Determining to what extent the "money-lender test" needs to be satisfied in the context of South African investment holding companies, focusing on the requirements of section 11(a) and 24J(2) of the Income Tax Act No. 58 of 1962.

by

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DECLARATION

I, the undersigned, declare that the content of this assignment is my own original work and has not been submitted, in part of it or its entirety, to any other University to obtain a degree.

J.A. Rupping

Date

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ABSTRACT

Determining to what extent the "money-lender test" needs to be satisfied in the context of South African investment holding companies, focusing on the requirements of section 11(a) and 24J(2) of the Income Tax Act No. 58 of 1962.

The requirements of section 11(a) and section 24J(2) were considered in this research assignment, from both a money-lender's and an investment holding company's perspective, to determine whether interest, losses on irrecoverable loans and raising fees were tax deductible. It was determined, that if the trade requirement is satisfied by the money-lender, then the above-mentioned expenses are fully tax deductible. However, if the trade requirement is satisfied by the investment holding company then only the interest is fully tax deductible.

It is further submitted however in this research assignment that it cannot be said that the money-lender alternative is better than the investment holding company alternative – both alternatives are of equal value in the current tax system. What is important though is that taxpayers who will fit the mould of an investment holding company will now be able to use the principles set out in this research assignment to prove that it is in fact carrying on a trade for tax purposes, something that taxpayers are generally reluctant to pursue. If this is pursued, taxpayers may have the added tax benefit of tax deductible interest expenditure (in full) in cases where this was not previously the norm (and an investment holding company will not have to satisfy any of the guidelines of the "money-lender test" when it seeks to deduct its interest expense in full).

However, if an investment holding company seeks to deduct losses on irrecoverable loans and raising fees for tax purposes, it will not have to satisfy all the guidelines of the "money-lender test", but it will have to satisfy one guideline, that being the "system or plan" and "frequent turnover of capital" guideline. It will be very difficult for an investment holding company to prove this on the facts of the case – it will arguably take a special set of facts to accomplish this mean feat.

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OPSOMMING

Vasstelling van die mate waarin die "geldskietertoets" aan voldoen moet word in die konteks van Suid-Afrikaanse beleggingshouermaatskappye, met die fokus op die bepalings van artikel 11(a) en 24J(2) van die Inkomstebelastingwet No. 58 van 1962.

Die vereistes van artikel 11(a) en artikel 24J (2) is in hierdie navorsingsopdrag vanuit ’n geldskieter en 'n beleggingshouermaatskappy se perspektief oorweeg, om die belastingaftrekbaarheid van rente, verliese op oninvorderbare lenings en diensfooie te bepaal. Daar is vasgestel dat indien die bedryfsvereiste deur ’n geldskieter nagekom word, bogenoemde uitgawes ten volle vir belastingdoeleindes aftrekbaar is. Indien die bedryfsvereiste egter nagekom word deur ’n beleggingshouermaatskappy sal slegs die rente ten volle aftrekbaar wees vir belastingdoeleindes.

Verder word dit in die navorsingsopdrag aan die hand gedoen dat daar nie gesê kan word dat die geldskieter-alternatief beter is as die beleggingshouermaatskappy-alternatief nie – beide alternatiewe is van gelyke waarde in die huidige belastingbestel. Die onderskeid is egter belangrik, aangesien die belastingbetalers wat aan die vereistes van ’n beleggingshouermaatskappy voldoen, nou in staat sal wees om die beginsels wat in hierdie navorsingsopdrag uiteengesit word, te gebruik om te bewys dat die beleggingshouermaatskappy in werklikheid ’n bedryf vir belastingdoeleindes beoefen. Belastingbetalers is oor die algemeen huiwerig om dit te poog. Indien wel, kan belastingbetalers ’n belastingaftrekking ten opsigte van rente uitgawes kry, wat voorheen nie die norm was nie (’n beleggingshouermaatskappy sal nie enige van die “geldskietertoets” riglyne hoef na te kom wanneer dit poog om ’n belastingafrekking vir die rente uitgawe te kry nie).

Indien ’n beleggingshouermaatskappy verliese op oninvorderbare lenings en diensfooie vir belastingdoeleindes wil aftrek, sal die belastingbetaler nie al die “geldskietertoets” riglyne hoef na te kom nie, maar sal egter moet voldoen aan die “stelsel of plan” en “gereelde omset van kapitaal” riglyne. Dit sal baie moeilik wees vir 'n beleggingshouermaatskappy om dit te bewys op grond van die feite van die saak – dit sal waarskynlik ’n spesiale stel feite verg om dit te bereik.

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"In Commissioner for SARS v Tiger Oats Ltd [2003] 2 All SA 604 (SCA), the Supreme Court of Appeal found that the taxpayer, the holding company of its operational subsidiaries, was 'no mere passive investor' but 'in a very real commercial sense was actively involved in the business of its operating subsidiaries and associated companies' (par [35] at 614), despite the fact that the holding company did not buy, sell, or manufacture goods or provide services for gain." ~ *Peter Surtees, Director at Norton Rose and tax lecturer at the University of Cape Town*[1].

[1] Surtees (2006)

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CHAPTER 1

Introduction

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1.1 Background

The management of finances within large groups of companies ("groups") are better known as treasury management and represent vitally important and potentially complex activities. Treasury management includes the management of financial risks, such as liquidity risks, counterparty risks and foreign exchange risks (Wong, 2012 p. 28-29). Practically, this includes the day-to-day control of cash and bank accounts, raising third-party finance, investing surplus funds, granting of intra-group loans to subsidiaries and hedging foreign exchange and interest rate risks.

It is envisaged that the recent credit crisis of 2012 will occur again, and amidst of this, large groups around the world are reviewing and streamlining their bank account structures, strengthening cash concentration and cash pooling arrangements and endeavour to achieve a high degree of control in their deployment of cash (Wong, 2012 p. 28-29).

In South Africa, large groups are also streamlining their businesses and, recently in practice, questions whether separate treasury companies are necessary, have been asked by certain groups[2]. The question is asked, because generally taxpayers would like to claim all costs relating to the taxpayer's finance function as an income tax deduction. These costs include, *inter alia*, interest expenditure, raising fees and losses on irrecoverable loans – costs that are an integral part of treasury companies' businesses.

1.2 Research problem

Separate treasury companies must satisfy the guidelines as crystallized in Solaglass Finance Company (Pty) Ltd v CIR (1991) to determine whether the company can be said to be carrying on a business as a money-lender ('the "money-lender test"'). If all of the guidelines of the "money-lender test" are satisfied, it is arguable that treasury companies may obtain full income tax deductions for interest expenditure that they incur (Practice Note 31('PN 31'), Sentra-Oes Koöperatief Beperk v KBI (1995) and Solaglass Finance Company (Pty) Ltd v CIR (1991)). The income tax deduction is allowed on the premise that treasury companies 'carry on a trade' for income tax purposes (as envisaged in section 11(a) and section 24J(2) of the Income Tax Act No. 58 of 1962 ('the Act')) when

[2] Driaan Rupping is a tax consultant at one of South Africa's leading professional firms. Questions surrounding the use of treasury companies were recently raised by the firm's clients.

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the “money-lender test” is satisfied. The other requirements of section 11(a) or section 24J(2) of the Act must also be satisfied. Other finance related expenditure incurred by money-lenders such as raising fees and losses on irrecoverable loans will generally also be allowed as an income tax deduction on the basis that the other requirements of section 11(a) of the Act are satisfied (Sentra-Oes Koöperatief Beperk v KBI (1995) [at p. 117]) – the details will be discussed later in this research assignment – refer to the conclusions reached in 4.5.1.

One issue raised by South African groups is that they do not want to incorporate separate treasury companies to ensure the full deduction of interest, raising fees and losses on irrecoverable loans. The reason is the strict and onerous requirements of the “money-lender test”, and in particular, the “all and sundry” test (Solaglass Finance Company (Pty) Ltd v CIR (1991) [at p. 14, 15]). This test determines that the taxpayer must be prepared to lend to a large, very loosely defined category of persons. This is clearly not the intention of taxpayers who seek to merely grant intra-group loans to their fellow group companies and finance these group companies in their operations.

When taxpayers do not meet the strict guidelines of the “money-lender test”, they are faced with the risk that SARS may not allow any expenditure incurred (including interest and raising fees) as a deduction for income tax purposes.

The non-deductibility of expenditure is supported by numerous court decisions laid down by our courts in the past (ITC 512 (12 SATC 246), ITC 1275 (40 SATC 197), ITC 496 (12 SATC 132), and ITC 957 (24 SATC 637)) which indicated that the passive earning of interest on capital or surplus funds invested is not the ‘carrying on of a trade’ and that any expenditure incurred in the production of such interest should not be allowed as an income tax deduction. Other expenditure such as raising fees and losses on irrecoverable loans will similarly not be allowed as an income tax deduction on the premise that these expenses were also not incurred in ‘carrying on of a trade’. PN 31 concurs with this view, but concedes that even though not strictly supported by law, taxpayers may in practice deduct expenditure to the extent the taxpayer receives interest income.

The question that is now submitted, is whether it is necessary to incorporate a separate treasury company (in the context of South African groups) that must satisfy the onerous

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"money-lender test" in order to obtain income tax deductions for interest and other expenditure incurred in the taxpayer's finance function?

In answering this question, it should be considered whether the treasury function could be housed in, for example, the investment holding company (i.e. the holding company of the South African groups) and consequently be privy to the same tax advantages.

1.3 Research objective

The objective of this study is to conduct a critical analysis of the trade requirement included in section 11(a) and 24J(2) of the Act, to determine the deductibility of interest expenditure (and related financing expenditure such as raising fees and losses on irrecoverable loans) for money-lenders and investment holding companies.

It will be determined through research of case law and relevant supporting literature whether the investment holding company may be seen as 'carrying on a trade' without referring to the onerous "money-lender test" (i.e. whether the investment activities of the investment holding company may be viewed as 'carrying on a trade'). It will further be determined whether the financing function of the investment holding company may be viewed as part of the investment activities of the investment holding company into its subsidiaries. It will be argued that loans made by investment holding companies to their subsidiaries fall within the ambit of, and may even be equated to, the trade carried on by the investment holding company in terms of its investment activities on the basis that such loans constitute an active participation by the investment holding company in the affairs of its subsidiary (CSARS v Tiger Oats Ltd (2003) [at p. 292]).

It will then be determined to what extent the "money-lender test" will need to be satisfied in the context of investment holding companies in order to deduct the full interest expenditure (and other related finance expenditure such as raising fees and losses on irrecoverable loans) from its taxable income. In other words, it will be determined whether investment holding companies need to satisfy the "money-lender test" to obtain full interest deductions for expenditure incurred in its finance function, or if not, what minimum criteria are necessary to obtain the full interest deductions.

Although the analysis will focus on the trade requirement, the other requirements of section 11(a) and section 24J(2) of the Act (such as the in production of income and capital requirements) will also be analysed in the research assignment to determine the deductibility of expenditure for both money-lenders and investment holding companies.

A comparison will then be made between the deductibility of expenditure by money-lenders (or companies satisfying the "money-lender test") and investment holding companies (especially where the finance function is linked to the investment holding company's investment activities) to determine to what extent the "money-lender test" needs to be satisfied.

1.4 Research method

A literature study will be performed as the analysis of the deductibility of interest (and other related finance expenditure such as raising fees and losses on irrecoverable loans) in terms of section 11(a) and 24J(2) of the Act can be done with reference to already published data. Data include literature, case law and statutory laws (both foreign and local).

In analysing the above-mentioned requirements to determine the deductibility requirements of expenditure incurred by money-lenders and investment holding companies, reference will to a great extent be made to the ordinary, grammatical meaning of the words in the specific provisions of the Act and thereafter by looking at the meaning the courts have ascribed to them. Reference will also be made to foreign case law, where applicable. Judgments of the courts of other countries, although not binding on SA courts, are of significance because they have persuasive value (De Koker, 2012).

1.5 Research design

In accomplishing the above-mentioned research objective (through the stated research method), consideration will be given to the requirements of the general deduction formula contained in section 11(a) and the requirements of section 24J(2) of the Act.

Firstly, a critical analysis of the trade requirement contained in section 11(a) and section 24J(2) of the Act will be conducted. The analysis will include an examination of the

definitions and interpretations of the words ‘carrying on any trade’. The ordinary and grammatical meaning of the different words will be considered and thereafter the meaning that the courts have ascribed to these words will be considered.

The trade requirement will then be applied to typical money-lending and investment holding companies.

In respect of money-lenders, consideration will be given to the “money-lender test” as set out by the courts over the years, to determine when a money-lender is ‘carrying on a trade’ for income tax purposes.

In respect of investment holding companies, it will be determined whether these companies ‘carry on a trade’ as a whole and more specifically, in which circumstances it will, or will not, carry on a trade for income tax purposes. As part of this analysis, the different income generating activities of investment holding companies will be identified and it will be determined whether these activities will carry on a trade. The investment holding company’s investment activities (in terms of which mainly exempt dividend income is received) and financing activities (in terms of which interest is received) will be focused upon.

Further, it will be determined whether the financing activities of investment holding companies can be seen as the carrying on of a trade by considering the principles laid down by our courts over the years, with a special focus on CSARS v Tiger Oats Ltd (2003) and other cases.

