

REPUBLIC OF SOUTH AFRICA



IN THE HIGH COURT OF SOUTH AFRICA
GAUTENG DIVISION, JOHANNESBURG

- | | |
|-----|--|
| (1) | NOT REPORTABLE |
| (2) | NOT OF INTEREST TO OTHER JUDGES |

CASE NUMBER: A3094/2022

DATE: 09th January 2024

In the matter between:

UNITRANS HOLDINGS LIMITED

Appellant

and

**THE COMMISSIONER FOR
THE SOUTH AFRICAN REVENUE SERVICES**

Respondent

Neutral Citation: *Unitrans Holdings v CSARS (A3094/2022)* [2023] ZAGPJHC
--- (09 January 2024)

Coram: Adams *et* Strydom JJ

Heard: 15 August 2023

Delivered: 09 January 2024 – This judgment was handed down electronically by circulation to the parties' representatives *via* email, by being uploaded to *CaseLines* and by release to SAFLII. The date and time for hand-down is deemed to be 11:00 on 09 January 2024.

Summary: Appeal from the Tax Court – whether interest expenditure is tax deductible, as having been incurred in the course of carrying out 'any trade' and in the production of income – section 24J(2) of the Income Tax Act – the

taxpayer trading as an investment holding company – the interest expenditure claimed not closely linked to its income earning operations as an investment holding company – the purpose of the expenditure was not to produce income but to further the interest of the subsidiaries – therefore, the expenditure was not incurred in the production of the taxpayer's income.

Appeal dismissed with costs.

ORDER

On appeal from: The Tax Court, Johannesburg (Bam J sitting as the Court of first instance, with an Accounting Member and a Commercial Member):

- (1) The appeal of the taxpayer against the order of the Tax Court dated 09 February 2022 is dismissed with costs.
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JUDGMENT

Adams J (Strydom J concurring):

[1]. The appellant ('the taxpayer') trades as an investment and a holding company – that much appears to be common cause. Its case is that, at the relevant time, it performed a treasury function for the Unitrans Group of Companies and that such function included the provision of loan funding, as well as cash management. Its wholly owned subsidiaries had a cash management arrangement with Standard Bank, whereby the group's bank accounts were balanced to zero on a daily basis. If the group's net position ended up in overdraft, the taxpayer would borrow funds from Standard Bank on a call loan and if the group was in a positive cash position, the taxpayer would pay back the call loan. As at 30 June 2011, the taxpayer had available cash resources of R347 million. This, so the taxpayer contends, demonstrates the fact that its dealings with its wholly owned subsidiaries and with the bank were not only inter-related, but actively managed on a daily basis.

[2]. The taxpayer declared in its 2011 income tax return, that it earned interest income from its subsidiaries in the amount of R34 935 900. It also claimed, as a deduction, an amount of R68 133 602, being interest paid by it to its shareholder, Steinhoff Africa Holdings (Pty) Limited ('Steinhoff'). Importantly, it also declared that during the relevant period, it did not enter into any transactions as contemplated by s 24J of the Income Tax Act¹ ('the Income Tax Act').

[3]. On 8 December 2014, the respondent ('SARS') issued a letter notifying the taxpayer of its audit findings and SARS's intention to raise additional assessments for the 2011 year of assessment. On 28 April 2015, SARS issued a 'letter of finalisation of audit' in terms of which it adjusted the taxpayer's taxable income of the 2011 year of assessment by disallowing the interest claimed in terms of section 24J(2) of the Income Tax Act. The basis for disallowing the interest deduction was that the interest claimed by the taxpayer was not an expenditure incurred in the conduct of any trade and was not in the production of income. SARS disputed that the taxpayer conducted a trade as a money lender and that the expenditure was incurred in the production of income. In other words, the expenditure claimed by the taxpayer did not meet the requirements of section 24J(2) of the Income Tax Act. SARS did however allow the interest expenditure to the extent of the income earned by the taxpayer from the investment income of R34 935 900. SARS also imposed an understatement penalty of 10% on the basis that there was substantial under-declaration of income.

[4]. On 10 June 2015 the taxpayer objected to the additional assessment and on 15 July 2015 SARS disallowed the objection. The taxpayer appealed the additional assessment and the disallowance of the objection to the Tax Court before which the main issue on appeal was whether the interest expense claimed by the taxpayer met the requirements of s 24(J)(2) of the Income Tax Act. Put differently, the Tax Court was called upon to decide whether the taxpayer incurred the interest expense of R68 134 000 in the production of income whilst conducting 'a trade'.

