Publication: Business Day (Late Final), Business Law & Tax
Date: Wednesday, May 01, 2019
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IN PRACTICE

When a business can claim for interest on loans

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Many companies in tough economic times are required to increase their gearing. The question arises whether the interest payable on these loans is tax deductible for the borrowing company.

For interest to be deductible it must, among other things, be incurred "in the production of income" as part of a "trade". Trade is widely defined in section 1 of the Income Tax Act as including every profession, trade, business, employment, calling, occupation or venture, including the letting of any property.

The main case relating to when expenditure will be incurred "in the production of income" is Port Elizabeth Electric Tramway Company Ltd v CIR (1936 CPD 241, 8 SATC 13) where Watermeyer AJP formulated the test thus:

- Whether the purpose of the act, to which the expenditure is attached, is to produce income, and
- Whether the expenditure is linked closely enough to this act.

In respect of the first leg of the test, in accordance with, inter alia, CIR v Allied Building Society (25 SATC 343), the purpose to be determined, is the dominant purpose of the taxpayer in question.

In Sub-Nigel Ltd v CIR (15 STAC 381) it was established that the words "incurred in the production of the income" do not mean that before a particular item of expenditure may be deducted it must be shown that it produced any part of the income for the particular year of assessment. The important question is whether the expenditure incurred for the purpose of earning income, whether in the current or in a future year of assessment.

Various South African cases have also dealt specifically with the deductibility of interest in respect of loan funding linked to the acquisition of shares, the declaration of dividends or capital distributions, ie linked to an activity not regarded as being in the production of income.

Our courts have followed the general principle that the purpose of the loan shall be the decisive factor in such an enquiry. Where a loan has been obtained for the purpose of declaring a dividend, no deduction will be allowed as the loan will not have been obtained in the production of income or for purposes of trade.

The important enquiry in deciding whether interest is incurred in the production of income is therefore the purpose of the borrowing. The test as to a taxpayer's "purpose" is a subjective matter. In Secretary for Inland Revenue v Ineson (42 SATC 125), the Appellate Division found that the amount claimed was not disputed, but that the only question was for what purpose the expenditure had been incurred.

With regard to the question of the purpose of the expenditure, the court stated that "[t]his raises a question of fact, and the finding made in regard thereto would virtually be decisive". While the test of purpose is a subjective and factual test, regard must also be had to the relevant facts and circumstances. Although it is primarily a subjective test, South African courts will not merely accept the "say so" of the relevant party, but will test this against the surrounding facts and circumstances.

OUR COURTS HAVE FOLLOWED THE PRINCIPLE THAT THE PURPOSE OF THE LOAN SHALL BE THE DECISIVE FACTOR

To ensure that interest is tax deductible it is therefore important to ensure that the purpose of the borrowing is in order to produce income, which would include funding the acquisition of working capital and operating expenses.

- *Peter Dachs is head of ENSafrica's tax department.*