Following from the above analysis, the deductibility of interest expenditure (and other related finance expenditure such as raising fees and losses on irrecoverable loans) in respect of money-lenders and investment holding companies will be determined by including a critical analysis of the requirements of section 11(a) and section 24J(2) of the Act.

The final chapter of the research assignment will determine whether investment holding companies need to satisfy the “money-lender test” to obtain full interest deductions for expenditure incurred in its finance function, or if not, what minimum criteria are necessary to obtain the full interest deductions.

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1.6 Importance of the research

The importance of the research is to provide clarity on the income tax consequences if taxpayers do not incorporate separate treasury companies, but rather keep the South African group's finance functions within the investment holding companies.

Practical implications will be given in the research assignment to determine to what extent the "money-lender test" needs to be satisfied to receive the best possible income tax advantages for investment holding companies.

Further, if investment holding companies may be regarded as 'carrying on a trade' then any assessed losses in a particular year may be carried forward to the next year. Currently, in instances where the interest expense is greater than the interest income no losses are carried forward on the basis that the company does not carry on a trade due to the application of section 20 of the Act. This research assignment may therefore also assist to give more clarity in this regard.

There is a technical argument that the charging sections of certain provisions of the Act, other than those specifically addressed in section 11 of the Act (i.e. section 24J, 24I, etc.), are actually deducted in terms of section 11(x) of the Act (De Koker, 2012). This means that all deductions will have to satisfy the trade requirement. Where this is important, for example, is in cases such as section 24I of the Act which does not include the trade requirement. This will result in foreign exchange losses being deductible only if the taxpayer carries on a trade – the research assignment will therefore provide more clarity on whether or not a company is carrying on a trade, but the working of section 11(x) of the Act and the analysis thereof should, however, be considered further. It could also be considered whether these foreign exchange losses may be carried forward to the following year of assessment as an assessed loss.

This research assignment will also provide clarity on whether investment holding companies may, or may not, claim losses on irrecoverable loans. There is a commercial risk attached to granting intra-group loans to support subsidiaries in their operations and therefore taxpayers will seek to deduct such losses from taxable income.

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The research assignment will also highlight other issues which should possibly be considered further in other research assignment, such as the carry forward of losses, the nature of deductibility of raising fees, etc.

1.7 Outline of the chapters

1.7.1 Chapter 2 - The general deduction formula and section 24J

The purpose of chapter 2 is to provide an introduction to the requirements of the general deduction formula as contained in section 11(a) and the requirements of section 24J(2) of the Act.

The chapter will include the anomalies specifically related to the deductibility of investment holding company expenditure and acts as an introduction to the more in depth analysis of the requirements of section 11(a) and section 24J(2) of the Act which will be specifically addressed in the next chapters.

1.7.2 Chapter 3 - The trade requirement

The purpose of chapter 3 is to critically analyse the trade requirement, which is a requirement in both section 11(a) and section 24J(2) of the Act.

The analysis will include an examination of the definitions and interpretations attached to the words ‘carrying on any trade’ as contained in section 11(a) and section 24J(2) of the Act and examining the words of the ‘trade’ definition in section 1 of the Act. This will firstly be done by observing their ordinary, grammatical meaning and thereafter by looking at the meaning the courts have ascribed to them.

The theory of the trade requirement will be applied to money-lenders and investment holding companies. The chapter will further analyse (1) the “money-lender test” set out by our courts to determine whether and when money-lenders carry on a trade for income tax purposes, and (2) whether an investment holding company can be said to ‘carry on a trade’ for income tax purposes.

The chapter will identify the different income earning activities of an investment holding company and determine which of these activities could be regarded as the carrying on of a trade for income tax purposes. In other words, the research assignment will focus on whether the investment activities, the financing activities and/or management activities of the investment holding company may be seen as the carrying on of a trade.

The chapter will include a critical analysis of CSARS v Tiger Oats Ltd (2003) and the effect this case may have on the application of the trade requirement in respect of investment holding companies (the court was asked to decide whether an investment holding company was carrying on an enterprise for purposes of the Regional Services Council Act 109 of 1985 ("the RSC Act")). It will then be determined whether the breadth of the application of CSARS v Tiger Oats Ltd (2003) judgement goes further than just the the RSC Act. This chapter will include a detailed discussion on whether CSARS v Tiger Oats Ltd (2003) may be used as authority for income tax purposes.

The above application of the trade requirement in respect of both money-lenders and investment holding companies will be used in the following chapters when the deductibility of expenditure is analysed in the hands of money-lenders and investment holding companies.

1.7.3 Chapter 4 - The deductibility of expenditure incurred by money-lenders and investment holding companies

The purpose of this chapter is to examine the requirements to obtain an income tax deduction for expenditure incurred by money-lenders and investment holding companies.

The chapter will analyse and apply the requirements of section 11(a) and 24J(2) of the Act to determine whether expenditure incurred by money-lenders and investment holding companies may be deductible for tax purposes (this chapter will focus more on the in production of income and capital requirements).

The chapter will further identify when expenditure incurred by investment holding companies will be deductible for income tax purposes, by considering to what extent the trade, in the production of income and the capital requirements will be satisfied when investment holding companies carry on limited activities.

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1.7.4 Chapter 5 - Conclusion

The purpose of this chapter is to provide a summary of the main research findings within each chapter, to reach an overarching conclusion in respect of the research assignment.

The chapter will compare the requirements to claim an income tax deduction in respect of expenditure incurred by both money-lenders and investment holding companies. A conclusion will be formed to what extent the "money-lender test" needs to be satisfied in the context of investment holding companies.

Suggestions for areas which may be further researched in the future will also be provided.

CHAPTER 2

The general deduction formula and section 24J

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CHAPTER 2

The general deduction formula and section 24J

2.1 Introduction

The objective of this study is to conduct a critical analysis of the deductibility of expenditure typically incurred by taxpayers (in its capacity as being a money-lender or an investment holding company) in its quest to obtain funding, and to then on-lend these funds, by granting intra-group loans to fellow group companies.

These expenses include, *inter alia*, interest expenditure, raising fees and losses on irrecoverable loans. The income tax deductibility of these expenses will be discussed in this research assignment.

The deductibility of expenditure for income tax purposes should be considered in terms of the general deduction formula contained in section 11(a), read with section 23(f) and 23(g), of the Act.

There is however the maxim *generalia specialibus non derogant,* which means in the context of interpreting statutes, the general provisions should not take from or reduce specific or special statutes (De Koker, 2012). In other words, the terms of a specific provision in a statute must be regarded as overriding those of a general provision in case of conflict.

In the case with the deductibility of interest expenditure, section 24J of the Act is a specific provision which provides how and when an interest obligation will be regarded as having been incurred. If it is determined that section 24J of the Act applies to a particular set of facts as regard the incurral of an interest obligation, the consequences prescribed by section 24J of the Act must be regarded as governing the point due to the maxim *generalia specialibus non derogant*. Therefore, if section 24J of the Act is applicable, there can be no room for applying the ordinary principles of incurral of interest in terms of section 11(a) of the Act.

The deductibility of the raising fees and losses on irrecoverable loans will however still be governed by section 11(a) of the Act.

2.2 Section 11(a)

2.2.1 Legislation

As aforementioned, the deductibility of expenditure (other than interest) for income tax purposes should be considered in terms of the general deduction formula contained in section 11(a), read with section 23(f) and 23(g), of the Act.

The preamble of section 11, together with subsection (a), reads 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;"
>
> [Own emphasis]

and, section 23 states, *inter alia*, the following:

> "No deductions shall in any case be made in respect of the following matters, namely —
>
> (f) any expenses incurred in respect of any amounts received or accrued which do not constitute income as defined in section one;
>
> (g) any moneys, claimed as a deduction from income derived from trade, to the extent to which such moneys were not laid out or expended for the purposes of trade;"

2.2.2 Requirements of section 11(a)

From above, it is evident that for an amount to qualify as a deduction from taxable income, the following requirements would need to be satisfied:

- The taxpayer must carry on any trade ('the trade requirement');

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- There must either be an expenditure or loss which is actually incurred during the year of assessment;
- It must be incurred in the production of income (the 'in the production of income requirement'); and
- The expenditure or loss must not be capital in nature ('the capital requirement').

If all of the above requirements are met, all expenditure, other than interest, should be deductible in terms of section 11(a) of the Act.

2.3 Section 24J

2.3.1 Legislation

The deductibility of interest expenditure for income tax purposes should be considered in terms of section 24J of the Act. The starting point of section 24J is found in its charging sections. As regard the incurral of interest, section 24J(2) of the Act reads as follows:

> "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 <u>carrying on any trade</u>, if that amount is <u>incurred in the production of the income</u>."
>
> [Own emphasis]

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2.3.2 Definitions

For section 24J(2) of the Act to apply, it needs to be determined whether an 'issuer' (as defined in section 24J(1)) has incurred an amount of 'interest' (as defined) in terms of an 'instrument' (as defined).

2.3.2.1 'holder' and 'issuer'

Section 24J(1) of the Act defines "*issuer"* as follows:

> "*'issuer'*, in relation to any instrument—
>
> (a) means any person who has incurred any interest or has any obligation to repay any amount in terms of such instrument; or
>
> (b) at any particular time, means any person who, if any interest payable in terms of such instrument was due and payable at that time, would be liable to pay such interest;"
>
> [Own emphasis]

The 'issuer' is therefore a borrower of funds who becomes liable for the payment of interest (De Koker, 2012). Therefore, if a taxpayer obtains funding from a bank, for example, the taxpayer will be the 'issuer' of an instrument, because the taxpayer has the obligation to repay any amounts of interest in terms of the instrument.

Section 24J(1) of the Act defines "*holder"* as follows:

> "*'holder'*, in relation to an income instrument—
>
> (a) means any person who has become entitled to any interest or amount receivable in terms of such income instrument; or
>
> (b) at any particular time, means any person who, if any interest payable in terms of such income instrument was due and payable at that time, would be entitled to receive payment of such interest;"
>
> [Own emphasis]

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The 'holder' is therefore the lender of funds (i.e. the person to whom interest accrues) (De Koker, 2012). Therefore, if a taxpayer on-lends funds by granting an intra-group loan to its subsidiary, or its fellow subsidiary, then the taxpayer will be the 'holder' of an instrument, because the taxpayer is entitled to any interest derived from this instrument.

2.3.2.2 'instrument'

Section 24J(1) of the Act defines "*instrument"* as follows:

> "*'instrument'* means—
>
> ….
>
> (c) any form of interest-bearing arrangement or any debt;
>
> …."
>
> [Own emphasis]

On the basis that the loan between the taxpayer and the bank, for example, is an interest bearing loan, the loan will clearly fall within the wide definition of an 'instrument' as explained above.

2.3.2.3 'interest'

Section 24J(1) of the Act defines "*interest"* as follows:

> "*'interest'* includes the—
>
> (a) gross amount of any interest or related finance charges, discount or premium payable or receivable in terms of or in respect of a financial arrangement;
>
> (b) amount (or portion thereof) payable by a borrower to the lender in terms of any lending arrangement as represents compensation for any amount to which the lender would, but for such lending arrangement, have been entitled; and
>
> …."
>
> [Own emphasis]

Interest is therefore widely defined and it is submitted that it includes any amount paid as compensation for the loan.

2.3.2.4 Conclusion

Section 24J(2) of the Act will apply to any interest incurred on a normal loan received from a bank. The taxpayer will be the ‘issuer’ as defined, there will be an incurral of ‘interest’ as defined and the interest will be incurred in terms of an ‘instrument’ as defined.

2.3.3 Requirements of section 24J(2)

Now that it is determined that section 24J(2) of the Act will apply to loans, it is important to summarise the requirements which need to be satisfied for interest to be deductible.

The following requirements must be satisfied in this regard:

- The trade requirement; and
- The in the production of income requirement.

Section 24J(2) of the Act deems the interest to have incurred during a year of assessment where an ‘issuer’ in relation to an ‘instrument’ is identified. Therefore, the “actually incurred” requirement as per section 11(a) of the Act is not required in section 24J(2) of the Act.

Further, according to the provisions of section 24J(2) of the Act, the capital requirement is not required when a deduction for interest expenditure is sought (De Koker, 2012).

2.4 Summary of requirements to deduct interest expenditure, and non-interest expenditure

In summary, both the trade– and the in production of income requirements must be satisfied to deduct all expenditure (i.e. including interest and other expenditure) from taxable income in terms of section 11(a) or section 24J(2) of the Act.

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The trade requirement will be discussed in more detail in chapter 3. The in the production of income requirement will be discussed in detail in chapter 4 when the deductibility of expenses incurred by money-lenders and investment holding companies are considered in detail.

The requirement that expenditure or losses must be actually incurred during the year of assessment for purposes of section 11(a) of the Act, will not be considered in detail in this research assignment. It will be assumed that all expenditure (irrespective of whether the expenditure connotes interest or not) will be actually incurred for income tax purposes.

The capital requirement of section 11(a) of the Act will be considered in chapter 4 when the deductibility of the raising fees and losses on irrecoverable loans are discussed. Interest expenditure is not subject to the capital requirement as discussed above (De Koker, 2012).

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CHAPTER 3

The trade requirement

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CHAPTER 3
The trade requirement

3.1 Introduction

As discussed in chapter 2, it is paramount for the trade requirement to be satisfied when expenditure (whether it is interest or not) is claimed as an income tax deduction in terms of either section 11(a) or section 24J(2) of the Act.