¹ Income Tax Act, Act 58 of 1962;

[5]. SARS denied that the taxpayer conducted trade as a money lender. It also disputed that the expenditure claimed by the taxpayer was closely linked to its income earning operations as a money lender. The purpose of the expenditure was not to produce income but to further the interest of the subsidiaries. Therefore, SARS's case was that the expenditure was not incurred in the production of the taxpayer's income.

[6]. In its Rule 32 statement of grounds of appeal, the taxpayer pleaded that it incurred interest on funds borrowed from group companies with a view to make loans to group companies in the course of its lending trade carried on by it and in the production of income in the form of interest to be earned from the loans to group companies. Apart from the lending trade, the taxpayer does not identify any other trade in its Rule 32 statement.

[7]. On 09 February 2022, the Tax Court (per Bam J, sitting with an Accounting Member and a Commercial Member) dismissed the taxpayer's appeal with costs and confirmed the assessment issued by SARS on 28 April 2015, thus rejecting the taxpayer's assertion that the interest expense of R68 133 602 was deductible in terms of s 24J(2) of the Income Tax Act.

[8]. It is that judgment and the order of the Tax Court which the taxpayer appeals against to this court. In issue in this appeal is whether the interest expenditure incurred by the taxpayer in its 2011 year of assessment 'must be deducted from the income of [the taxpayer]' in accordance with s 24J(2) of the Income Tax Act. Having regard to the aforesaid provision, the more crystallised question to be considered is whether the expense was incurred in the production of income derived from carrying on any trade. A further issue before this appeal court is whether an understatement penalty was correctly imposed by SARS.

[9]. I interpose here to mention that the main question to be considered by this court is the correctness of the partial disallowance by SARS of the amount of R68 134 000 claimed by the taxpayer as a deductible interest expenditure. The amount disallowed by SARS was R33 197 698, being the difference between the interest income earned by the taxpayer from its subsidiaries and

the interest expenditure incurred by it in its 2011 year of assessment. The taxpayer contends that the full amount of the interest expenditure of R68 134 000 incurred by it was deductible in terms of section 24J(2) of the Act.

[10]. It may be apposite, at this juncture, to cite s 24J(2) in full. It reads as follows: -

(2) Where any person is the issuer in relation to an instrument during any year of assessment, such person shall for the purposes of this Act be deemed to have incurred an amount of interest during such year of assessment, which is equal to –

- (a) the sum of all accrual amounts in relation to all accrual periods falling, whether in whole or in part, within such year of assessment in respect of such instrument; or
- (b) an amount determined in accordance with an alternative method in relation to such year of assessment in respect of such instrument,

which must be deducted from the income of that person derived from carrying on any trade, if that amount is incurred in the production of the income.'

[11]. The term 'trade', which is central to the dispute between the parties, is defined in section 1 of the Income Tax Act as follows: -

' "trade" includes every profession, trade, business, employment, calling, occupation or venture, including the letting of any property and the use or grant of permission to use any patent as defined in the Patents Act or any design as defined in the Designs Act or any trade mark as defined in the Trade Marks Act or any copyright as defined in the Copyright Act or any other property which is of a similar nature.'

[12]. It is also important to note that the 'trade' requirement of s 24J(2), in terms of which expenditure in the form of interest must be deducted, provides that expenditure in the form of interest must be deducted from the income of a person derived from carrying on any trade, if that amount of interest is incurred in the production of the income.

[13]. The foregoing issues are to be decided against the factual backdrop of the matter and the facts, the most notable of which relate to the type of trade that the taxpayer was involved in and whether the interest expenditure incurred during the 2011 tax year of assessment was incurred in the production of income whilst trading.

[14]. In this appeal, as in the Tax Court, it was argued by Mr Emslie SC, who appeared on behalf of the taxpayer, that, if interest is incurred in the production

of income (which is not limited to interest income), it can be deducted from the income derived from carrying on any trade, which is not limited to the trade of 'moneylending'. This, in my view, appears to be a trite enough principle, if regard is had to the provision of s 24J(2). The main thrust of the taxpayer's argument was that the interest was in fact incurred by it not in its trade as a 'moneylender', but more in its capacity as an investment holding company. In support of its case in that regard, much emphasis was placed by the taxpayer on SARS's averment in its Rule 31 statement (para 33) that 'the appellant conducts trade as an investment and holding company'.

[15]. The main difficulty with these contentions, according to SARS, was that it was at variance with the case pleaded by the taxpayer itself, not just in its rule 32 statement of appeal, but also in its grounds of objection to the additional assessment.

