric Tramway Co. Ltd. v CIR** 8 SATC 13 at 16 as follows:

> "Now, as pointed out above, income is produced by the performance of a series of acts, and attendant upon them are expenses. Such expenses are deductible expenses, provided they are so closely linked to such acts as to be regarded as part of the cost of performing them.
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> A little reflection will show that two questions arise (a) whether the act, to which the expenditure is attached, is performed in the production of income, and (b) whether the expenditure is linked to it closely enough."

[17] The meaning of the words "regarded as part of the cost of performing them" has been expanded in **CIR v Genn & Co (Pty) Ltd** 1955 3 SA 293 (A). The court there held that these words required that it must be determined whether "it would be proper, natural or reasonable to regard the expenses as part of the cost of performing the operation."[18]

[18] In *casu* the appellant incurred expenses in the form of interest. This expenditure was incurred due to the fact that the appellant borrowed money. Interest is the cost payable for borrowing money, whether it was borrowed from the directors or from an outside party such as the bank. The appellant first of all borrowed the money from the directors in order to acquire the partnership's practice (goodwill and certain assets) from the former partners.

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[18] See the judgment of Schreiner JA at 299 C.

Thereafter when it became necessary for the appellant to repay the directors a certain portion of their loan account, it was forced to seek a loan from an outside party, in *casu* the bank.

[19] It was never seriously in dispute that the purchase of the partnership's practice constituted the acquisition of an income producing asset. The actual payment of the purchase price for acquiring such asset, is, of course, capital in nature. The purchase price of a capital asset is, therefore, never tax deductible. The question here is, however, whether the payment of interest to obtain such money on loan, is deductible as a revenue expenditure. By way of analogy, it is trite that a farmer purchasing a farm cannot deduct the purchase price from his taxable income. However, where he has to lend money from the Land Bank or other financial institution to purchase the farm, the monthly or annual interest payable on such loan will be deductible from the income derived from his farming operations as a revenue expenditure. Mrs. Vogel for the respondent was forced to concede that the interest payable on the director's loan account would be deductible as a revenue expenditure in the same way as the interest payable to the Land Bank by a farmer in the example cited above, would be deductible. Her concession in this regard was well made as it is incontestable that money borrowed to purchase an income producing asset is loaned for purposes of obtaining the asset in order for it to be used in the production of income. In **CIR v G Brollo Properties (Pty) Ltd** 1994 2 SA 147 (A), it was stated at 152 J – 153 B as follows:

> "In a case concerning the deductibility or otherwise of interest payable on money borrowed, the enquiry relates primarily to the purpose for which the money was borrowed. That is often the 'dominant' or 'vital' enquiry, although the ultimate user (*sic* "use"?) of the borrowed money may sometimes be a relevant factor. Where a taxpayer's purpose in borrowing money upon which it pays interest is to obtain the means of earning income, the interest paid on the money so borrowed is *prima facie* an expenditure incurred in the production of income. See **Commissioner for Inland Revenue v Allied Building Society** 1963 4 SA 1 (A) at 13 C- G. In this judgment approving reference was made to what was said in **Farmer v Scottish North American**

> **Trust** [1912] AC 118 at 127 in relation to a company which had borrowed money for use in its investment business:
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> > 'The interest is, in truth, money paid for the use or hire of an instrument of their trade, as much as is the rent paid for their office or the hire paid for a typewriting machine. It is an outgoing by means of which the company procures the use of the thing by which it makes a profit, and, like any similar outgoing, should be deducted from the receipts to ascertain the taxable profits and gains which the company earns.'"

In ITC 1124 (1968) 31 SATC 53 at 55 Trollip J stated as follows:

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

[20] Based on the authorities above, we have come to the conclusion that the concession made by Mrs Vogel is correct in law that in *casu* the interest payable on the directors' loan account constituted a revenue expenditure which was, in fact, tax deductible.