The preamble to section 11 of the Act reads 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..."
>
> [Own emphasis]

In addition, section 23(g) of the Act should also be considered. Section 23(g) stipulates that a deduction will not be allowed in respect of:

> "any moneys...to the extent to which such moneys were not laid out or expended for the purposes of trade."
>
> [Own emphasis]

Lastly, with regards to interest expenditure, section 24J(2) of the Act reads as follows:

> "Where any person is the issuer in relation to an instrument … such person shall for the purposes of this Act be deemed to have incurred an amount of interest …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."
>
> [Own emphasis]

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Both section 11 and section 24J of the Act only permits a deduction if the taxpayer is "carrying on any trade".

3.2 Definitions in the Act

Section 1 of the Act defines the term "trade" as follows:

> "*'trade'* includes every profession, trade, business, employment, calling, occupation or venture, including the letting of any property and the use of or the grant of permission to use any patent ..., or any design ..., or any trade mark ..., or any copyright ..., or any other property which is of a similar nature;"
>
> [Own emphasis]

The use of the word "includes" in the definition of "trade" connotes that this term generally has to be afforded a wide meaning and it is submitted that the meaning of the term should not be confined to the list of items specifically included in the definition.

The above view is confirmed by Grosskopf JA in Burgess v CIR (1993) [at p. 196]:

> "It is well-established that the definition of trade...should be given a wide interpretation. In ITC 770 (1953) 19 SATC 216 at p 217 Dowling J said, dealing with the similar definition of 'trade' in Act 31 of 1941, that it was 'obviously intended to embrace every profitable activity and...I think should be given the widest possible interpretation.'"
>
> [Own emphasis]

The definition of "trade" includes the words "profession", "business", "employment", "calling", "occupation" and "venture". These terms are not defined in the Act and the application of these terms to the activities of both money-lenders and investment holding companies must be considered. On this basis it is necessary to consider the ordinary meaning of the words "trade", "profession", "business", "employment", "calling", "occupation" and "venture", and then consider how our courts have through the years viewed the concept of "trade".

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In addition, the Act also requires the “carrying on [of] any trade” to claim an income tax deduction, yet only the term “trade” is defined above. It follows that the term “carrying on [of] any trade” is not defined, thus this term will also be considered in more detail.

The Appellate Division of the Court in Coopers & Lybrand v Bryant (1995) said the following regarding statutory interpretation [at p. 767]:

> “According to the “golden rule” of interpretation the language in the document is to be given its grammatical and ordinary meaning, unless this would result in some absurdity, or some repugnancy or inconsistency with the rest of the instrument.”

Another important passage in the context of statutory interpretation is the following dictum of Rowlatt J in Cape Brandy Syndicate v IRC (1921) [at p. 71]:

> “It simply means that in a taxing Act one has to look at what is clearly said. There is no room for any intendment. There is no equity about a tax. There is no presumption as to a tax. Nothing is to be read in, nothing is to be implied. One can only look fairly at the language used.”

Therefore, unless words and phrases are specially defined in the Act, they must be interpreted according to their ordinary meaning (and natural sense) (De Koker, 2012).

3.3 Ordinary meaning

3.3.1 Definitions

The Oxford Dictionary of English (Soanes and Stevenson, 2005) provides the most apposite definitions for the following relevant words:

> “**trade > noun** [mass noun] **1** the action of buying and selling goods and services. **2** a job requiring manual skills and special training. **3** (the trade) [treated as sing. or pl.] the people engaged in a particular area of business.”

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> "**profession > noun 1** a paid occupation, especially on that involves prolonged training and a formal qualification."
>
> "**business > noun** [mass noun] **1** a person's regular occupation, profession, or trade...an activity someone is engaged in. **2** commercial activity."
>
> "**employment > noun** [mass noun] **1** the state of having paid work. the action of giving work to someone. a person's trade or profession."
>
> "**calling > noun 2** a strong urge towards a particular way of life or career."
>
> "**occupation > noun 1** a job or profession."
>
> "**venture > noun** a risky or daring journey or undertaking. a business enterprise."
>
> [Own emphasis]

The Black's Law Dictionary (Garner, 2004) in turn provides the most apposite definitions for the following words:

> "**trade**, n. **1.** The business of buying and selling or bartering goods or services. **2.** A transaction or swap. **3.** A business or industry occupation; a craft or profession."
>
> "**profession. 1.** A vocation requiring advanced education and training; esp., one of the three traditional learned professions – law, medicine, and the ministry. **2.** Collectively, the members of such a vocation."
>
> "**business**. **1**. A commercial enterprise carried on for profit; a particular occupation or employment habitually engaged in for livelihood or gain. **2**. Commercial enterprises... **3**. Commercial transactions..."
>
> "**employment. 1.** The relationship between master and servant. **2.** The act of employing. **3.** The state of being employed. **4.** Work for which one has been hired and is being paid by an employer."

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> “**occupation. 1.** An activity or pursuit in which a person is engaged; esp., a person’s usual or principal work or business.”

> “**venture**. An undertaking that involves risk; esp., a speculative commercial enterprise.”

> [Own emphasis]

The above dictionary definitions regularly use the term “enterprise”. The Oxford Dictionary of English (Soanes and Stevenson, 2005) defines the term “enterprise” as follows:

> “**enterprise > noun 1** a project of undertaking, especially a bold or complex one. **2** a business or company. entrepreneurial economic activity.”

> [Own emphasis]

The Black’s Law Dictionary (Garner, 2004) defines “enterprise” as follows:

> “**enterprise**, n **1.** An organization or venture, esp. for business purposes. **3.** One or more persons or organizations that have related activities, unified operation or common control, and a common business purpose.”

> [Own emphasis]

In addition, the Act also requires the “carrying on [of] any trade” to claim an income tax deduction. The Oxford Dictionary of English (Soanes and Stevenson, 2005) defines the terms “carry” and “carry on” as follows:

> “**carry > noun 3** *finance* the maintenance of an investment position in a securities market, especially with regard to the costs or profits accruing.”

> “**carry > carry on 1** continue an activity or task. Continue to move in the same direction.”

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The Black's Law Dictionary (Garner, 2004) defines "carry" as follows (note that it does not have a definition for "carry on"):

> "**carry**, vb. **6.** To provide funds or credit for the payment of (stock, etc.), often as an advance, for an agreed-on period... **7.** To absorb the cost of holding or having, usu. temporarily…"

3.3.2 Conclusion

It is submitted that from the above it emerges that the terms "trade", "business", "venture" and "enterprise" may perhaps, from a grammatical point of view, be used synonymously on the basis that all these terms share the requisite of something being done for commercial (or business) purposes.

It is further submitted that, from a practical perspective, there is very little difference between the above terms. Therefore, if someone is "carrying on a business", it may also be said that such a person is "carrying on a trade" or "involved in an enterprise" or "has undertaken a venture".

Based on the above definitions, it appears that the concept of "carrying on a trade" arguably has a wide meaning. It should at the very least be a "continual activity" of the taxpayer's "trade". It is submitted that from an investment holding company's perspective, the "continual activity" of "maintaining the investment position of the taxpayer in a particular area of business" should also meet the "carrying on [of] a trade" requirement in its ordinary grammatical sense.

3.4 Common law meaning

In deciding whether a taxpayer is carrying on a trade our courts have held that this inquiry is a question of fact, to be decided on the circumstances of each case (ITC 1476 (52 SATC 141) [at p. 146]).

This view is concurred by Wessels JA, who delivered the judgment of the Appellate Division of the Supreme Court in CIR v Stott (1928) [at p. 257]:

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> "The question it had to determine was whether the facts as set out in the special case showed that the proceeds of the sale of the Ifafa and Bluff properties constituted gross income or capital. In order to arrive at that decision it was necessary to know whether the acts of the taxpayer in buying and selling those properties showed that he was carrying on the trade or business of a landjobber. Whether he was or was not carrying on such a business was an inference from facts. That inference was a matter of law. Did or did not such facts as were found lead to the conclusion that the taxpayer was carrying on a business or trade within the meaning of the law? Whatever view other Courts had expressed, it was quite clear that the Court had regarded the inference from the acts of the taxpayer that he carried on a trade or business as a question of law."
>
> [Own emphasis]

Although it is clear that the inquiry on whether a taxpayer carries on a trade should be based on the facts of each case, this inquiry has been proved to be problematic to answer in our courts over the years.

As an introduction to the term "trade", it was held that a taxpayer will be carrying on a trade even if he has no objective to make a "profit" or even if he deliberately sets out to make a loss (ITC 615 (14 SATC 399) [at p. 403]), but that the absence of the prospect of making profits might indicate, along with other factors, that the taxpayer contemplated purposes other than trade or was not exclusively concerned with trade (ITC 1385 (46 SATC 111) at p. 114 - 115). In delivering judgement of the court in ITC 1385 (46 SATC 111), Nestadt J quoted ITC 1292 (41 SATC 163) [at p. 115]:

> "In ITC 1292 (to take an example) the following was stated (at 165); 'If the possibility to earn a profit is excluded by the evidence, as is the position in the present case, then such expenses are not deductible. The test is the real hope to make a profit. Such hope must not be based on fanciful expectations but on reasonable possibility.'"

The activities of the taxpayer should however be examined as a whole in order to establish whether the taxpayer is in fact carrying on a trade (Estate G v COT (1964)).

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Furthermore, the carrying on of a trade involves an "active step", something more than a watching over existing investments that are not income-producing and are not intended or expected to be so. The mere retention of investments, even if acquired when a trade was carried on, therefore did not imply a continuance of trade (ITC 1476 (52 SATC 141)).

It follows, that as in the case with the ordinary meaning of the term "carrying on a trade", a taxpayer must take "active steps" or have a "continual of activities or tasks" for the taxpayer to "carry on a trade". The following are also specific examples extracted from common law which is relevant to the position of taxpayers that grant intra-group loans:

A taxpayer who accumulates his savings and invests them in interest-bearing securities does not derive such income from carrying on any trade. In ITC 512 (12 SATC 246) the taxpayer contended that funds accumulated from his auctioneering and other business activities should also be regarded as capital employed in his trade. The court rejected this contention [at p. 248]:

> "It is clear that these are savings in the ordinary way which are being put out on investment. That may be said of every person who is thrifty enough to save money from his ordinary daily activities and invest it in the savings bank or on fixed deposit or in shares for that matter, or in any of the numerous forms of investment. .... The appellant had merely accumulated his savings and invested them in bonds and other interest-bearing securities. It seems to us to be going too far to say that these savings or investments form part of the appellant's trade capital. His trade is that of an auctioneer and he has candidly admitted that: he was asked to say what his business was and he replied that he would say that he was interested in auctioneering and then, as an afterthought, he added that he was also interested in properties and bonds. The case is virtually unarguable."
>
> [Own emphasis]

A taxpayer who accumulates his savings and invests them in shares held as assets of a capital nature does not derive such income from carrying on any trade. This is confirmed by ITC 1275 (40 SATC 197) [at p. 199]:

> "Now, I have no doubt that if appellant was carrying on the business of dealing in shares and securities some of the deductions he claims could well be allowed even if not to the extent he claims. But that is not the position we are dealing with here. The law does not allow a taxpayer who derives a portion of his income from investments to deduct from his income expenses he incurs in watching over those investments, however wisely incurred those expenses may be. Section 11 of the Income Tax Act contemplates deductions from income derived from the carrying on of a trade. …. Appellant did not even claim to be carrying on the business of investing in equities and other interest-bearing securities, nor in my opinion could he on the face of the evidence before the court have done so."
>
> [Own emphasis]

A holding company, which carried on a retail merchant's business, made advances to a subsidiary company, which was the owner of the premises in which the holding company was operating. It was held that the interest received by the holding company was not derived from the carrying on of a trade (ITC 496 (12 SATC 132)).

In ITC 957 (24 SATC 637) a taxpayer that earned interest on loans made by it to certain of its shareholders could not show, on the facts of the case, that it was carrying on the business of money-lending, and it was held that the interest received was not derived from the carrying on of a trade [at p. 639]:

> "All the facts suggest that the appellant company may simply have been assisting the shareholders financially without any intention of making a business of money-lending out of its transactions."

However, if a taxpayer can show that he has been carrying on the business of banking or money-lending, then irrecoverable losses incurred by him as a result of loans, made during the course of his business, are losses of a non-capital nature and deductible. This was confirmed by Sentra-Oes Koöperatief Beperk v KBI (1995) [at p. 117]:

> "It has been accepted in a number of cases, mainly in the Special Court, that <u>where the taxpayer can show that he has been carrying on the business of banking or money-lending, then losses incurred by him as a result of loans, made in the course</u>

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of his business, becoming irrecoverable are losses of a non-capital nature and deductible... . The rationale of these decisions appears to be that the capital used by a money-lender to make loans constitutes his circulating capital and that consequently losses of such capital are on revenue account."

[Own emphasis]

In ITC 957 (24 SATC 637) it was confirmed [at p. 638] that "whether a person carries on a business of money-lending is a question of fact which has to be decided in the light of surrounding circumstances and transactions". The same case also confirmed that it is not enough to show that a taxpayer has on several occasions lent money at interest, but that there must be a certain degree of continuity and system about the transactions (ITC 957 (24 SATC 637) [at p. 638]).

To qualify as a money-lender it is requisite that he should be in the business of money-lending, i.e. one "whose business is lending money at interest" (Sentra-Oes Koöperatief Beperk v KBI (1995) [at p. 117]).