[16]. The term 'income' is defined in s 1 of the Income Tax Act as 'the amount remaining of the gross income of any person for any year or period of assessment after deducting therefrom any amounts exempt from normal tax'. Thus 'income' does not mean profit. It means gross income less exempt income, that is before any deductible expenses have been taken into account.

[17]. The taxpayer also sets much store by the findings of the Supreme Court of Appeal ('the SCA') in *Commissioner, South African Revenue Service v Tiger Oats Ltd*², as the facts of that matter, according to the taxpayer, bear a striking resemblance to the facts in this appeal. In that matter, the SCA pronounced authoritatively on the question whether a holding company advancing low interest and interest-free loans to its subsidiaries, in whose businesses it was intimately involved, was carrying on a business, which constitutes a 'trade' as defined for income tax purposes. These are precisely the activities carried on by it, so the taxpayer contends, which was also intimately involved in the businesses of its subsidiaries, to which it advanced low-interest and interest-free loans.

[18]. At para 27, the SCA in *Tiger Oats* makes the following observation: -

² *Commissioner, South African Revenue Service v Tiger Oats Ltd* [2003] ZASCA 43, 65 SATC 281;

[27] The loans made by the respondent are loans made to subsidiary and associated companies. No loans are made to anybody else. These loans are managed by Tiger Management Services. In making loans to subsidiaries and associates the respondent applies the following policies: All loans are funded by share capital and reserves and loans from subsidiary companies with surplus cash. ... Loans to subsidiaries are shareholders' loans which typically do not bear interest. Loans to associated companies are only made in proportion to shareholding and to loans made by outside shareholders. Where interest is charged, the rate of interest is invariably lower than the rate at which the subsidiary is able to borrow from outside sources. ... '.

[19]. And at para 28, the following is said:

[28] Loans to subsidiaries are intended to fund long-term working capital or capital expenditure requirements of subsidiaries with the purpose of facilitating the efficient deployment of the capital and reserves of the respondent. All loans are unsecured and no term for repayment is fixed.'

[20]. This scenario described by the SCA in the *Tiger Oats* case, so the taxpayer contends, is exactly the position *in casu* in relation to it. And this conclusion is to be deduced from SARS's allegation that the taxpayer is an investment holding company.

[21]. A further correlation between the facts in *Tiger Oats* and those in this matter is highlighted by the taxpayer as per para 36, of the judgment, which reads as follows: -

[36] Although the respondent has no employees and no fixed assets, it pays for the management services provided to its operating subsidiaries and associated companies by Tiger Management Services, a division of Tiger Food Industries Limited. That company is wholly owned by Tiger Foods Limited which is in turn wholly owned by the respondent. The wherewithal to pay those management fees is derived by the respondent from directors' fees paid to certain of its non-executive directors by subsidiary or associated companies of which those directors are also directors. It is the policy of the respondent that its non-executive directors who are also directors of its subsidiary or associated companies must account to the respondent for all directors' fees paid to them. Again this shows that the respondent is actively involved in the operations of the subsidiaries and associated companies and is not simply a passive investor in them, equatable with a member of the public who invests in listed shares on the stock exchange.'

[22]. The taxpayer accordingly argues that *Tiger Oats*, albeit decided in the context of liability for the now repealed regional establishment levy legislation, is

authority for the proposition that a holding company carrying on business as an investment holding company and making interest-free or low-interest loans to its subsidiaries in whose management it is intimately involved, is a company carrying on a business and therefore carrying on a 'trade', as defined, for income tax purposes. This being the case, so the argument on behalf of the taxpayer is concluded, the interest earned by it from its subsidiaries was income 'of that person derived from carrying on any trade' as contemplated in section 24J(2), and that the interest incurred by it was 'incurred in the production of the income', also as envisaged by s 24J(2).

[23]. Moreover, so the argument on behalf of the taxpayer continues, the turnover generated from its interest-earning and interest-incurring activities (as against moneylending business) in most years in fact translated into a profit, which support their contention that the interest expense in respect of the 2011 year of assessment can and should be deducted in terms of s 24J(2). Those figures, extracted from the annual financial statement of the taxpayer for the 2008 to 2017 financial years, reveal the following for each of the above financial years:

| YEAR | Source | Interest Income | Interest Paid | Profit / Loss |
|------|--------|-------------------|-------------------|--------------------------|
| 2008 | Bank | 375 000 | 99 000 | |
| | Group | 41 921 000 | 41 921 000 | 276 000 |
| 2009 | Bank | 1 072 000 | --- | |
| | Group | 17 335 000 | 44 978 000 | (26 571 000) Loss |
| 2010 | Bank | 342 000 | --- | |
| | Group | 25 591 000 | 33 710 000 | (7 777 000) Loss |
| 2011 | Bank | --- | --- | |
| | Group | 34 936 000 | 68 134 000 | (33 198 000) Loss |
| 2012 | Bank | 74 572 000 | 9 783 000 | |
| | Group | 87 700 000 | 122 722 000 | |
| | Other | 3 000 | 156 000 | 29 584 000 |
| 2013 | Bank | 79 787 000 | 27 182 000 | |
| | Group | 42 460 000 | 102 723 000 | |
| | Other | --- | 208 000 | (7 866 000) Loss |
| 2014 | Bank | 84 104 000 | 49 752 000 | |
| | Group | 86 206 000 | 120 330 000 | |
| | Other | 108 000 | 230 000 | 106 000 |
| 2015 | Bank | 69 832 000 | 48 192 000 | |

| | | | | |
|-------------|-------|------------|-------------|------------------|
| | Group | 90 386 000 | 110 145 000 | |
| | Other | --- | 300 000 | 6 483 000 |
| 2016 | Bank | 73 642 000 | 49 213 000 | |
| | Group | 74 182 000 | 91 828 000 | |
| | Other | --- | 300 000 | 6 483 000 |
| 2017 | Bank | 46 765 542 | | |
| | Group | 2 277 355 | 44 697 629 | 4 345 268 |

[24]. It can be seen from the above that although the taxpayer made a loss from its interest-earning and interest-incurring activities in the 2011 year of assessment, it made a profit from these activities in five of the succeeding six years. And, so the contention on behalf of the taxpayer continues, if the dividends earned by Unitrans are taken into account in addition to the interest earned by it in every year of assessment from 2008 to 2017, the taxpayer made a profit in each and every one of those years. The taxpayer furthermore submits that it is legitimate to take the dividends into account for this purpose because dividends are gross income, and it is legitimate to take gross income into account when determining profit and the existence of the purpose of making a profit.

[25]. In sum, the taxpayer's contention is that it should be recognised that the relevant trade is its trade as an investment and a holding company (as pleaded by SARS) and not that of 'moneylending' (as contemplated in the *Stone*³ and *Solaglass*⁴ cases).

[26]. The taxpayer's witness, Ms Smuts, gave evidence that, in all of its interest-earning and interest-incurring activities, involving both its subsidiaries and the Bank, the taxpayer borrowed, advanced and deposited funds with the purpose of making an overall profit. Mr Emslie submitted that from Ms Smuts' direct evidence of the taxpayer's purpose, when weighed and tested against the probabilities and the inferences normally to be drawn from the established and objective facts, it can and should be concluded that the taxpayer had the requisite profit-making purpose to be carrying on a trade from its interest-

³ *Stone v Secretary for Inland Revenue* 1974 (3) SA 584 (A);

⁴ *Solaglass Finance Company (Pty) Ltd v Commissioner for Inland Revenue* 1991 (2) SA 257 (A);

earning and interest-incurring activities, that being its trade as an investment and holding company. I do not agree with these submissions for the reasons alluded to later on in the judgment, notably the fact that the evidence, as a whole, do not support the taxpayer's case especially not as regards the 2011 tax year of assessment. It cannot be said with any conviction that during its 2011 year of assessment the taxpayer had the purpose of making profits in the medium term.

[27]. The point is simply that the evidence of Ms Smuts was to the effect that the taxpayer performed a treasury function for its group of companies. This function included the provision of loan funding as well as cash management. She testified that the taxpayer and its wholly owned subsidiaries had a cash management arrangement with Standard Bank, whereby the group's bank accounts were balanced to zero on a daily basis. She testified that information had to be provided to the Bank by 11 am each day as part of this cash management arrangement with the Bank. If the group's net position ended up in overdraft, the taxpayer would borrow funds from Standard Bank on a call loan and if the group was in a positive cash position, the taxpayer would pay back the call loan.

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

[29]. The question remaining is whether, having regard to the pleadings and the evidence, the taxpayer had discharged the burden of proving that it conducted trade as an investment and holding company and that in the course

of that trade it incurred expenditure in the form of interest in the production of income in the form of interest from its subsidiaries. Moreover, the further outstanding issue is whether in the production of that income, the taxpayer incurred the interest expenditure. I return to these issues hereinbelow.