[21] Support for the aforesaid conclusion is found in an article, "*Can expenditure on interest be 'of a capital nature' and on that ground be non-deductible for income tax purposes?*"[19] by R.C. Williams, where the author comments on the argument, that the acquisition of a capital asset constitutes the acquisition of an income-earning structure and that interest paid by the purchaser constitutes an expenditure of a capital nature by virtue of its close proximity to the nature of the asset acquired, as follows:

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[19] 1997 SALJ 641 at 643.

> "Now, if this argument were to gain acceptance by the courts, the implications for taxpayers nationwide would be little short of cataclysmic. Almost every capital project – the erection and expansion of factories, the construction of office blocks, hotels and shopping complexes, the acquisition of plant and machinery – is financed wholly or largely with borrowed funds. If the interest paid by the developers or entrepreneurs were of a capital nature and consequently not tax deductible, many or even most of such capital projects would be stillborn."

At 644 the aforesaid author continues as follows:

> "Looking at the issue in broad perspective it is (I suggest) difficult to see how the payment of interest can ever 'improve [or] augment the capital assets' of the borrower any more than the payment of rent by a lessee can ever augment or improve the lease premises. Interest is, after all, a periodic charge for the use of money in the same way as rent is the periodic charge for the use of property."

[22] It would seem that the respondent's main argument was its contention that the subsequent loan from the bank was obtained not for purposes of producing an income. Mrs. Vogel stressed the fact that Dr. A testified to the effect that the loan became necessary because of the financial difficulties of one of the appellant's directors. In our view the fact that the loan was triggered by the directors' financial difficulties is of no consequence. It is common cause that the appellant owed the amounts standing to the credit of the directors' loan accounts. Once the directors called up payment of all or any portion of these loans, the appellant was obliged to pay, irrespective of the purpose for which the directors (as its creditors) intended using the money. Viewed from the perspective of the appellant, it is of no consequence to which use the directors intended to put the money once they received it from the appellant.

[23] Furthermore, we agree with the argument of Mr. Louw for the appellant that the loan from the bank constituted a so-called "replacement loan". Initially the payback of a portion of the loan accounts was financed by utilising the appellant's overdraft facility with the bank. The payment of these loan

accounts to the directors then caused a substantial increase in the appellant's overdraft. Upon receipt of the bank loan, the appellant reduced its overdraft to manageable proportions. It is common cause that the bank levied the interest referred to above on the loan to the appellant. The deductibility of expenditure incurred in respect of such "new loan" has to be determined by reference to the purpose for which the "original loan" was raised. Thus, the interest payable on the new loan replacing the old one, will be deductible if the interest paid on the old loan was deductible.[20] In *casu* the purpose of the original loan from the directors was to enable the appellant to acquire the goodwill and assets of the partnership as an income generating asset. The purpose of the replacement loan from the bank is therefore the same.

THE INTEREST INCURRED WAS NOT LAID OUT OR EXPENDED FOR PURPOSES OF TRADE

[24] I did not understand Mrs Vogel to stress this argument. The definition of "trade" in section 1 of the Act defines trade as including every "profession, trade, business, employment, calling, occupation or venture, including the letting of any property….." It is obvious from this definition that the word "trade" must be given a wide interpretation.[21] It is common cause that the appellant conducted a business which rendered professional medical services being gynaecological and obstetric services. Repayment of genuine creditors of the appellant will constitute payment of debts in the normal course of conducting its trade. The payment of the debts owed to the directors was, therefore, a payment in the normal course of concluding its trade. In our view there was no basis in fact or in law which would have entitled the respondent to raise the objection that the appellant was not conducting a trade or paying a debt outside the conduct of its trade activity during the relevant years.

[20] See ITC 1553 (55 S C 105) at 112 – 113; **Commissioner for Inland Revenue v General Motors (SA) (Pty) Ltd** 1982 1 SA 196 (T) at 204; **Commissioner for Inland Revenue v Sunnyside Centre (Pty) Ltd.** 1993 3 SA 940 (T) at 945 B-C.