From the above it is clear that, in terms of the common law meaning, interest incurred by a taxpayer on its intra-group loans will not be deductible unless the taxpayer is in the business of money-lending.

3.5 PN 31

In terms of PN 31, interest paid on funds borrowed for purposes of lending the funds out at a higher rate of interest will, in terms of section 11(a) of the Act, be allowed as an income tax deduction on the premise that the above activity constitutes a profit making venture, i.e. the taxpayer carries on a trade of a 'money-lender'.

PN 31 further submits that the earning of interest on capital or surplus funds invested is not the 'carrying on of a trade' and that any expenditure incurred in the production of such interest should not be allowed as an income tax deduction (PN 31 therefore concurs with the common law principles highlighted above).

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However, it is SARS' practice to allow expenditure incurred in the production of the interest to the extent that it does not exceed such income. Although, strictly in terms of the law, there is no justification for this income tax deduction, the practice has developed over the years and will ostensibly be followed by SARS (PN 31).

However, it has been submitted that it cannot be safely assumed SARS will always consider himself bound by his own practice notes (De Koker, 2012). It is also generally not good policy for SARS to issue a practice note which is a departure from the provisions of the Act.

To this end it is submitted that taxpayers should rather ensure compliance to the Act and relevant common law principles, as opposed to only PN 31, and ensure that it carries on a trade and that "active steps" are taken to ensure the continuance of the taxpayer's trade.

3.6 The "money-lender test"

Over the years the SA courts have developed onerous guidelines to determine whether a person can be said to be carrying on a business as a money-lender ('the "money-lender test"'). It is submitted that if a taxpayer succeeds to order its affairs in a manner which satisfies the "money-lender test", then the full interest expenditure would be allowed as an income tax deduction (Sentra-Oes Koöperatief Beperk v KBI (1995) and Solaglass Finance Company (Pty) Ltd v CIR (1991)), as opposed to the limitation envisaged by PN 31 (the extent that the interest paid does not exceed the interest received from the borrowings). The full loss on irrecoverable loans should also be allowed as a deduction (subject to the comments later in this research assignment regarding whether or not the loss is capital in nature). The "money-lender test" will be considered in more detail below.

It follows that taxpayers must arrange their affairs to have more certainty with regards to the tax deductibility of total interest incurred on borrowings, or losses incurred on advances or loans to customers and/or group companies. Taxpayers must arrange their affairs to satisfy the "money-lender test" which deem them to be one that conducts a money-lending business comprising the making of loans and advances (similar to a banker or financier).

The decision in Solaglass Finance Company (Pty) Ltd v CIR (1991) is an important authority (if not the main one) on the “money-lender test” and requires careful consideration, particular given the negative finding of the majority on the facts. The facts of this case will therefore firstly be considered, and then the general criteria which were developed by our courts (and confirmed by this case) for a taxpayer to qualify as a money-lender, will be discussed.

3.6.1 Solaglass – summary of the facts

In this case, Plate Glass Shatterprufe Industries Limited (‘Plate Glass’) decided that there was a need for a treasury company in the group which would secure and arrange the funds required by all the companies in the group. It would also monitor the use of those funds in the hands of the subsidiaries. In order to give effect to this decision a dormant subsidiary (‘Solaglass’) was utilised. One of Solaglass’ objects, in terms of its memorandum of association, was to lend money to any person or company and to borrow such money as it deemed fit. Solaglass’ sole business consisted of borrowing moneys and utilising the moneys so acquired for making loans, albeit only to companies in the group, to staff members and customers of trading companies in the group. Certain losses were incurred by Solaglass as a result of loans having become irrecoverable. Solaglass then sought a deduction for these losses in terms of section 11(a) of the Act.

The court held that if a taxpayer can show that it has been carrying on the business of banking or money-lending, losses incurred by him as a result of loans made by him in the course of such business becoming irrecoverable, constitute losses of a non-capital nature and are accordingly deductible (Solaglass Finance Company (Pty) Ltd v CIR (1991) [at p. 14]). The court then made the distinction between a money-lender or banker on the one hand and that of an ordinary case of the lending of capital. With reference to foreign authorities, the court approved the below definition of circulating capital. The court quoted with approval [at p. 14], the foreign case Ammonia Soda Co v Chamberlain (1918), where Swinfen Eady LJ defined circulating capital [at p. 286 and 287]:

> “[Circulating capital] is a portion of the subscribed capital of the company intended to be used by being <u>temporarily parted with and circulated in business</u>, in the form of money, goods or other assets, and which, or the proceeds of which, are intended to return to the company with an increment, and are intended to be used again and

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again, and to always return with some accretion. Thus the capital with which a trader buys goods circulates; he parts with it, and with the goods bought by it, intending to receive it back again with profit arising from the resale of the goods. A banker lending money to a customer parts with his money, and thus circulates it, hoping and intending to receive it back with interest."

[Own emphasis]

On the facts of the case the court held that Solaglass utilised its capital for the purpose of its money-lending business, consequently it was not fixed, but circulating capital. Therefore, the capital which Solaglass lost as a result of being unable to recover the loans was revenue in nature and the losses in question were accordingly deductible in terms of section 11(a) of the Act (Solaglass Finance Company (Pty) Ltd v CIR (1991) [at p. 18]).

However, the court then considered the trade requirement of section 23(g) of the Act, which at the time was still cast in its restrictive mould, requiring exclusive "trade" purposes. It was therefore concluded that for the deductions claimed by Solaglass to pass the test of section 23(g) of the Act, it must be shown that the amounts of the loans made by Solaglass were wholly and exclusively laid out or expended for the purposes of trade. The majority of the court then found that on the facts, Solaglass' trading activities were geared to the achievement of a dual purpose of (1) furthering the interests of the group's subsidiaries and thus of the group itself, and (2) making a profit for Solaglass (from its money-lending business) (Solaglass Finance Company (Pty) Ltd v CIR (1991) [at p. 26]).

It was found on the facts of the case that "furthering the group's interest" was not part of its money-lending business (Solaglass Finance Company (Pty) Ltd v CIR (1991) [at p. 29]). The result was that, based on the wording of section 23(g) of the Act then in existence, the taxpayer forfeited the entire deduction.

The impact of this case with regards to losses incurred by taxpayers on irrecoverable loans will be considered in more detail in chapter 4. The discussion will now be more focussed on the "money-lender test".

3.6.2 The Solaglass summary of the "money-lender test"

The money-lender guidelines, as developed by a number of court cases, were crystallized as follows in Solaglass Finance Company (Pty) Ltd v CIR (1991) [at p. 14, 15]:

> "Whether or not a taxpayer can be said to be carrying on the business of a money-lender or banker is in each case a question of fact to be decided in the light of the circumstances of the particular case. The following are guidelines which have been laid down for the determination of the question whether a taxpayer can be said to be carrying on such a business:
>
> 1. There must be an intention to lend to all and sundry provided they are, from his point of view, eligible (SIR v Crane (1977) [at p. 198]).
> 2. The lending must be done on a system or plan which discloses a degree of continuity in laying out and getting back the capital for further use and which involves a frequent turnover of the capital (ITC 1138 (32 SATC 3) [at p. 6], ITC 812 (20 SATC 469) [at p. 473], ITC 933 (24 SATC 347) [at p. 348], and SIR v Crane (1977) [at p. 198]).
> 3. The obtaining of security is a usual, though not essential, feature of a loan made in the course of a money-lending business (ITC 999 (25 SATC 183) [at p. 186], ITC 1003 (25 SATC 237) [at p. 239]; ITC 1138 (32 SATC 3) [at p. 6]).
> 4. The fact that money has on several occasions been lent at remunerative rates of interest, is not enough to show that the business of money-lending is being carried on; there must be a certain degree of continuity and system about the transactions (ITC 812 (20 SATC 469).
> 5. The proportion of the income from loans to the total income: the smallness of the proportions cannot, however, be decisive if the other essential elements of a money-lending business exist (ITC 1138 (32 SATC 3) [at p. 6], ITC 979 (25 SATC 44) [at p. 46])."

It follows from above that whether a taxpayer is carrying on a business of money-lending by advancing loans to other group entities and customers is a question of fact. The outcome will obviously depend on the precise circumstances of the proposed business activities that the taxpayer carries on or will undertake.

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3.6.2.1 "All and sundry" test

It is submitted that the intention of the taxpayer must be to lend to "all and sundry". The taxpayer must therefore be prepared to lend to a large, very loosely defined category of persons.

It appears however, that there is a relaxation of the "all and sundry" requirement, namely that the money-lender need only lend to persons who are considered "eligible" from the money-lender's point of view, which is presumably subjective (SIR v Crane (1977) [at p. 198]). Therefore, if it were not for such a relaxation of the test, not even an ordinary bank could be a money-lender, on the basis that it is not prepared to lend to "all and sundry" in an absolute sense, as it generally only lend to "eligible" clients.

3.6.2.2 "System or plan" test

The advances or loans to group companies should be done on a "system or plan" which discloses "continuity in laying out and getting back the capital for further use and involves a frequent turnover of capital" (Solaglass Finance Company (Pty) Ltd v CIR (1991) [at p. 14, 15]).

In ITC 812 (20 SATC 469) the learned Judge Roper, J stated the following [at p. 472] in discussing the principles of money-lending:

> "A question similar to this also came before this Court in September, 1953, and we have been furnished with a copy of the judgment by Mr Justice Neser (Income Tax Appeal No 5243)... Mr Justice Neser said this:
>
> 'Whether or not the appellant is a money-lender or carries on the business of a money-lender is a question of fact and in that connection Hannan in his work, The Principles of Income Taxation, at page 165 says:
>
> '…
> The main difference between an investor and a money-lender appears to consist in the fact that the latter <u>aims at frequency of turnover of his money</u>, and for that purpose usually requires borrowers to make regular repayments on account of

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principal. This has been described as a "system or plan in laying out and getting in his money …". The question whether a money-lending business is being carried on is always a matter of fact … consequently, a person may be a money-lender even though he does not advertise or hold himself out as such.' '

In a later passage in the judgment it appears that the Court in that case considered the question whether there was any continuity or system as being an important element, as of course it is, because towards the end of the reasons for judgment the learned Judge says:

'There was no continuity or system of laying out his money, and we are of opinion that the appellant has entirely failed to establish that the loan made to "A" and the expense … were transactions entered into in the course of a money-lending business.'"

[Own emphasis]

When considering the system or plan, it actually involves how frequently the taxpayer's capital is turned over. A taxpayer should also then consider details of what needs to be transferred to it to add substance to its existence as a "money-lender", which will aid in its quest to continually turnover its capital.

Note the qualification though, that it is not enough that a person has on several occasions lent money at interest. To qualify as a money-lender, he should be in the business of money-lending. Refer to the extract in Sentra-Oes Koöperatief Beperk v KBI (1995) [at p. 117]:

"A money-lender is 'One whose business is lending money at interest'. (The Shorter Oxford English Dictionary.) Both a bank and a money-lender are in the business of dealing in money as their stock-in-trade. Whether a person is a money-lender is a question of fact. It is not enough that a person has on several occasions lent money at interest. To qualify as a money-lender it is requisite that he should be in the business of money-lending. That imports a certain degree of system and continuity

about the transactions and that he is a person who is ready and willing to lend to all and sundry if they are acceptable to him."

[Own emphasis]

3.6.2.3 "Security" test

Although the obtaining of security is not generally an essential feature of loan funding, it remains an important factor to consider (ITC 999 (25 SATC 183) [at p. 186], ITC 1003 (25 SATC 237) [at p. 239]; ITC 1138 (32 SATC 3) [at p. 6]).

3.6.2.4 "Degree of continuity" test

In ITC 812 (20 SATC 469) the learned Judge Roper, J stated the following [at p. 473] in discussing the principles of "continuity" and "system" from a money-lending perspective:

> "Now when the authors say there must be a certain degree of continuity and system about the transactions they obviously do not mean that if there is a certain degree of continuity and system then the inference follows that a business of money-lending is being carried on. The question whether there is continuity and system is only an element to be considered with the other facts of the case and the surrounding circumstances.
> In my opinion it is perfectly clear that in the present case there was a certain degree of continuity and system, but it does not follow that the appellant in this case was carrying on a money-lending business, although that is, as I have said, a factor to be considered in deciding whether in fact he was carrying on such a business.
>
> [Own emphasis]

Once again, from above, it is clear that the "degree of continuity" test is merely one element of the "money-lender test" and that a high degree of continuity and system to the loans and advances by the taxpayer should be in place to meet this element.

It follows, that agreements should be put in place to ensure a high degree of continuity, and that funds should be regularly advanced in such a manner that indicates that the

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money-lending is an integral part of the taxpayer's business. See how the Judge reached a conclusion on the matter in ITC 812 (20 SATC 469) [at p. 474]:

> "Then it appears from the passage which I quoted from Mr Justice Neser's judgment that the frequency on turnover is an important element in this question, and of course it is, and it is necessary to consider the present case from that aspect.
>
> The appellant's representative, in his argument to us, referring to this aspect of the case told us that the loans on promissory notes advanced by the appellant did not usually extend beyond one year or two years … in some cases these promissory notes have been outstanding for much longer than that. … It does not appear from the papers put before us that the appellant has had a very rapid turnover of his money in this kind of investment. It does not appear that he can have made more than three or four loans on promissory notes in any one year. The frequency of turnover in his case then was not very great."

