

SOUTH AFRICA / JUDGMENT

Mr X v Commissioner for the South African Revenue Service (13791; 13792) [2016] ZATC 15 (13 December 2016)

[2016] ZATC 15

COURT

Tax Court

DECIDED

13 December 2016

BEFORE

Yekiso

CASE / FILE NUMBER

13791; 13792

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IN THE TAX COURT OF SOUTH
AFRICA
(CAPE TOWN)
CASE NO: 13791
13792

In the matter between: MR X
Appellant
And
THE COMMISSIONER
FOR THE SOUTH AFRICAN REVENUE SERVICE
Respondent

Coram: Yekiso J

Hearing Dates: 2 and 3 June 2016

Judgment Date: 13 December 2016

JUDGMENT

YEKISO, J

- [1] Mr X (“the appellant”) is a qualified solicitor in England and Wales, currently in the employ of Y Attorneys, an incorporated firm of attorneys carrying on practice as such in Sandton, Johannesburg with offices in Cape Town, Durban etc. He is not a qualified attorney in South Africa and thus not eligible to the position of an equity director, that position only being open to persons who have been admitted as attorneys in South Africa. Although not eligible

to the position of an equity director, he enjoys the same remuneration package as an equity director. Being in this position, he is obliged to assist with the on-going working capital requirements of his employer through maintenance of a credit balance on his loan account for which his employer pays interest on the loan at prime.

- [2] The loan account referred to in the preceding paragraph arises from the contract of employment concluded between the appellant and his employer on 12 June 2004. In terms thereof the appellant is obliged to contribute a predetermined amount to the director's loan account deductible from his gross remuneration. The amount required to be retained in the loan account would be deducted proportionately from the appellant's monthly remuneration until the predetermined amount is reached. The source of funds contributed to the director's loan account thus derives from the appellant's gross remuneration. The source of funds contributed to the loan account thus derive from the appellant's accrued income. Occasionally, when there are sufficient funds available, the finance director would recommend occasional distributions, in the form of interest, to the holder of the loan account. Interest accrues on the balance of the director's loan account at the rate of prime, such interest constituting taxable income in the hands of the appellant. In terms of the agreement, the appellant is not entitled to withdraw the outstanding balance of the director's loan at any point in time unless he resigns.
- [3] During 2005 the appellant purchased a property in Constantia, secured by a mortgage bond from Z Bank. The property was acquired for purposes of the appellant's own occupation. The nature of the home loan with Z Bank was ultimately converted to a so-called access bond which, in effect, is a facility to access available funds in the home loan account and, as a consequence of funds in the facility being accessible to the appellant, rendered the account being capable of fluctuating between a zero amount to the maximum amount for which the facility is granted. Through this facility, the appellant could repay the portion of the capital borrowed and simultaneously draw on the facility to fund any of his expenses. From time to time the appellant had paid in and drawn on this facility to fund a variety of his expenses. The amount outstanding on the mortgage loans was, at all times, greater than the amount outstanding on the loan account. The balance outstanding in the home loan account attracts interest at prime less 1,85% per annum.
- [4] In his income tax returns for the 2010, 2011 and 2012 years of assessment the appellant claimed, as deductions, amounts in respect of interest incurred on the mortgage loans on the basis that such interest was incurred in the production of interest income. The appellant contends this is so because the interest incurred on his loan account does not exceed interest income derived on his loan account with his employer. The appellant thus contends and makes a point in his submissions that the interest incurred on his mortgage loan account is sufficiently close to interest income earned on his loan account to justify a conclusion that the interest expenditure incurred on his mortgage loan account was incurred in the production of interest income. This, so the appellant contends, is because each portion of interest income levied on the loan account and distributed to the appellant

was applied to

repay the mortgage loan. Finally, the appellant contends that the retention by his employer of the amounts owing under the loan account had, as a direct consequence, the appellant being unable to repay an equivalent amount on the mortgage loan account resulting in him having to pay on the mortgage loan account a larger interest than he otherwise would have had to pay had the amount in credit on his loan account been available to him. This approach, so the appellant contends, is consistent with Practice Note 31, which deals with the practice of the Commissioner of permitting the deduction of the interest incurred on monies borrowed in the production of interest income and limiting the interest expenditure to the amount of the interest income earned. The question which immediately arise, and which will have to be determined later in this judgment, is whether the amount in credit in the appellant's loan account constitutes monies borrowed on the basis of which the expenditure incurred, in the form of interest paid on the home loan account, to justify a conclusion that the interest so paid could be said to have been expended to earn interest income.