[21] See **Burgess v CIR** 1991 4 SA 161 (A) at 181 I-J.

THE INTEREST INCURRED WAS EXPENDITURE OF A CAPITAL NATURE

[25] It is of course true that expenditure which produces income or is intended to produce income does not necessarily mean that such expenditure is of a non-capital nature.[22] The question whether the interest is expenditure of a capital or revenue nature can be answered only by ascertaining the purpose for which the loan was obtained during the period for which interest was paid.[23]

[26] In this regard Mrs. Vogel stated in her heads of argument in paragraph 41 as follows:

> "A factor which complicates the issue is the confusion in some cases between the test as to whether the expenditure was incurred in the production of income and the test as to the nature of the expenditure, i.e. both types of expenditure might be in the production of income, but one is of a revenue nature and the other of a capital nature."

Mrs. Vogel submitted that the purpose of the appellant in making the loan was not to produce income but to reduce its current bank overdraft which the payment of the three doctors caused to increase extensively.

[27] In our view there is no substance in this argument. The appellant's overdraft increased only because the appellant was obliged to liquidate the debts arising out of the loan accounts when payment thereof was demanded by the directors, in their capacities as the appellant's creditors. The appellant was unable to pay these amounts due to lack of available funds and financed it by way of an overdraft. The loan from the bank was simply obtained to liquidate the overdraft in order to assist the appellant to comply with its obligations to make payment of the debts due to the directors of the appellant.

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[22] See **Sub-Nigel Ltd. v CIR** 1948 4 SA 580 (A) at 594.

[23] See **Wharf Properties Ltd. v IRC** [1997] AC 505 (PC) at par. 8.

[28] Mrs. Vogel relied on two decisions i.e. **CIR v Drakensberg Garden Hotel (Pty) Ltd.** 1960 2 SA 475 (A) and the judgment by Galgut J in ITC 1126 31 SATC 111 at 113. These cases are distinguishable as the *ratio decidendi* of both courts was not that interest paid on money borrowed to buy shares was of a capital nature.[24]

[29] We are therefore of the view that the appellant succeeded in discharging the onus of proving that the interest incurred by the appellant was not of a capital nature and should have been allowed as a deduction under section 11(a) of the Act.

<u>COSTS</u>

[30] We agree with the contention advanced by Mr. Louw that the respondent acted unreasonably in alleging that the interest incurred was of a capital nature and not incurred in the production of income. The weight of the authorities cited above clearly favoured the contentions advanced by the appellant. The respondent never seriously disputed the facts in the case nor did it tender rebutting evidence. The facts were relatively simple. As stated earlier the argument advanced by the respondent that the interest was not paid in the conduct of a trade or profession was entirely without any substance. We are therefore of the view that a punitive costs order is called for.

The following order is issued:

1. It is declared that the interest paid by the appellant in the amounts of R585 888.00 in respect of 1999; R419 694.00 in respect of 2000 and

[24] See **ITC 1604 58 SATC 263** at 271; **ITC 1625 59 SATC 383** at 394 where Wunsch J pertinently stated:

> "There can be no doubt that the interest expenditure incurred by the appellant in the year of assessment was for the purpose of financing the acquisition of the property from which it derived income. Interest recurrently so expended is not of a capital nature."

R154 042.00 in respect of 2001 constituted revenue expenditures deductible in the determination of appellant's taxable income pursuant to the provisions of section 11(a) and 23(g) of the Act.

2. The assessments made by the respondent in respect of the years 1999, 2000 and 2001 are set aside and the matter is remitted back to the respondent for re-assessment in terms of 1 above.

3. The respondent is ordered to pay the appellant's costs on an attorney and client scale.

DATED AT JOHANNESBURG ON THIS ……… DAY OF APRIL 2007

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C.J. CLAASSEN
JUDGE OF THE HIGH COURT

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PROF. H.A. COETZEE
ACCOUNTANT MEMBER

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MR. G.M. NEGOTA
COMMERCIAL MEMBER OF THE COURT