3.6.2.5 Proportion of income from loans or advances to total income

A very high percentage of the taxpayer's income should be derived from its actively pursuing business of granting loans or advances or credit. However, the smallness cannot be decisive it other elements exist (ITC 1138 (32 SATC 3) [at p. 6], ITC 979 (25 SATC 44) [at p. 46]).

3.6.3 Conclusion of "money-lender test"

The "money-lender test" comprise of different elements, which are mere guidelines to be used in determining whether a taxpayer carries on the trade of a money-lender, or not. Although the "money-lender tests" were crystallized in Solaglass Finance Company (Pty) Ltd v CIR (1991), the learned judge Friedman AJA confirmed later in the same case [at p. 16] that the taxpayer did not satisfy all of the "money-lender tests":

> "There is no gainsaying the fact that appellant does not fall within the ambit of all the guidelines referred to above. It does not, for example, lend to all and sundry; it does not seek to obtain security for the loans which it advances; its business is not

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> structured to maximise profits. On the other hand, appellant's sole business consists of borrowing moneys and utilising the moneys so acquired for making loans, albeit only to companies in the group, to staff members and customers of trading companies in the group. This business was moreover conducted on an extensive scale."

Not all the "money-lender tests" need to be satisfied for the court to take the view that a taxpayer carry on the trade as a money-lender. The judge provided more clarification later in Solaglass Finance Company (Pty) Ltd v CIR (1991) [at p. 18] as to why it viewed the taxpayer to have carried on the business as a money-lender:

> "Subject to the self-imposed constraints under which appellant operated within the Group context, appellant's business could be described as one consisting entirely of the borrowing of money and the lending of that money at a profit. Because of these constraints, there are features of appellant's business which are not normally found in an ordinary, commercial money-lending business. *Non constat* [it does not appear], however, that the business conducted by appellant is not that of money-lending. To my mind, that is exactly what appellant is doing. In the circumstances the capital utilised by appellant for this purpose is, in my judgment, not fixed, but circulating capital. It is obtained for one purpose and one purpose only, namely that of parting with it temporarily in the form of loans, in the expectation of receiving it back with an increment in the form of interest. The capital which appellant lost as a result of being unable to recover the loans, was therefore of a revenue nature. The losses in question were accordingly deductible in terms of s 11(a)."
>
> [Own emphasis]

From above, it is concluded and submitted that the "money-lender test" is firstly a mere guideline of when companies will be viewed as money-lenders (which act as bankers or financiers). Secondly, the "money lender test" merely contains features which are normally found in an ordinary, commercial money-lending business, but (thirdly) whether or not a taxpayer can be said to be carrying on the business of a money-lender (or banker or financier), is in each case a question of fact to be decided on the circumstances of each case.

It must also be said (as a fourth point), however, that if a taxpayer satisfies all the requirements of the "money-lender test" on the facts of the specific case, then a court is likely to interpret, on the facts, that the taxpayer is carrying on the business of a money-lender (or banker or financier) (there should therefore not be too much room for the courts to deviate from this principle).

If the above "money-lender test" is satisfied, then the trade requirement of section 11 of the Act will also be satisfied. As such, the taxpayer should then qualify for a deduction on the total interest expense incurred in terms of its borrowings. In addition, should the taxpayer incur losses on irrecoverable loans during its trade as a money-lender then such expenditure should also be allowed as a deduction in terms of section 11(a) of the Act. The same analysis applies if raising fees are incurred by the money-lender.

However, our courts have previously confirmed that in the case where a taxpayer only grant loans to other group entities the taxpayer will find it more difficult to satisfy the "money-lender tests" than a taxpayer who grant loans and credit to group entities and customers (i.e. inclusive of third parties).

Solaglass Finance Company (Pty) Ltd v CIR (1991) confirmed that if a taxpayer's trading activities were geared to achievement of furthering the interest of the group's subsidiaries then this will not form part of the taxpayer's money-lending business. It follows that in the case where a taxpayer's funding transactions only comprise transactions with its group companies, it may be at risk to prove that it carries on the business of money-lending.

In addition, it will also be difficult to prove, in the above instance, that the taxpayer lends to "all and sundry", and has a "system and plan" and that there is "degree of continuity" to lending to its fellow group companies. It follows that where the taxpayer only grants funding to its fellow group companies, the burden of proof (placed on the taxpayer) will be difficult in the case where the taxpayer must prove that it is in fact carrying on a business of money-lending.

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3.7 Investment holding companies

3.7.1 Introduction

As aforementioned, in deciding whether a person is carrying on a trade our courts have held that this inquiry is a question of fact, depending on the circumstances of each case (ITC 1476 (52 STC 141) [at p. 146]). Our courts have also held that the sensible approach in deciding whether a person is carrying on a trade, is to look at the activities of the person concerned as a whole (Estate G v COT (1964)). In addition, in ITC 1802 (68 SATC 67) it was held that, in determining if the taxpayer had traded in a year, the court must look to the activities of the taxpayer and the functions performed by it.

It follows that, based on the interpretation of the above, as a first step, a company's various income generating activities should be identified, and as a second step, it should be analysed whether each activity is considered as a trading activity (or, in other words, is carrying on a trade).

Generally, in the case of investment holding companies, these companies' income generating activities can be categorised as management activities (in terms of which for example administration fee (or management fee) is received), financing activities (in terms of which interest is received) and investment activities (in terms of which mainly exempt dividend income is received).

The common law principles in respect of these activities are considered further below in order to conclude whether they are trading activities.

3.7.2 Investment activities

3.7.2.1 Common law principles

An important starting point is that courts have specifically held that carrying on a trade involves taking active steps, more than a mere watching of your investments. Our courts have explained it as follows (ITC 1476 (52 SATC 141) [at p. 148]):

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> "[T]he carrying on of a trade involves an active step – something far more than merely watching over existing investments which are not, and are not intended or expected to be, income producing during the year in question."
>
> [Own emphasis]

In an unreported case in 1978 the appellant, who derived his income mainly from interest and dividends, sought to deduct the following items of expenditure which he had incurred in watching over his investments, *viz-a-viz* bank charges, stationery, postages, telephone, secretarial fees, office rent (for a room in his flat set aside for this purpose), entertainment, travelling expenses, etc. The taxpayer contended that the expenditure in question is deductible in terms of section 11(a) of the Act as being expenditure incurred in the production of his income. In dismissing the appeal the court held that the income against which the appellant sought to deduct the expenditure was not derived from carrying on a trade and that a deduction cannot be made under section 11(a) of the Act.

The court stated in ITC 1476 (52 SATC 141) that the mere retention of investments, even if acquired when a trade was carried on, did not imply a continuance of trade.

In ITC 770 (19 SATC 216) Dowling J held [at p. 217] that:

> "A business of investment in shares in companies is a well-established occupation in the business world and in my opinion it falls under all or some of the words "trade", "business", "occupation", or "venture" used in the definition of "trade", which is obviously intended to embrace every profitable activity and which I think should be given the widest possible interpretation."
>
> [Own emphasis]

In Burgess v CIR (1993) the taxpayer sustained investment losses as a result of a short term investment scheme into which he entered during 1987. In essence the scheme required him to put up a guarantee of R425,000 for a transaction where money was borrowed from a bank and invested for a short period (one or two years) in assets such as shares. At the end of the period the assets would be realised, the bank repaid and the balance pocketed. Unfortunately the Johannesburg Stock market plummeted causing the

scheme to incur considerable losses. A portion of the losses incurred was attributable to interest amounting to R477,070 payable to the bank which was allocated to the taxpayer. The taxpayer sought to claim this interest expense as a deduction for tax purposes.

Grosskopf JA made the following comments regarding the meaning of "trade" in the context of investment holding companies in Burgess v CIR (1993) [at p. 194 to 196] (quoting with approval certain extracts from ITC 770 (19 SATC 216)):

> "The structures of the...scheme, as I set out above, were designed to achieve the commercial result of a short term gain on the investment of borrowed money with the s[a]me limitation on the extent of possible losses. <u>No part of the structures can be described as artificial. Each one was designed for a commercial purpose</u>. The expenses incurred in the cost of the bank guarantee and the interest paid...were actual expenses."

and

> "Nevertheless, it is contended, 'an "investment" of the nature in question will not, as a matter of law, and on the common cause facts amount...to the carrying out of a trade... . It is well-established that the definitions of trade, which I have quoted above, should be given a wide interpretation. In ITC 770 (1953) 19 SATC 216 at p 217 Dowling J said, dealing with the similar definition of 'trade' in Act 31 of 1941, that <u>it was obviously intended to embrace every profitable activity and...I think should be given the widest possible interpretation</u>."
>
> [Own emphasis]

From the extracts in ITC 770 (19 SATC 216) and Burgess v CIR (1993) it appear that investment activities (i.e. investments in subsidiaries) should in general bear the imprint of a trading nature on the basis that the term "trade" has to be afforded the widest possible interpretation. Such a conclusion should further be supported if the investment activities can be regarded as genuine commercial activities which should fall within the ambit of the ordinary dictionary meanings of "trade", "business" and "venture" – in this regard please refer to the ordinary meaning of these words in 3.3.1 above.

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However, based on the dictionary meanings, it has to be admitted though that the words "trade", "business" or "venture" may want activities to be of a regular, continuing or habitual nature, or for such activities to be part of a series of commercial endeavours before it may be construed as a proper "business" or "trade", and thus the "carrying on [of] a trade". So the question which arises is whether the investment activities of a passive investment holding company, against this background, may be seen as a trading activity if its activities are limited? This specific question was considered in CSARS v Tiger Oats Ltd (2003).

In CSARS v Tiger Oats Ltd (2003) it was recognised [at p. 36] that the performance of limited activities (which may generally be the case for investment holding companies) does not necessarily preclude such a company from carrying on a business:

> "The carrying on of business, no doubt usually calls for some activity on the part of whoever carries it on, though, depending on the nature of the business, the activity may be intermittent with long intervals of quiescence in between."

CSARS v Tiger Oats Ltd (2003) further distinguished the activities of an investment holding company from that of a passive investor, who is generally not considered to be carrying on of a business. Marais JA explained the court's view as follows [at p. 34 to 35]:

> "The respondent is a public company listed on the stock exchange and it proclaims its main object to be "to carry on the business of an investment holding company". That immediately negates any suggestion that the making of investments by it, if it occurs at all, will be purely collateral and unrelated to other business activities. It is to be its very raison d'etre. (Indeed, if that is not the business which it is carrying on, what, one may ask, is that business? No other is described in the memorandum and articles of association as being its main business and main object.) That, in turn, also negates the suggestion that the making of investments by it was not intended to be an "activity of a continuing nature". Any member of the public subscribing for shares in such a company would be entitled to expect, and it would be the duty of the company's board of directors to ensure, constant monitoring of the investments which the company chose to make, and appropriate action by way of new investment, further investment or disinvestment as the need arose.

> The respondent is not a mere passive investor. It is an investor which is the holding company of the subsidiaries in which it holds shares. It is in a position to control the appointment of the directors of those subsidiaries. Its own executive directors are drawn from the boards of the subsidiaries. So intimately is it involved in the affairs of the subsidiaries that it is their banker. The very appellation given to the group of companies (The Tiger Group) is reflective of its dominance. Its fortunes, and those of its shareholders are dependent upon the performance of the companies in which it has invested. Their performance is enhanced by the active participation of the respondent in their affairs by acting as their banker and providing loans which are either interest-free or bear rates of interest more favourable than could be bargained for in the market... In a very real commercial sense the respondent is thus actively involved in the business of its subsidiaries and associated companies and it is its making of investments in those companies which enables it to be actively involved."
>
> [Own emphasis]

It seems that CSARS v Tiger Oats Ltd (2003) therefore draws a fine, but very definite, line between a passive investor and an investment holding company that performs limited activities in connection with an investment – according to CSARS v Tiger Oats Ltd (2003) the latter may be regarded as carrying on business whilst the former is not.

At this point one should however give consideration to the context of CSARS v Tiger Oats Ltd (2003).

3.7.2.2 Ambit of CSARS v Tiger Oats Ltd (2003)

In CSARS v Tiger Oats Ltd (2003) the court was asked to decide whether an investment holding company was carrying on an enterprise (not "carrying on a trade") for purposes of the RSC Act (not the Income Tax Act).

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The background facts of CSARS v Tiger Oats Ltd (2003) are summarised as follows:

- The issue in CSARS v Tiger Oats Ltd (2003) was whether the taxpayer, Tiger Oats Ltd ("Tiger Oats") was liable for regional establishment levies in terms of the RSC Act on dividend income received from 1995 to 1997.

- In terms of section 12(1)(a)(ii) of the RSC Act a council was obliged to "levy and claim from – every person carrying on or deemed to be carrying on an enterprise within its region, a regional establishment levy".

- The term "enterprise" was defined in section 1 of the RSC Act to mean "any trade, business, profession or other activity of a continuing nature, whether or not carried on for the purpose of deriving a profit...".

- Tiger Oats was a public company listed on both the Johannesburg and London Stock Exchanges. It was an investment holding company in the sense that it held long-term equity investments in subsidiary and associated companies and lent money to those companies. This was also articulated by its memorandum and articles of association as its "purpose describing the main business".

- The investments of Tiger Oats comprised at the time several equity investments in subsidiary and associated companies, other investments in listed and unlisted shares, and substantial interest-free and interest bearing loans to subsidiaries and associated companies.