[30]. Before that I need to deal briefly with the issue as to whether the taxpayer's pleaded case accords with the one argued on its behalf during the appeal in the Tax Court and in this appeal court. I do not accept the contention on behalf of SARS that the case relied upon by the taxpayer was not pleaded. The simple fact of the matter is that it was common cause between the parties on the pleadings that the taxpayer traded as an investment holding company. SARS pleaded as much in its rule 31 statement of grounds of assessment. The taxpayer was accordingly fully within its right to rely on that common cause fact as a basis for its case in terms of the provisions of s 24J(2) of the Income Tax Act.

[31]. What is more is that, as early as 2013 in correspondence between the taxpayer and SARS, the former advised the latter that the money lending business of the taxpayer, as well as its investment activities, fall within the Act's definition of 'trade' as envisaged by the Income Tax Act. In one such communiqué, the taxpayer advised SARS as follows: -

'We have shown the [taxpayer] to be carrying on a trade, being investment in shares and advancing of funds to group companies (money lending), ...'.

[32]. I therefore conclude that there is no merit in the contention by SARS that the case relied upon by the taxpayer was not properly pleaded by it. The court *a quo*, in holding otherwise, misdirected itself. Its emphasis on the fact that the taxpayer was not carrying on a trade as a 'money lender' obfuscated the requirement in the said section that the interest expenditure should be allowed as a deduction if it derives income from 'any trade' and the interest expenditure is incurred in the production of such income. The court *a quo*'s reliance on *Solaglass* was misguided. It is so, as contended by the taxpayer, that the court *a quo* erred by failing to appreciate that the term 'moneylending' has a specialised meaning which is relevant only where a taxpayer seeks to deduct a loss arising from a loan from becoming irrecoverable, in which case only a

'moneylender' or bank can treat such a loss as being not of a capital nature. *In casu*, there was no capital versus revenue dispute, but rather the deductibility of expenditure in the form of interest.

[33]. I return to the issue whether the taxpayer has discharged the onus on it to prove that it has met the requirements of s 24J(2).

[34]. In its judgment, the court *a quo* looked at the nature of the activities conducted by the taxpayer, the correspondence between the parties and the evidence before it.

[35]. On the basis of the authority in *Solaglass*, the court *a quo* held that the taxpayer had not proven that it carried on the trade of a moneylender and concluded that s 24J(2) is not implicated. As already indicated, this conclusion was reached on the basis that the case pleaded by the taxpayer was that its trade was that of a moneylender. That finding I have found to have been a misdirection. The simple point is that the fact that the taxpayer was not a moneylender, as defined by the authorities, does not necessarily mean that it was not conducting a trade as envisaged by the said section. That is a separate issue which is required to be considered and decided on the basis of the facts in the matter, to which I now turn. In that regard, the question must surely be whether the deductions claimed arose from the taxpayer's business to make a profit from the money-lending activity, as well as from the business of providing a benefit to the Group.

[36]. It is the case of the taxpayer that it conducted two related ventures. First, it carried on an investment business aimed predominantly at reaping dividends from a number of its subsidiaries engaged, by and large, in the logistics trade. Not all of the subsidiaries' ventures were equally profitable. All of them participated, however, in competitive markets, and it was always an objective of the taxpayer to protect, nurture and build its investments in its intergroup subsidiaries. The taxpayer also conducted a second venture: it borrowed funds with a view to on-lending such funds to the entities wherein its investments resided. The interest rate charged on such loans advanced to its subsidiaries ranged from 0% to about 8% and was always lower than the rate of interest at

which the taxpayer borrowed the monies from its related companies in the Group.

[37]. The question therefore is what was the 'trade which produced income' conducted by the taxpayer and how does it entitle the taxpayer to claim interest in terms of section 24J(2). In that regard, the court *a quo* correctly noted that the taxpayer no longer wished to rely on its argument that it is a moneylender.

[38]. Insofar as the taxpayer alleges that it conducted an investment trade, it is clear from the financial statement, as was submitted on behalf of SARS, that the taxpayer earned unproductive interest. Therefore, even if such investment business is considered to be a trade, it yielded unproductive interest and it cannot be allowed a deduction. The point is simply that, to the extent that the taxpayer argues that it performed a treasury function on behalf of the group companies, such a contention is not supported by the facts and evidence before this court and the court *a quo*. The evidence before the court *a quo* was that between 2007 and 2011, the taxpayer did not perform any administrative, financial or secretarial services to group companies. The financial statements of the taxpayer confirm the foregoing.

[39]. Moreover, no evidence was placed before the court *a quo* that, during the relevant period, being the 2011 tax year of assessment, the taxpayer was involved intimately in the management of its subsidiaries. The only evidence before the court *a quo* was that it invested in its subsidiaries so that it can enhance their performance and in turn reap the benefits in the form of dividends.