- [5] Interest earned on the balance of the loan account payable by the employer, was paid into the appellant's home loan facility. In respect of the 2010, 2011 and 2012 years of assessment the appellant claimed, as a deduction from his interest income, various amounts, being portions of interest paid to Z in the relevant years of assessment, such portions having been determined by limiting the deduction claimed to the value of interest earned on the loan account. The deduction claimed for the 2010 year of assessment

was in an amount of R131,160-51; for the year 2011 of assessment, the amount claimed having been R117,750-00; and for the 2012 year of assessment, the deduction claimed having been in an amount of R134,298-00.

- [6] The respondent disallowed the interest deductions claimed. The appellant, in turn, objected to the disallowances. The respondent also disallowed the objections on the basis that Practice Note 31, on which the appellant relies for the proposed deductions, requires that the funds, on the basis of which interest is paid and the deduction are claimed, should be borrowed and be advanced to a third party from whom interest income earned is derived; that the interest on the basis of which the deduction is claimed must be expended in the production of interest income; that in the instance of this matter no funds were borrowed for the purposes of advancing a loan capital to the employer to constitute a basis on which income interest could be levied; that the appellant's employer did not require the appellant to advance funds to it to utilise as capital, so that, in view thereof, there was no flow of funds from the appellant to the employer on the basis of which interest income could be levied; that the funds constituting the balance on the loan account were not sourced from Z Bank; and that in order for the interest incurred to be in the production of interest income from the employer, the appellant would have had to borrow such funds and advance them to his employer as a loan on which interest earned could be calculated.

- [7] It thus turns out that the dispute between the parties is whether or not the appellant is entitled to deduct from the income interest earned on the loan account a portion of interest expended on the mortgage loan account for each of his 2010, 2011 and 2012 years of assessment. In the light of the provisions of Practice Note 31, and the reasons given for the disallowance of the objection, the significant dispute appears to be whether a portion of the interest paid on the mortgage loan account constitutes an expense incurred in the production of interest income earned on the loan account with the appellant's employer. Whilst the appellant contends that the interest paid on the mortgage loan account constitutes an expenditure in the production of interest earned from the loan account, the respondent, on the other hand, contends that such expenditure was not incurred in the production of interest earned from the employer thus placing an onus on the appellant to prove that the expenditure so incurred is sufficiently close to interest income earned to justify a conclusion that such expenditure was incurred in the production of interest income.
- [8] The appellant was the only witness called to testify in the appellant's case. His evidence was based on the documents contained in the bundle of documents handed in entitled "Taxpayer's Bundle of Documents". Facts emanating from this bundle appear to be common cause and these relate to how the appellant's remuneration from his employer was structured; how the loan account with his employer is structured; how the loan account grew from R173,728-20 in 2004 to an amount of R917,261-39 in 2010; and the extent to which the loan account would fluctuate depending on the amount paid out of it in the form of distribution and the extent to which distributions to the loan account holders would serve to reduce the amount outstanding to his credit in the loan account.
- [9] The appellant further testified that the mortgage loan account with Z Bank was taken in 2005; that the purpose the loan was taken was to finance the purchase of his residence; that in the course of time the loan was restructured to constitute two separate loans but both related to the same property and are both secured on the same property. The appellant described these loan accounts as loan 002 and loan 005. These two loan accounts were later consolidated to constitute loan 011. The appellant claimed, as deductions, portions of interest paid on these loan accounts on the basis that the interest so incurred was in the production of interest income. The interest income derived from his loan account was paid into this account by his employer.
- [10] During the years of assessment under review the appellant had repaid certain amounts into the home loan and, on several occasions, withdrew funds from the home loan account for his personal use and to fund his private expenses. Based on the appellant's evidence, both oral evidence and documentary evidence tendered, it appears to me that what I need to determine in this appeal is whether interest expended by the appellant on his home loan account constitutes expenditure in the production of income, in the form of interest income, on the appellant's loan account with his employer.