- Tiger Oats had no employees (other than its board of directors) and no fixed assets. Directors' fees received were derived from fees paid by subsidiary or associated companies to Tiger Oats for the services rendered by certain of its non-executive directors.

- Loans were made exclusively to subsidiary and associated companies. Such loans were intended to fund long-term working capital or capital expenditure requirements with the purpose of facilitating the efficient deployment of the capital and reserves of Tiger Oats.

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- The deployment of Tiger Oats' capital and reserves to its subsidiaries was done in accordance with annual budgets and strategic plans that took into account the company's available resources, the capital structure of the subsidiary concerned, the nature of its business and the sector in which the subsidiary operated.

- Tiger Oats did not trade in financial assets.

Tiger Oats contended that a person was only liable for the levy "in relation to an enterprise carried on by that person" so that even if certain lending and borrowing activities of the respondent constituted an enterprise, the respondent would only be liable for the levy in relation to the dividend income it received if, viewed in isolation, the making of the investments which yielded the dividends constituted the carrying on of an enterprise within the meaning of the RSC Act (CSARS v Tiger Oats Ltd (2003) [at p. 13]).

To this contention Marais JA replied as follows [at p. 32 to 33]:

> "In my view the respondent's contention that, in deciding whether it is carrying on a financial enterprise, its activities require compartmentalisation and that its acquisition of interests in other companies via shareholding must be viewed in isolation and equated with that of a citizen who merely holds a portfolio of shares as an investment and is not a share-jobber, cannot be upheld. It is conceded, and rightly so, that at least in so far as the respondent acts as banker for the group and makes interest- bearing loans to its subsidiary and associated companies it is carrying on an enterprise. But, so it is argued, that is an enterprise "separate from the long-term equity investments in the...subsidiaries" and inasmuch as the making of such latter investments is not an "activity of a continuing nature" it cannot be regarded as an enterprise within the meaning of section 1 of the Act.
>
> To my mind there is an air of commercial unreality which pervades this argument... The respondent is a public company listed on the stock exchange and it proclaims its main object to be "to carry on the business of an investment holding company". That immediately negates any suggestion that the making of investments by it...will be purely collateral and unrelated to other business activities."
>
> [Own emphasis]

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From the above it follows that the making of equity investments by a holding company and the making of loans to such companies in which it is invested should, on a whole, be viewed as part and parcel of the business carried on by that company.

Marais JA further remarked [at p. 38] as follows:

> "The obvious broad thrust of the establishment levy charging provisions is that those engaged in continuing commercial activity within the area of a regional council should contribute towards the cost of its establishment. Holding companies are familiar figures on the landscape of South African commerce and are usually so engaged. Indeed, that may well be the very reason why, in the definition of "financial enterprise" in GNR 340, the word "company" (as opposed to "person") is used in the concluding words: "or any company which carries on business as an investor of money"."

From the decision of CSARS v Tiger Oats Ltd (2003) it could be argued that if a taxpayer was seen to conduct an enterprise (or a business or a trade for that matter) the activities of that taxpayer would have come within the ambit of the RSC Act.

However, it is submitted that the breadth of the application of CSARS v Tiger Oats Ltd (2003) goes further than just RSC-legislation. Although the judgement was handed down for purposes of the RSC Act, the application is not limited to that legislation only – the judgement itself does not contain any express wording to that effect.

In addition, the court indicated that the definition of "enterprise" per the RSC Act include terms such as "trade", "business" and "profession", which is also included in the "trade" definition of the Income Tax Act. It is submitted that although the court decided whether Tiger Oats carried on an enterprise (or not) in terms of the RSC Act, the principles developed in this court case has a direct bearing on the interpretation of the "carrying on any trade" requirement on the basis that the words included in the respective definitions are the same.

Based on CSARS v Tiger Oats Ltd (2003), it could be argued that the investment in the equity shares of subsidiaries by an active holding company (as opposed to a passive

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holding company) may be viewed as the carrying on of an enterprise (or a business or trade) by that holding company.

It could further be argued from CSARS v Tiger Oats Ltd (2003) that intra-group loans by such holding company to its subsidiaries may also be regarded as the carrying on of that holding company's enterprise. As mentioned, there exists counter-arguments to the above (i.e. the money-lender test) which will be discussed later.

3.7.2.3 Active and passive businesses

In ITC 496 (12 SATC 132) the taxpayer, a holding company, carried on a retail merchant's business, and made advances to a subsidiary company, which was the owner of the premises in which the holding company was operating. The court held that the interest received by the holding company was not derived from the carrying on of a trade (ITC 496 (12 SATC 132)).

Although the financing activity of the holding company was deemed not to form part of the overall trade of the company, the case provides more clarity on how the courts view active businesses and passive businesses from the various cases it quoted with approval.

The Commissioners for Inland Revenue v The Korean Syndicate Limited (12 T.C. 196) was quoted in ITC 496 (12 SATC 132) [at p. 135] as follows:

> "ATKIN, L.J., said at page 205: 'Now I myself have no difficulty at all in coming to the conclusion that this company is in fact carrying on a business, and it carried on a business of receiving the profits from the concession, in which it still retains an interest. <u>It is true that it may be called, if you please, a passive carrying on of business, as opposed to an active carrying on of the business</u>, but I for my part think, with regard to the definition, I am not sure that it was really intended for a precise definition, but if it were so intended, I think the words would be too narrow that are used by Mr Justice ROWLATT in the case of the Commissioners for Inland Revenue v The Marine Steam Turbine Company (1920, 1.K.B. 193). At page 204 he says: '<u>The word business, however, is also used in another and a very different sense, as meaning an active occupation or profession continuously carried on, and</u>

it is in this sense that the word is used in the Act with which we are here concerned'.

Personally, if any emphasis is attached to the word "active", I think it would narrow the meaning of the word, for I see nothing to prevent a holding company, which is a very well-known method of carrying on business these days, from carrying on business. It is unnecessary to consider the effect of the Act on such companies, because it may be that they are protected in another way; but there is nothing in the Act which says that the business must be actively carried on.

I think, therefore, that this company are in fact carrying on a business and they are making profits out of the carrying on of a business, and therefore I think they were properly assessed.'"

It appears from above that the discussion regarding active businesses and passive businesses are purely academic, because the court categorically stated that there is no reference to businesses that have to be "actively" carried on.

It is submitted, however, that even though businesses do not have to be "actively" carried on, activities must be of a regular, continuing or habitual nature, or for such activities to be part of a series of commercial endeavours before it may be construed as a proper "business" or "trade", and thus the "carrying on [of] a trade" – refer to comments in 3.7.2.1. Therefore, if an investment holding company has limited trading activities (even if it is so limited to the extent that it is seen as a passive investor), but still have activities which it carries on, then its activities should be seen as the "carry on [of] a trade".

3.7.2.4 Conclusion on investment activities

It appears that there is contradicting case law on whether investment holding companies' investing activities (i.e. the mere holding of investments in subsidiary companies) could be regarded as a trading activity.

In ITC 1476 (52 SATC 141), ITC 512 (12 SATC 246) and ITC 1275 (40 SATC 197) the courts viewed that investment holding companies cannot be "carrying on any trade", but in ITC 770 (19 SATC 216) the exact opposite was submitted by our courts, stating [at p. 217] that "a business of investment in shares in companies is a well-established occupation in the business world …". This view was then confirmed by Burgess v CIR (1993).

There is therefore very good authority that the investment activities by investment holding companies should be seen as trading in nature on the basis that the term "trade" has to be afforded its widest possible interpretation.

Whether or not the investment activities of an investment holding company may be seen as a trading activity if its activities are limited (i.e. when the company does not actively sell and acquire investments since the deductibility requirement is "carrying on a trade" as opposed to just "trade") is the next question to be answered.

This was considered in CSARS v Tiger Oats Ltd (2003). In this case it was recognised that the performance of limited activities (which may generally be the case for investment holding companies) does not necessarily preclude such a company from carrying on a business. This case may be used as authority to argue that the investment in the equity shares of subsidiaries by an investment holding company may be viewed as the "carrying on [of] a trade" by that holding company. ITC 496 (12 SATC 132) further clarified the usage of the term "passive carrying on of a business" on the one hand and the "active carrying on of a business" on the other hand. ITC 496 (12 SATC 132) confirmed that although the word "active" would narrow the meaning of the word "business", limited activities of investment holding companies should not prevent a holding company to be deemed to carry on a business.

From the facts of CSARS v Tiger Oats Ltd (2003), it could also be argued that intra-group loans by an investment holding company to its subsidiaries may also be regarded as the carrying on of that holding company's enterprise (or business, or trade). It follows that the question is whether the earning of interest on loans made to its subsidiary by an investment holding company, where that holding company is not a bank or a financier, may be viewed as a trading activity. Or is it only loans made by bankers and financiers which may be viewed as trading activities, i.e. money-lenders? This appears to be at odds with what the court said in CSARS v Tiger Oats Ltd (2003).

In terms of an alternative view, it will be further considered whether the question is not merely whether the investment holding company is a money-lender or a financier, but rather whether loans made by an investment holding company to its subsidiaries may be viewed as part of the investment activities of the holding company into its subsidiaries

(Surtees, 2006 at p. 58). In other words, may it be said that loans by investment holding companies to their subsidiaries may be viewed in a very real commercial sense as an active participation on the part of the holding company in the affairs of its subsidiaries?

Therefore, it is arguable that loans made by investment holding companies to their subsidiaries fall within the ambit of, and may even be equated to, the trade carried on by the investment holding company in terms of its investment activities on the basis that such loans constitute an active participation by the holding company in the affairs of its subsidiary (Surtees, 2006 at p. 59).

Loans by an investment holding company to fund the activities of its subsidiaries may not necessarily be seen as carrying on a trade in terms of the "money-lender test". However, such activities may still constitute a trade carried on by an investment holding company on the basis that these loans may be viewed as an active commercial participation by an investment holding company in the affairs of its subsidiaries. Consequently, there is a strong argument that the 'trade' requirement will then be satisfied in this instance. It follows that the interest- and other finance related expenditure will be fully deductible if the other requirements of section 11(a) or 24J(2) of the Act are met.

3.7.3 Financing activity

3.7.3.1 Interest from bank deposits

There is specific case law to support that, where a person accumulates his savings and invests them in interest-bearing securities or shares held as assets of a capital nature, the income derived from such activities are not from carrying on any trade (ITC 512 (12 SATC 246) and ITC 1275 (40 SATC 197)).

On this basis it would appear unlikely that an investment holding company's financing activity, in instances where it comprises deriving interest purely from bank deposits, would qualify as "carrying on [of] a trade".

SARS has, however, stated in PN 31 that, whilst 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

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allowed as a deduction, it is nevertheless the practice of SARS to allow expenditure incurred in the production of the interest to the extent that it does not exceed such income.

3.7.3.2 Interest on loans to subsidiaries

Following from the above, the question is whether the earning of interest on loans made to its subsidiary by an investment holding company, where that holding company is not a bank or a financier, may be viewed as a trading activity? Or is it only loans made by bankers and financiers which may be viewed as trading activities?

The court held in ITC 957 (24 SATC 637) that interest earned on loans made by it to certain of its shareholders could not show, on the facts of the case, that it was carrying on the business of money-lending, and it was held [at p. 639] that the interest received was not derived from the carrying on of a trade. It was further confirmed [at p. 638] that "whether a person carries on a business of money-lending is a question of fact which has to be decided in the light of surrounding circumstances and transactions".

The question whether a person is a moneylender has been considered by our courts in a number of cases. One such case is Sentra-Oes Koöperatief Beperk v KBI (1995) where the court held [at p. 117] that:

> "Whether a person is a money-lender is a question of fact. It is not enough that a person has on several occasions lent money at interest. To satisfy as a money-lender it is requisite that he should be in the business of money-lending.
>
> <u>A money-lender is 'One whose business is lending money at interest'</u>. (The Short Oxford English Dictionary). Both a bank and a money-lender are in the business of dealing in money as their stock-in-trade."
>
> [Own emphasis]

It appears that the principle flowing from Sentra-Oes Koöperatief Beperk v KBI (1995) is that loans made by investment holding companies to their subsidiaries will only be viewed as a trade if that investment holding company is a banker or a financier; or if such loans

are stock-in-trade in the hands of the investment holding company. This appears to be at odds with what the court said in CSARS v Tiger Oats Ltd (2003).

In terms of an alternative view, it is submitted that this is not the case with regards to investment holding companies. The question is not whether the investment holding company is a moneylender or a financier - that answer should generally undoubtedly be "no". The question is rather whether loans made by an investment holding company to its subsidiaries may be viewed as part of the investment activities of the holding company into its subsidiaries (as opposed to form part of its financing activities). Can it be said that loans by investment holding companies to their subsidiaries may be viewed in a very real commercial sense as an active participation on the part of the holding company in the affairs of its subsidiaries?