[40]. In sum, SARS was correct in its findings that insofar as the taxpayer conducted an investment trade, such investment trade yielded exempt income, and as such, it would not be entitled to deduct interest in terms of section 24J(2). Moreover, the loan in investment activities produced unproductive interest and exempt income in the form of dividends. Also, on its own version, the taxpayer did not, in 2011, conduct any trade which provided financial and secretarial services to its subsidiaries. Ms Smuts conceded under cross-examination that in 2011, the taxpayer did not provide these services.

[41]. It was furthermore submitted by Ms Magano, Counsel for SARS, that the carrying on of a trade involves an 'active step', which means that something more is required than a mere watching over existing investments that are not income-producing and are not intended or expected to be so.

[42]. In *Solaglass*, unlike the case *in casu*, the evidence suggested that the promotion of the Group interests was an integral part of the very activities carried on by the taxpayer. It borrowed money from subsidiaries in the Group whenever they have a surplus available, irrespective of the needs of the taxpayer at that time. It loaned money to subsidiaries at a reduced rate of interest whenever the interests of the subsidiaries concerned required that to be done, irrespective of the attendant disadvantage to the taxpayer. In short, the trading activities of the taxpayer in that case were governed by policy considerations dictated by the interests of the Group. No such evidence was tendered *in casu*.

[43]. In deciding whether the taxpayer is carrying on a trade, courts have held that it is a question of fact. Those facts were not placed before SARS or before the court *a quo*. The court *a quo* was correct in finding that even if the taxpayer was trading as an investment company, that fact on its own did not suffice. The taxpayer still bore the onus to prove its entitlement to the interest deduction, which it failed to discharge. The court *a quo* was correct in finding that the taxpayer did not incur the expense in the production of income.

[44]. For interest to be deductible in terms of section 24J of the Income Tax Act, it must also be incurred in the production of income. Income is produced by a performance of a series of acts attendant upon them as expenses, provided that they are so closely linked to such acts as to be regarded as part of the cost of performing them⁵. The most important factor in that inquiry is the purpose of borrowing money. If the purpose is to apply the funding to produce taxable income, the interest expenditure incurred should be deductible. However, if the purpose is not to produce taxable income, then the interest expenditure is not deductible.

⁵ The *Tiger Oats* case referred to *supra*;

[45]. It is trite that the purpose of the expenditure concerned and the closeness of its connection with the relevant income-earning operations are the important factors to be considered in the enquiry relating to the tax deductibility of such an expense. As a general rule, in deciding whether amounts of money outlaid by a taxpayer constitute expenditure incurred in the production of the income (in terms of the general deduction formula), important and sometimes overriding factors are the purpose of the expenditure and what the expenditure effects. And in that regard, the closeness of the connection between the expenditure and the income-earning operations must be assessed. This is the test to be applied to the provisions of s 24J of the Income Tax Act.

[46]. Moreover, in determining whether interest (or other like expenditure) incurred by a taxpayer in respect of sums of money borrowed for use in his business is deductible in terms of the general deduction formula and its negative counterparts in the Act, a distinction may in certain instances be drawn between the case where a taxpayer borrows a specific sum of money and applies it to an identifiable purpose and the case where the money is borrowed to raise floating capital for use in the taxpayer's business.

[47]. In the former type of case, both the purpose of the expenditure (in the form of interest) and its effects can readily be determined and identified: a clear and close causal connection can be traced. Both these factors are, therefore, important considerations in determining the deductibility of the expenditure. In the latter type of case, however, certain factors prevent identifying such a causal connection, and one cannot say that the expenditure was incurred to achieve a particular effect. All that one can say is that, in a general sense, the expenditure is incurred to provide the institution with the capital with which to run its business, but it is not possible to link particular expenditure with the various ways in which the capital is in turn utilised.

[48]. As regards the requirement that the purpose of the act, to which the expenditure is attached, must be to produce income, it has been held by our Courts that 'provided the act is *bona fide* done to carry on the trade which earns the income, the expenditure attendant on it is deductible'. Further, with regard to

the second requirement, that the expenditure should be linked closely enough to this act, it is trite that all expenses attached to the performance of a business operation *bona fide* performed to earn income are deductible whether such expenses are necessary for its performance or attached to it by chance or are *bona fide* incurred for the more efficient performance of such operation provided they are so closely connected with it that they may be regarded as part of the cost of performing it.

[49]. From the foregoing, it is evident that one must determine whether the interest expense incurred will qualify for a deduction considering: (a) the purpose of the loan and (b) whether the expenditure is linked closely enough to the production of income.