RELEVANT STATUTORY PROVISIONS

- [11] In considering whether the interest paid on the appellant's mortgage loan account constitutes an expenditure in the production of interest income, it is necessary to deal with the provisions of section 11(a) of the Income Tax Act, No 58 of 1962 ("Income Tax Act") which provides as follows:

"For the purpose of determining the taxable income derived by any person from carrying on any trade, there shall be allowed as deductions from the income of such person so derived –

- (a) Expenditure and losses actually incurred in the production of the income provided such expenditure and losses are not of a capital nature;"

Thus, a taxpayer will be permitted to deduct expenses from its gross income provided that such expenses are actually incurred in the production of income.

- [12] There is, however, an exception in relation to the "trade" aspect as required by section 11(a) of the Income Tax Act. Practice Note 31 deals with the practice of the commissioner of permitting the deduction of the interest incurred on monies borrowed in the production of interest income and limiting the interest expenditure to the amount of the interest income earned. Practice Note: No 31 – 3 October 1994 Income Tax: Interest paid on monies borrowed, provides as follows:

"1. To qualify as a deduction in terms of section 11(a) of the Income Tax Act (the Act), expenditure must be incurred in the carrying on of any 'trade' as defined in section 1 of the Act. In determining whether a person is carrying on a trade, the Commissioner must have regard to, inter alia, the intention of the person. Should a person, therefore, borrow money at a certain rate of interest with the specific purpose of making a profit by lending it out at a rate of interest, it may well be that the person has entered into a 'venture' and is thus carrying on a trade (50 SATC 40). In other words, interest paid on funds borrowed for purposes of lending them out at a higher rate of interest will, in terms of section 11(a) of the Act, constitute a admissible deduction from the interest so received by virtue of the fact that this activity constitutes a profit-making venture.

2. While it is evident that a person (not being a moneylender) earning interest on capital or surplus funds invested does not carry on a trade and that any expenditure incurred in the production of such interest cannot be allowed as a deduction, it is nevertheless the practice of Inland Revenue to allow expenditure incurred in the production of the interest to the extent that it does not exceed such income. This practice will also be applied in cases where funds are borrowed at a certain rate of interest and invested at a lower rate. Although, strictly in terms of the law, there is no justification for the deduction, this practice has developed over the years and will be followed by Inland Revenue."

- [13] It would appear that, in contending that the interest expenditure incurred on his mortgage loan account is expenditure incurred in the production of interest income, the appellant relies on paragraph 2 of Practice Note 31, the reliance being based thereon that the appellant earns interest income, but not on capital or funds invested, but on funds which have accrued

to him as income and retained by his employer in terms of the conditions contained in his contract of employment. But the funds, on the basis of which the appellant earns interest income, would never have been available to the appellant for purposes of reducing the balance outstanding on his mortgage loan during his term of employment. The appellant concluded a contract of employment with his employer well-knowing that the funds retained on his loan account would not be available during his term of employment, but would only be available to the appellant on termination of the employment relationship, be it on resignation or any other form of termination of an employer-employee relationship.

- [14] When the appellant acquired a mortgage bond to finance the purchase of his residence, he knew that the amount in credit on his loan account with his employer was structured in such a way that it never would have been available to him to reduce the balance outstanding on his mortgage loan account during his term of employment; that interest expenditure incurred on the mortgage loan account would be incurred independently of his loan account and interest income derived on his loan account; and, this being so, it can thus never be said that interest expenditure incurred on his mortgage loan account was incurred in the production of interest income on the appellant's loan account. Interest earned on capital or surplus funds invested, as contemplated in paragraph 2 of Practice Note 31, in my view, contemplates interest earned on capital or surplus funds which would have accrued to the investor but, once such capital or surplus funds are received, the investor, of his own volition, invests such capital or surplus funds on interest and, any interest incurred as a consequence of investment of such capital or surplus funds, is incurred in the production of interest income from the capital or surplus funds so invested. In the instance of this matter, interest income earned by the appellant on his loan account is not interest income on capital or surplus funds invested, but simply interest income earned on his loan account on funds retained by the appellant's employer in terms of the contract of employment.
- [15] But the appellant's objection to his assessment was disallowed on completely separate grounds and these appear to be mainly based on paragraph 1 of Practice Note 31. The appellant, in his notice of objection in respect of the 2010, 2011 and 2012 years of assessment, provides opening and closing balances on his loan account in respect of each year of assessment. The closing balance, in each instance, is invariably larger than the opening balance. The appellant construes the closing balance in the loan account in respect of each year of assessment as an amount he is required to advance to his employer. In advancing the contention that the interest paid on the mortgage loan account constitutes an expenditure in the production of interest income, the appellant states in his evidence that if his employer was not required to retain the closing balance on his loan account in respect of each year of assessment, such closing balances would have been available to him to reduce his mortgage loan account so that, because of the unavailability to him of such closing balances, interest paid on the mortgage loan account constitutes an expenditure in the production of income in the form of interest income on his loan account.