In terms of the alternative view, it is arguable that loans made by investment holding companies to their subsidiaries fall within the ambit of, and may even be equated to, the trade carried on by the investment holding company on the basis that such loans constitute an active participation by the holding company in the affairs of the subsidiary. In this regard Marais JA said in CSARS v Tiger Oats Ltd (2003) [at p. 35] that:

> "Their performance is enhanced by the active participation of the respondent in their affairs by acting as their banker and providing loans which are either interest-free or bear rates of interest more favourable than could be bargained for in the market... <u>In a very real commercial sense the respondent is thus actively involved in the business of its subsidiaries and associated companies and it is its making of investments in those companies which enables it to be actively involved</u>."
>
> [Own emphasis]

Loans granted by an investment holding company to fund the activities of its subsidiaries may not necessarily be seen as carrying on a trade in terms of the "money-lender test". However, such activities may still constitute a trade carried on by the investment holding company on the basis that these loans may be viewed as an active commercial participation by the investment holding company in the affairs of its subsidiaries.

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3.7.4 The evidence of trading activities by investment holding companies

3.7.4.1 ITC 11329 (2010)

As aforementioned, and as an introduction to this section, in CSARS v Tiger Oats Ltd (2003) the court found that (Surtees, 2006 [at p. 58]):

> "…the taxpayer, the holding company of its operational subsidiaries, was 'no mere passive investor' but 'in a very real commercial sense was actively involved in the business of its operating subsidiaries and associated companies' (par [35] at 614), despite the fact that the holding company did not buy, sell or manufacture goods or provided services for gain."

The taxpayer in ITC 11329 (2010), a case considered in 2005 by the Johannesburg Tax Court, sought to apply the principles in CSARS v Tiger Oats Ltd (2003) in its quest to prove that it carried on a trade in terms of section 11 and section 20 of the Act (section 20 was considered, because SARS cancelled the taxpayer's assessed loss) for its 2001 year of assessment. It is therefore an important case to consider when determining the practicalities when taxpayers try to prove that the activities carried on by an investment holding company (from both an investment and financing perspective) bears the imprint of a trading nature.

The court in ITC 11329 (2010) highlighted important facts from CSARS v Tiger Oats Ltd (2003). It was submitted that these facts were important drivers to reach the conclusion that Tiger Oats was carrying on a business at the time (ITC 11329 (2010) [at p. 18]):

> "…the taxpayer was "no mere passive investor" and "in a very real commercial sense was actively involved in the business of its operating subsidiaries and associated companies". One need only look at the facts of that case for the distinction between the taxpayer in that case and the taxpayer before us to be startlingly obvious. That holding company had <u>equity investments in both subsidiaries and associated companies</u>; it <u>drew some of its non-executive directors from the boards of the subsidiary and associated companies</u>; it <u>held other investments in both listed and unlisted shares</u>; in <u>the period under consideration the taxpayer had substantially increased it's loans to its subsidiaries</u>; <u>income was</u>

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received on the loans to subsidiaries and associate companies and by way of cash balances with banks; it operated bank accounts in it's own name; it had no employees but paid management fees in respect of management services provided to it's operating subsidiaries and associated companies; deployment of the taxpayer's capital and reserves to it's subsidiaries were managed in accordance with annual budgets and strategic plans and so on and so on."

[Own emphasis]

In determining which drivers the court in ITC 11329 (2010) considered for the taxpayer to be seen as carrying on a trade, Surtees (2006) summarised it as follows in his article [at p. 59]:

"In considering whether *Tiger Oats* applied to the taxpayer, the court held that being a holding company did not in itself constitute carrying on a trade. One must rather look at —

- the activities performed by the taxpayer;
- the functions it performs;
- the impact of any such activities on the activities of its subsidiaries;
- the nature of its expenditure and income; and
- any benefit derived by the group from the taxpayer's activities."

This is confirmed as follows in ITC 11329 (2010) [at p. 11]:

"It is trite that the proof of the pudding is in the eating. This court must look to the activities of the taxpayer, the functions performed by the taxpayer, the impact which any such activities of the taxpayer had on the activities of it's subsidiaries to determine whether or not the taxpayer can be said to have been carrying on 'trade' of it's own accord."

3.7.4.2 Lessons to learn from ITC 11329 (2010)

In order to delve into the detail of the important factors (or drivers) that courts will consider when interpreting whether a specific taxpayer (in the investment holding company context)

carries on a trade, ITC 11329 (2010) must be considered in more detail. The following facts were highlighted by the court in ITC 11329 (2010):

General

There was no bank account in the name of the taxpayer, erratic interest was received from subsidiaries over the years, no dividends were declared by the holding company, and no loans were granted by the taxpayer to any of its subsidiaries in most of the years preceding the year of assessment under consideration, including that year of assessment (ITC 11329 (2010) [at p. 10]).

Listing of the taxpayer

It was contended by the taxpayer that the listing of the taxpayer on Johannesburg Stock Exchange ("JSE") was for the benefit of the taxpayers and its subsidiaries, but the court contended that the "mere fact of 'keeping itself alive' cannot constitute 'trade'" (ITC 11329 (2010) [at p. 12]).

Annual general meetings

The court also stated that the holding of annual general meetings, appointment of directors, to ensure that annual financial statements are signed, and to ensure that directors and auditors are appropriately remunerated "constitutes no more than ensuring that the taxpayer did not become statutorily moribund" (ITC 11329 (2010) [at p. 12]).

It follows that these activities were merely compliance activities, as opposed to be trading activities.

Supervision of affairs and activities of subsidiaries

It appears that the best argument that the taxpayer made to prove that it supervised the affairs and activities of its subsidiaries, was with regards to submitting to the court that it had seconded directors to its subsidiary companies. It was submitted to the court that the directors' task and responsibilities were to report back from the subsidiary company to the

taxpayer. However, the taxpayer could not prove this contention at all. The court made the following devastating remarks in this regard (ITC 11329 (2010) [at p. 13]):

> "There is <u>no evidence as to the cross-fertilisation (if any) between the taxpayer and the subsidiaries in the year under review</u>. The directors of the subsidiaries in 2001 are unknown to us. Finally, there is no evidence at all as to the purpose for which any directors were ever seconded, if indeed they were. The fiduciary responsibilities of the directors of the subsidiaries, whoever they might have been, were to those companies of which they were directors. This court would, of course, accept that subsidiary and group interests would usually coincide."
>
> [Own emphasis]

It appeared from the case and per the words of Surtees (2006) [at p. 59] that "such secondment could be an indicator that the influence of the holding company in its subsidiaries constituted a trade". This is based on what the court stated in CSARS v Tiger Oats Ltd (2003) that the investment holding company "directly or indirectly" utilised its investments to exert a "significant influence". Unfortunately for the taxpayer in ITC 11329 (2010), it could not prove such influence in its subsidiaries.

Another contention made by the taxpayer was that "the taxpayer, as holding company, took [board] decisions which filtered down to the benefit of the subsidiaries" (ITC 11329 (2010) [at p. 13]). Once again the taxpayer could not prove these board decisions by submitting appropriate board minutes for its 2001 year of assessment.

An important lesson in this regard was that although the taxpayer was able to prove that these decisions were made in 1998, it could not prove the same for the 2001 year of assessment. The court categorically stated that it "cannot infer that what was done in 1998 must in all likelihood have been performed in 2001" (ITC 11329 (2010) [at p. 14]).

Again, per Surtees (2006) [at p. 59], if the taxpayer was able to prove that these decisions were in fact made, "such decisions could have established the existence of a trade by the taxpayer…" This is confirmed by the court as follows (ITC 11329 (2010) [at p. 15]):

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> "However, it may well be, though we do not need to decide this point, that these 1998 discussions did proceed beyond the mere formulation of intentions and did fall within the ambit of carrying on a 'trade' in the 1998 financial year."

Financing activities

With regards to the financing activities carried on by the taxpayer, the court made some very important statements to determine how a court may view these activities in the future, and the type of activities that should be present to deem an investment holding company to carry on a trade through its financing activities. From the outset, the court indicated that the taxpayer only made loans to two of its subsidiaries, and these loans were mainly granted before 1998. It follows that from the 1998 year, there were no real changes to these loans and there remained an "ongoing indebtedness to the taxpayer" (ITC 11329 (2010) [at p. 15]), which lead to no further actions on the part of the taxpayer.

The court continued further by quoting with approval Burman v CIR (1991) when it considered the true nature of an inter-company loan by a holding company to its subsidiary (ITC 11329 (2010) [at p. 16]):

> "After discussing the position of a shareholder with a loan account *vis-à-vis* the company, it was stated: 'Even though it is not permanent capital, a member's loan is therefore a contribution to the capital of the company, and in a real, economic sense such loan is a component, together with his shareholding, of the member's interest in the company'. That may well be the situation in the present case, but it does not mean that the holding company , qua shareholder, may not have engaged in real and active endeavour pertaining to such loan. It just means that this taxpayer should not attempt to rely on it's continuing loan and therefore investment in the subsidiaries to constitute activity in a non-loan financial year."
>
> [Own emphasis]

The court therefore found on the facts of the case that the taxpayer did not carry on a trade through its financing activities due to, plainly stating, its lack of activities in this regard. The court highlighted the following factors in ITC 11329 (2010) [at p. 16 and 17],

which should be considered by other investment holding companies when seeking to prove the existence of a trade:

- No further funding was obtained elsewhere, including other types of funding such as issue of shares, or raising loans from external sources during the 2001 year;
- There was “no evidence that loans were contemplated, negotiated, arranged, or concluded for or on behalf of the subsidiaries during the 2001 tax year”;
- There was no supporting documentation / information to prove that the terms and conditions of the intra-group loans “occupied the mind of or resulted in any action on the part of the taxpayer” during the year of assessment. The court however highlighted the need for an “active step to constitute ‘trade’” as opposed to “merely watching over existing investments”; and
- There was no evidence of interest policies or terms of repayments with regards to the intra-group loans.

3.7.4.3 Trade conducted through the investment holding company’s subsidiaries

Very importantly, ITC 11329 (2010) [at p. 17] confirmed the principle as set out in Smith v Anderson (1879) and CSARS v Tiger Oats Ltd (2003) that a taxpayer can trade through other entities.

> “We do not doubt that it is both possible and permissible for this taxpayer to have carried out ‘trade’ through the medium of it’s subsidiaries. The question is whether or not it actually so did. Whether and to what extent the carrying on of ‘trade’ could be attributed to the taxpayer would depend upon the link between it and it’s subsidiaries and the nature of the arrangements made.”
>
> [Own emphasis]

The court then found that the taxpayer could not establish the link between it and its subsidiaries, and in determining this, the court relied heavily on the principles set out in

CSARS v Tiger Oats Ltd (2003). The court stated that “none of the Tiger Oats activities were shown to have been performed for or on behalf of the taxpayer during the 2001 financial year” (ITC 11329 (2010) [at p. 19]). It then continued by reaffirming the following (ITC 11329 (2010) [at p. 19]):

> “This apparent inactivity of the taxpayer is compounded by the fact that it had no banking accounts with commercial institutions in it’s own name. No monies passed through it’s hands for funding it’s subsidiaries, financing it’s own activities, meeting administration costs or remunerating its directors.”

3.7.4.4 Conclusion

As a concluding remark, it is submitted that the principles in CSARS v Tiger Oats Ltd (2003) with regards to investment holding companies are applicable, and actually, very relevant when determining (1) the trading nature of investment holding companies, and (2) to determine whether the financing activities may be linked to the trade of the investment holding company. These principles were confirmed by ITC 11329 (2010).

However, to highlight again the important extract in ITC 1476 (52 SATC 141):

> “In deciding whether a taxpayer is carrying on a trade our courts have held this inquiry is a question of fact, to be decided on the circumstances of each case”.

It follows then that although the principles laid out by our courts are clear and sound in determining whether investment holding companies carry on a trade, and to link the financing activities to the investment holding company’s trade, it remains up to the taxpayer to prove that this was in fact the case. Taxpayers should guard against trying to retrospectively prove that a trade was carried on (as what appears, with respect, to be the case in ITC 11329 (2010)). It is submitted that taxpayers should rather ensure that there affairs are properly arranged from when trade commences, with proper supporting documentation proving the same.

In ITC 11329 (2010) the court concluded as follows [at p. 20 and 21]:

> "This full court can only conclude that the taxpayer has not evidenced, during the 2001 year of assessment under review, any indication of the 'controlling mind' to which reference was made in Solaglass supra. We have nothing before us, not even passivity. There is no evidence of any activity of a continuing nature pertaining to the loans made some years previously by way of monitoring those investments and there were certainly no further investments or disinvestments. There is no evidence of involvement in the affairs of the subsidiaries during 2001. We have no knowledge of the appointment of the directors of those subsidiaries or of any appointment from those companies to the taxpayer during the year under review. We cannot find any control or dominance exercised over the subsidiaries. There is no evidence of strategic management or direction of policy formulated by the taxpayer which was implemented by the subsidiaries. We have no knowledge of any facilitation by the taxpayer of any of the activities of the subsidiaries in any of the spheres of human resources, production, management, financing, administration or elsewhere. Nor do we have knowledge of any activity of the taxpayer conducted on it's own account."
>
> [Own emphasis]

In concluding on the principles that should be in place when an investment holding company would like to prove that it carries on a trade for tax purposes, it is submitted that the following should be considered and backed-up by substantial evidence:

- The specific activities performed by the taxpayer should be documented in its articles of association, minutes of meetings and other documentation. Documentation should be as detailed as possible.

- The functions the taxpayer performs must once again be documented in detail in relevant documentation, such as shareholder agreements, management agreements, loan agreements and minutes of meetings.

- The impact that of any of the above activities and functions have on the activities of its subsidiaries should also be documented in minutes of meetings and other supporting

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documentation. In this regard, minutes of meetings and other documentation of the subsidiary company should also reflect the impact of decisions that were made by the holding company.