[50]. On the question of 'purpose' the following was said in the case of *CIR v Standard Bank of SA Ltd*:

'Generally, in deciding whether moneys outlaid by a taxpayer constitute expenditure incurred in the production of the income (in terms of the general deduction formula) important and sometimes overriding factors are the purpose of the expenditure and the income-earning operations must be assessed.'

[51]. The question in the *Standard Bank* case was whether the bank could deduct interest on money deposited by its customers if it used the money to earn tax-free dividends on preference shares. The court said that as all the money from depositors went into a general pool, it could not be said for which specific purpose the money was borrowed, so one had to look at the general purpose of the bank, which was to borrow money at one interest rate and on-lend it at a higher interest rate, the general purpose being to produce income.

[52]. In *Producer v Commissioner of Taxes*⁶, the taxpayer company lent money to a subsidiary in respect of which it charged interest and then converted part of the loan to the subsidiary into equity. Its claim on the loan account against the subsidiary was set off against the shares issued to the subsidiary. Thus, when the money was borrowed by the taxpayer company, the purpose was certainly to produce income. At some stage the money was used to

⁶ *Producer v Commissioner of Taxes* 1948 (4) SA 230 (SR);

produce dividends, the Commissioner disallowed the part that was used to subscribe for equity. The court held as follows: -

'It is clear that if a taxpayer borrows a specific sum of money and applies that sum to a purpose unproductive of income, and not directly connected with the income earning part of his business, then the interest paid on the borrowed money cannot be deducted as expenditure incurred in the production of income.'

[53]. The court in *Producer* drew a distinction between borrowing money for a specific purpose and borrowing money in order to fund general business operation. The court emphasised the fact that interest will not be deductible if a specific sum of money is borrowed, and that amount is used for a purpose unproductive of income and not directly connected with the income earning business operation of the taxpayer.

[54]. Applying the above principles *in casu*, it cannot be said with any conviction that the interest expenditure was incurred in the production of income whilst the taxpayer was conducting its trade as an investment holding company. Moreover, an in-depth examination and a proper interpretation of the 2007 to 2011 annual financial statements of the taxpayer reveal that the loan from Steinhoff was used to acquire a subsidiary from one of the Group companies. The loan of R4 414 257 000 during the 2007 financial year equates exactly to the cost of acquiring during that year 'the business of Unitrans Limited' – this is as per note 15.5 to the annual financial statements for that year. This then means that there is an element of unproductive interest which is not deductible in terms of the Income Tax Act.

[55]. What is more is that Ms Smuts conceded that the purpose of borrowing money from group companies was to on lent to group companies where group companies require assistance to salvage their business. It was conceded that the purpose of the loan was to benefit the group companies. The intention was not for the taxpayer to earn an income but to help the group companies to increase their earning capacity. Hence it charged interest that was less than the interest paid on borrowed funds from Steinhoff. The simple point being that the purpose of the loan was not to finance the income producing operations of the taxpayer but to benefit the group companies. The Supreme Court of Appeal in

*The Commissioner for the South African Revenue Service v Spur Group (Pty) Ltd 2021*⁷ held as follows: -

[37] In *Solaglass Finance Co (Pty) Ltd v Commissioner for Inland Revenue*, this Court made it clear that the deduction of expenditure in relation to monies spent for the purposes of advancing the interests of the group of companies to which the taxpayer belongs, is precluded.

[38] Applying *PE Tramway*, I find that the purpose of Spur in incurring the expenditure was not to produce income, as required by s 11(a) of the ITA, but to provide funding for the scheme, for the ultimate benefit of Spur HoldCo. There was only an indirect and insufficient link between the expenditure and any benefit arising from the incentivisation of the participants. The contribution was therefore not sufficiently closely connected to the business operations of Spur such that it would be proper, natural and reasonable to regard the expense as part of Spur's costs in performing such operations.'

[56]. In its evidence in this matter, the taxpayer did not lead any evidence as to why it considers the expense claimed to be in the production of income. It also did not challenge SARS' evidence that the expense was not incurred in the production of income. Based on the above principles, it is clear that the taxpayer does not meet the requirements of section 24J(2) of the Income Tax Act and is not entitled to the interest deduction claimed. In addition to the above, it has declared in its tax returns that it did not enter into any transactions as contemplated in section 24J of the Income Tax Act.

[57]. On the evidence before the court *a quo*, it can safely be concluded that the nature of the transaction was that the taxpayer borrowed funds to enable its group companies to improve their future financial income-earning capabilities by not charging interest. This, therefore, means that the intention was never to earn any income. The taxpayer was not pursuing its self-interest but was subjugating its profitmaking potential to the interests of the group companies.