- [16] In disallowing the objection in respect of each year of assessment, the respondent contends that the requirements of Practice Note 31 are that for interest incurred to constitute an expenditure in the production of income, the funds, on the basis of which such interest is incurred, in the first instance, have to be borrowed and, in the second instance, have to be lent and advanced to a third party who ultimately would be liable to pay interest in respect of the funds so lent and advanced. In the instance of this matter, so it is contended on behalf of the respondent, the appellant did not have to borrow funds to advance to his employer as a loan. The funds due to the appellant by the employer are part of an income which has accrued to the appellant but retained by the employer in terms of the contract of employment. The respondent concludes its submissions by contending that the funds on the basis of which the interest income was calculated were not funds borrowed by the appellant and advanced to his employer as a loan so that, in view thereof, interest incurred on his mortgage loan account cannot be said to be interest incurred in the production of interest income as contemplated in Practice Note 31.
- [17] Commissioner of Inland Revenue v Smith
- [1998] JOL 1778 (N) is authority for the proposition that the determination as to whether or not the expenditure incurred (in instances of this matter interest expenditure incurred) qualifies as an allowable deduction depends on the question as to whether there is a sufficiently close link between the expenditure and the income earning operations, having regard both to the purpose of the expenditure and what it actually effects.
- [18] As has already been pointed out in paragraph [11] of this judgment, for expenditure to qualify as an allowable deduction from the taxpayer's taxable income, such expenditure should have been incurred in the production of income. In as far as an exception to "trade" contemplated in Practice Note 31 is concerned, the expenditure, in the form of interest incurred, should be incurred in the production of interest income.
- [19] That expenditure, to qualify as an allowable deduction, should be incurred in the production of income, has been confirmed in several authorities. In P E Electric Tramway Company Limited v CIR 1936 CPD 241, the court held that in the determination of the question as to whether an expenditure has been incurred in the production of income, the test that has to be applied involves a determination whether the expenditure is so closely related to the trade that it can be said that it is part of the costs of running the business.
- [20] In CIR v Genn & Company (Pty) Ltd 1955 (3) SA 293 (A) Schreiner JA made the following observation at p299:
- "In deciding how the expenditure should properly be regarded the court clearly has to assess the closeness of the connection between the expenditure and the income earning operations, having regard both to the purpose of the expenditure and to what it actually effects."*

- [21] Mr A, who appeared for the appellant, in contending that the interest incurred by the appellant on his mortgage loan account constitutes an expenditure in the production of interest income earned on the appellant's loan account with his employer, relies heavily on the authority of *Commissioner for Inland Revenue v Standard Bank of South Africa Ltd* 1985
- (4) SA 485 (A). The dispute in that matter, gleaned from the headnote of the authority, was the Commissioner's contention (which was rejected by the special court) that since the amounts received by the respondent bank by way of dividends on the redeemable preference shares were exempt from taxation, a proportionate amount of the interest paid to depositors on deposit monies, not being productive of "income" as defined in section 1 of the Income Tax Act, should, in terms of section 23(f) of the Income Tax Act be excluded from deductions as expenditure in the production of income as contemplated in section 11(a) of the Income Tax Act. In the determination of that question the then Appellate Division, per Corbett JA, held that the vital enquiry to be determined was as to the bank's purpose in borrowing the monies on which it paid interest to the depositor; and in regards thereto it had to be asked whether the connection between the expenditure of interest (or some of it) and the acquisition of the redeemable preference shares was sufficiently close to justify the conclusion that such expenditure was in each year of assessment incurred in the production of the dividends derived from the shares and, in the instance of that matter, the production of exempt income since dividend income is exempt income in terms of section 10(1)(k) of the Income Tax Act.
- [22] Corbett JA, in *Commissioner for Inland Revenue v Standard Bank of South Africa*, supra, made the following observation at pp 500-501H-B in confirmation of the approach adopted in *Commissioner for Inland Revenue v Genn & Company (Pty) Ltd*, supra, made the following observation:
- "(1) Generally, in deciding whether monies outlaid by a taxpayer constitute expenditure in the production of income (in terms of the general deduction formula) important and sometimes overriding factors are the purpose of the expenditure and what expenditure actually effects; and in this regard the closeness of the connection between the expenditure and the income-earning operations must be assessed.*
- (2) More specifically, in determining whether interest (or other like expenditure) incurred by a taxpayer in respect of monies borrowed for the 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 have to be drawn between the case where a taxpayer borrows a specific sum of money and applies it to identifiable purpose, and the case where, as in the instance of the Society in the *Allied Building Society* case and the Bank in the present case, the taxpayer borrows money generally and upon a large scale in order to raise floating capital for use in his (or its) business."

- [23] Although the court in *Commissioner for Inland Revenue v Standard Bank*, supra, dismissed the appeal and found in favour of the taxpayer, the facts are clearly distinguishable from the facts of this case. The facts of the matter before me fall within the first distinction referred by Corbett J, namely, an instance where a taxpayer borrows a specific sum of money and applies it to an identifiable purpose.
- [24] In the instance of the matter before me the taxpayer acquired a home loan from Z Bank for purposes of purchasing his residence. The proceeds of the loan were utilised for the payment of the purchase price. That was the appellant's intention in acquiring the loan from Z and there is no indication on the record of evidence of a change of intention or, if his initial intention had changed at some point, at what point was there a change of intention. It therefore follows, in my view, that whatever interest the appellant paid on mortgage loan account, was interest incurred in the acquisition of a capital asset and, as such, the expenditure thus incurred was expenditure of a capital nature as it was not borrowed for the purpose of earning interest income, nor does it have the effect of earning interest income.
- [25] In my view, the appellant has failed to prove, as a matter of fact, that the purpose and the effect of the acquisition of a mortgage loan from Z Bank were for purposes of production of interest income. The interest incurred on the mortgage loan account with Z Bank is not sufficiently close to the interest income earned on the loan account to justify a conclusion that the interest so incurred was incurred in the production of interest income. The appellant has thus failed to discharge the onus on him. There is no sufficiently close connection between the interest paid to the Z loan account and the interest income received on his loan account in respect of the 2010, 2011 and 2012 years of assessment.
- [26] At this stage of this judgment I must record that the conclusion I arrived at, as set out in the preceding paragraph, is not unanimous. Whilst the commercial member, agrees with my conclusion and the reasons therefore, the accountant member, is not of the same view. He is of the view that there is a sufficiently close connection between the interest incurred in respect of the mortgage loan account and the interest income derived from the appellant's loan account. He is of the view that a portion of interest paid in respect of the mortgage loan account was incurred in the production of interest income and should therefore have been allowed

for the 2010, 2011 and 2012 years of assessment. He is of the view that portion of interest incurred which should be allowed should be left for determination by the respondent.

- [27] It is worth repeating in this judgment that initially, when the appellant applied for a home loan with Z the purpose was to finance the purchase of his property. In the course of time the appellant changed his bond account with Z into an access facility. Whilst the appellant, from time to time, withdrew funds from the access facility to fund his personal expenses and incurred interest in the process, he serviced his bond from the same facility. The appellant testified extensively in his evidence in chief and, to an extent, in his evidence under cross examination in an attempt to demonstrate payments of capital distributions

into the access bond and monthly interest levied thereon. But nowhere, in the appellant's testimony, is there any form of indication as regards what the applicant's intention was in changing his bond account into an access bond. Mr A, in argument, sought to persuade us that interest incurred in the access bond was closely linked to the interest earned on the loan capital with the employer and that, therefore, such interest was closely linked to interest incurred in the production of interest. The basis for this submission, in my view, is difficult to fathom.

[28] No evidence was led and, indeed, there is no evidence to suggest that when the appellant changed his bond account into an access facility, the purpose was the production of interest on the loan account and that any interest incurred out of funds withdrawn from the access facility was for purposes of production of that interest. Except to fund his personal expenses, no evidence was led to suggest that whatever withdrawals that were made, and any interest incurred arising therefrom, was incurred in the production of interest in the loan account. I am not persuaded that interest incurred in the access facility was closely linked to the interest earned on the loan account with the employer.

[29] Having said that, I make the following order:

- (1) The Commissioner's assessment of the appellant's tax liability in respect of the 2010, 2011 and 2012 years of assessment is hereby confirmed.
- (2) There shall be no order as to costs.

N J Yekiso

Judge of the High Court

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