[58]. It is, as contended by SARS, that the taxpayer structured its affairs so that it would never earn any income, and, in the process, it would not make any profit. This is supported by what it states in the letter of appeal that it was never its intention to borrow money at a higher rate than it charged. It intended to provide cheaper funding to group companies than what they could procure in the market. Not only did it not have any intention to earn income, it structured its

⁷ *The Commissioner for the South African Revenue Service v Spur Group (Pty) Ltd 2021 JDR 2530 (SCA)*;

affairs so that it would never earn any income but would pay expenses incurred on benefits reaped by group companies.

[59]. The above two requirements for the deduction of the interest expenditure to be allowed as a tax deduction were therefore not met. And SARS was correct in disallowing the interest expenditure as a deduction in terms of s 24J(2).

[60]. I now proceed to briefly deal with the imposition by SARS of the understatement penalties, which was upheld by the court *a quo*. Having exercised its own original discretion, the court *a quo* confirmed that SARS correctly imposed the understatement penalty of 10%.

[61]. On this issue the case of the taxpayer is simply that, in the event of the court finding that the interest was deductible, there was not an understatement in that its claim for a deduction of the interest was as a result of a *bona fide* inadvertent error. In that regard, the taxpayer places reliance on section 222(1) of the Tax Administration Act⁸, which reads as follows: -

‘222 Understatement penalty

- (1) In the event of an “understatement” by a taxpayer, the taxpayer must pay, in addition to the “tax” payable for the relevant tax period, the understatement penalty determined under subsection (2) unless the “understatement” results from a *bona fide* inadvertent error.
- (2)’.

[62]. The taxpayer contends that it was for SARS to satisfy itself that the understatement did not result from such an error, this being a jurisdictional fact for SARS to overcome prior to imposing any understatement penalty. SARS, according to the taxpayer, did not even plead that the understatement was not due to an inadvertent *bona fide* error.

[63]. In my view, the taxpayer did not demonstrate a basis to justify the appeal court’s interference with the court *a quo*’s decision to impose understatement penalties. The court *a quo*, in dealing with the understatement penalty, was called upon to exercise its own original discretion. The discretion exercised by the court *a quo* in imposing this understatement penalty is a discretion in the true sense of the word and therefore, it would ordinarily be inappropriate for this

⁸ Tax Administration Act, Act 28 of 2011;

court to interfere unless it is satisfied that the discretion was not exercised judicially, or that it had been influenced by wrong principle or a misdirection on the facts or that it had reached a decision which could not have been made by a court properly.

[64]. As required in terms of section 102 of the Tax Administration Act, SARS proved the facts on which the understatement penalty was imposed. It is clear from the evidence that was led before the court *a quo* that there was substantial understatement which caused prejudice to the fiscus as defined in section 221 of the Tax Administration Act.

[65]. It is so, as submitted by SARS, that the taxpayer did not commit a mistake in claiming the interest deduction. Throughout its correspondence and in the proceedings before the court *a quo*, it maintained its tax position that it is entitled to claim the deduction. If this was an error, it could and should have corrected it at the inception of the audit or when the tax dispute commenced.

[66]. The taxpayer did not lead any evidence to show that the understatement was caused by an inadvertent *bona fide* error on its part. The court *a quo* was correct in finding that the taxpayer did not show that the understatement was caused by an inadvertent error. In my view, therefore, the court *a quo* did not err when it concluded that the understatement penalty had been appropriately imposed. The court *a quo* exercised its discretion judicially and there was no material misdirection on its part, and it was not influenced by a wrong principle. Therefore, this ground of appeal falls to be dismissed.

[67]. For all of these reasons, the appeal to the Full Bench should fail.

[68]. As for costs, same should be awarded to SARS for the simple reason that the taxpayer's grounds of objection to the additional assessment were unreasonable. In my view, the taxpayer, in objecting to the additional assessment for the 2011 tax year, acted unreasonably.

Order

[69]. Accordingly, the following order is made: -

- (1) The appeal of the taxpayer against the order of the Tax Court dated 09 February 2022 is dismissed with costs.

L R ADAMS
*Judge of the High Court,
Gauteng Division, Johannesburg*

HEARD ON: 15th August 2023

JUDGMENT DATE: 09th January 2024

FOR THE APPELLANT Advocate Trevor Emslie SC

INSTRUCTED BY: Werksmans, Cape Town

FOR THE RESPONDENT: Advocate K D Magano

INSTRUCTED BY: The State Attorney, Pretoria