- Continuing activities relating to the granting of loans to subsidiaries, including the continual review of terms and conditions, interest policies, and considering other financing options. These decisions and thought processes must be documented in minutes of meetings and other supporting documentation.

- The nature of its expenditure and income, especially if it was derived or incurred in the production of income – see the comments later in this research assignment; and

- Any benefit derived by the group from the taxpayer's activities must be clearly documented and proved.

3.7.5 Management activity

It could possibly be argued that the management activities of an investment holding company is of an active nature based on the ongoing and frequent activities carried on by its subsidiaries' employees and partly its directors (for which a director's fee is paid) in providing services to the investment holding company's subsidiaries. These services typically include acting on behalf of the investment holding company's subsidiaries in its capacity as a listed entity (in the case when the company is part of a listed group), standing in guarantor for subsidiary companies to obtain favourable borrowing terms from third party financiers, etc. Administration fees are then received in return for rendering these services to subsidiaries.

Due to the active nature of this activity, it is generally assumed that the activity qualifies as a trading activity. This research assignment will however not discuss whether it is a trading activity, or not, in any further detail as it is not the focus of the research assignment.

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3.8 Conclusion

It is submitted in this research assignment that from a grammatical point of view it emerges that there is very little difference between the terms “trade”, “business”, “venture” and “enterprise”. Therefore, if someone is “carrying on a business”, it may also be said that such a person is “carrying on a trade” or “involved in an enterprise” or “has undertaken a venture”.

It was further submitted that the concept of “carrying on a trade” arguably has a wide meaning and it should at the very least be a “continual activity” of the taxpayer’s “trade”.

The purpose of this chapter was to determine whether an investment holding company must satisfy the guidelines of the “money-lender test” to determine whether it carries on a trade for tax purposes, or whether it could follow the guidelines and principles laid out by our court in CSARS v Tiger Oats Ltd (2003).

On the one hand, it is concluded and submitted that the “money-lender test” is a mere guideline of when companies will be viewed as money-lenders (which act as bankers or financiers). The “money lender test” also merely contains features which are normally found in an ordinary, commercial money-lending business, but whether or not a taxpayer can be said to be carrying on the business of a money-lender (or banker or financier), is in each case a question of fact to be decided on the circumstances of each case.

It was further submitted that in the case where a taxpayer’s funding transactions only comprise transactions with its group companies (like in the case with investment holding companies), it may be at risk to prove that it carries on the business of money-lending.

It must be said though, that if a taxpayer satisfies all the requirements of the “money-lender test” on the facts of the specific case, then a court is likely to interpret, on the facts, that the taxpayer is carrying on the business of a money-lender (or banker or financier), and then the trade requirement of section 11 of the Act will also be satisfied. If so, the taxpayer should qualify for a deduction on the total interest expense incurred in terms of its borrowings. Should the taxpayer incur losses on irrecoverable loans during its trade as a money-lender then such expenditure should also be allowed as a deduction in terms of

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section 11(a) of the Act. The same analysis applies if raising fees are incurred by the money-lender.

On the other hand, with regards to investment holding companies, it appears that there is contradicting case law on whether investment holding companies' investing activities (i.e. the mere holding of investments in subsidiary companies) could be regarded as a trading activity. However, when it is considered in more detail, there is enough proof that the investment activities could be regarded as a trading activity (ITC 770 (19 SATC 216), Burgess v CIR (1993), CSARS v Tiger Oats Ltd (2003) and ITC 11329 (2010)).

In CSARS v Tiger Oats Ltd (2003) it was recognised that the performance of limited activities (which may generally be the case for investment holding companies) does not preclude such a company from carrying on a business. This case may be used as authority to argue that the investment in the equity shares of subsidiaries by an investment holding company may be viewed as the "carrying on [of] a trade" by that holding company.

From the facts of CSARS v Tiger Oats Ltd (2003), it could also be argued that intra-group loans by an investment holding company to its subsidiaries may also be regarded as the carrying on of that holding company's enterprise (or business, or trade). This was confirmed by ITC 11329 (2010).

It follows that loans by an investment holding company to fund the activities of its subsidiaries may not necessarily be seen as carrying on a trade in terms of the "money-lender test". However, such activities may still constitute a trade carried on by an investment holding company on the basis that these loans may be viewed as an active commercial participation by an investment holding company in the affairs of its subsidiaries. Consequently, there is a strong argument that the 'trade' requirement will then be satisfied in this instance. It follows that the interest- and other finance related expenditure will be fully deductible if the other requirements of section 11(a) or 24J(2) of the Act are met – see the comments with regards to this later in the research assignment.

It must be noted that although the principles laid out by our courts are clear and sound in determining whether investment holding companies carry on a trade, and to link the financing activities to the investment holding company's trade, it remains up to the taxpayer to prove that this was in fact the case. It is submitted that taxpayers should

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rather ensure that there affairs are properly arranged from when trade commences, with proper supporting documentation proving the same.

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CHAPTER 4

The deductibility of expenditure incurred by money-lenders and investment holding companies

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CHAPTER 4

The deductibility of expenditure incurred by money-lenders and investment holding companies

4.1 Introduction

One of the objectives of this research assignment is to conduct a critical analysis of the deductibility of (typical) expenditure incurred by money-lenders and investment holding companies. These expenses include, *inter alia*, interest expenditure, raising fees and losses on irrecoverable loans.

As discussed in chapter 2, the deductibility of raising fees and losses on irrecoverable loans should be considered in terms of the general deduction formula contained in section 11(a), read with section 23(f) and 23(g), of the Act. However, when the deductibility of interest expenditure is considered, the principles prescribed by section 24J of the Act must be regarded as governing the point.

In summarising the requirements for expenditure to be deductible for tax purposes, both the trade– and the in production of income requirements must be satisfied to deduct interest and other expenditure (i.e. raising fees and losses on irrecoverable loans) in terms of section 11(a) and section 24J(2) of the Act.

The capital requirement only needs to be satisfied for purposes of deducting raising fees and losses on irrecoverable loans in terms of section 11(a) of the Act. Interest expenditure is not subject to the capital requirement in terms of section 24J(2) of the Act.

The requirement that expenditure or losses must be actually incurred during the year of assessment will not be considered in detail in this research assignment. It will be assumed that all expenditure (irrespective of whether the expenditure comprise interest or not) will be incurred for income tax purposes.

4.2 The trade requirement

As discussed in chapter 3, to determine whether a money-lender carries on a trade, the money-lender should consider whether it satisfies the “money-lender test”. If a taxpayer

satisfies all the requirements of the "money-lender test" on the facts of the specific case, then a court is likely to interpret, on the facts, that the taxpayer is carrying on a trade of a money-lender (or banker or financier). If the above "money-lender test" is satisfied, then the trade requirement of section 11 of the Act will also be satisfied.

With regards to investment holding companies, chapter 3 submitted that there is sufficient support in case law that the investment activities of an investment holding company could be regarded as a trading activity. It was further submitted that although loans by an investment holding company to fund the activities of its subsidiaries may not necessarily be seen as carrying on a trade in terms of the "money-lender test", it will constitute a trade on the basis that these loans may be viewed as an active commercial participation by an investment holding company in the affairs of its subsidiaries. Consequently, the trade requirement of section 11 of the Act will also be satisfied.

Once it is established that a trade does exist, the money-lender and investment holding company should determine whether it satisfies the other requirements of section 11(a) or section 24J(2) of the Act to obtain a tax deduction for interest, raising fees and/or losses on irrecoverable loans.

Please refer to the below analysis of the in production of income requirement (for interest, raising fees and/or losses on irrecoverable loans) and the capital requirement (for raising fees and/or losses on irrecoverable loans, i.e. all expenditure except interest).

4.3 In the production of income requirement

The term 'in the production of income' is not defined in the Act. Consideration should therefore be given to the meaning the courts have ascribed to this term.

4.3.1 Common law principles

Income is generally produced by the performance of a series of acts and attendant upon them are expenses. To determine whether expenditure is incurred in the production of income, the purpose of the act necessitating the expenditure must be considered. If the act is performed for the purpose of earning income then the expenditure attendant upon it is deductible. See Port Elizabeth Electric Tramway Co Ltd v CIR (1936) [at p. 16]:

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> "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.
>
> 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. Now, at first sight, it would appear that only acts necessary to earn the income and expenditure necessarily attendant upon such acts should be deducted; but this is not so. As pointed out above, businesses are conducted by different persons in different ways. The purpose of the act entailing expenditure must be looked to. If it is performed for the purpose of earning income, then the expenditure attendant upon it is deductible."
>
> [Own emphasis]

Therefore, in deciding whether expenditure is incurred in the production of income, one must identify the act(s) that produces the income and consider the closeness of the connection between the expenditure and the act. It follows that for expenditure to be deductible there should be a causal link between the expenditure and the expenditure transaction; between the expenditure transaction and the income act; and between the income act and the income intended to be produced. In summary, this effectively requires a causal link between the expenditure incurred and the income the taxpayer intends to produce.

The causal link can be determined by assessing 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 affects. See CIR v Genn & Co (Pty) Ltd (1955) [at p. 121]:

> "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."

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The court continued in Port Elizabeth Electric Tramway Co Ltd v CIR (1936) [at p. 17] as follows:

> "The other question is, what attendant expenses can be deducted? How closely must they be linked to the business operation? Here, in my opinion, all expenses attached to the performance of a business operation bona fide performed for the purpose of earning 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."
>
> [Own emphasis]

It follows that expenses attached to the performance of a business operation which is *bona fide* performed for the purpose of earning income are deductible where such expenses are (Port Elizabeth Electric Tramway Co Ltd v CIR (1936) [at p. 17]):

- necessary for its performance;
- attached to it by chance; or
- *bona fide* incurred for the more efficient performance of such operation.

The expenditure must be so closely connected with the business operation of the taxpayer that they may be regarded as part of the cost of performing it. The court clarified in CIR v Genn & Co (Pty) Ltd (1955) that if it is proper, natural or reasonable in the circumstances of the particular case to regard expenses as part of the cost of performing a business operation(s), the expenses would be incurred in the production of income. See the extract in CIR v Genn & Co (Pty) Ltd (1955) [at p. 120]:

> "If I am right in understanding the words 'they may be regarded' as connoting that it would be proper, natural or reasonable to regard the expenses as part of the cost of performing the operation this passage seems to state the approach to such questions correctly. Whether the closeness of the connection would properly, naturally or reasonably lead to such treatment of the expenses must remain dependent on the court's view of the circumstances of the case before it."

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It is therefore necessary to have regard to the purpose of the expenditure and to what it actually effects. The next step, however, is to consider whether the expenses are incurred in respect of 'income' as defined.

Section 1 of the Act defines the term "income" as follows:

> "*'income'* means 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 under Part I of Chapter II;"
>
> [Own emphasis]

Essentially, it means that 'income' is defined to mean 'gross income' (as defined) less exempt income.

'Gross income' is defined in section 1 of the Act (for resident taxpayers in general) as the total amount received by or accrued to or in favour of such resident excluding receipts or accruals of a capital nature. The definition also continues further, and include other amounts (whether of a capital nature or not).

Part 1 of Chapter II of the Act comprises section 5 to section 37G. The sections in Part 1 of Chapter II that deals with exemptions include *inter alia* sections 10, 10A, 10B and 10C. It follows that any amounts exempted in terms of sections 10, 10A, 10B or 10C of the Act, will not constitute 'income' as defined.

For example, dividend income received by a taxpayer should be exempt from normal tax, therefore not constitute 'income' as defined. Any expenses incurred in respect of dividend income will therefore not be allowed as an income tax deduction, on the premise that it is not in the production of income. This also concurs with the working of section 23(f) of the Act.

However, interest income derived by the money-lender or the investment holding company from the granting of intra-group loans to its subsidiaries will constitute 'income' as interest is not exempt from taxation. Any expenses incurred in the production of interest income

by the taxpayer, will therefore be allowed as an income tax deduction, on the basis that the expenditure is so closely linked to the act that is performed for the purpose of earning the interest income.

4.3.2 Application to money-lenders

Interest, raising fees and losses on irrecoverable loans incurred by a money-lender to obtain, for example, a loan from a bank, will be closely linked to the interest income it derives from the on-lend of the funds to its subsidiary.

The act of obtaining finance is a necessary act in a money-lender's trade in order to be in a position to grant intra-group loans to its subsidiaries. Therefore, the expenditure relating to the act of obtaining finance is regarded to be very closely connected to the business operation of the money-lender.

Expenditure such as interest, raising fees and losses on irrecoverable loans are types of expenditure that are commonly incurred by taxpayers that carry on a trade of a money-lender, or banker, or financier. It is proper, natural or reasonable to expect that taxpayers such as money-lenders will incur these types of costs. Thus, it is reasonable to regard these expenses as part of the cost of performing the trade of a money-lender. It follows that there is a sufficiently close link between these expenses and the activities that give rise to the money-lender's interest income.

It is therefore submitted that interest, raising fees and losses on irrecoverable loans are expenditure incurred in the production of the money-lender's interest income. These type of expenditure therefore satisfies the 'in production of income' requirement of section 11(a) and section 24J(2) of the Act.

4.3.3 Application to investment holding companies

Expenditure such as interest, raising fees and losses on irrecoverable loans are also expenditure that would be incurred by an investment holding company when obtaining, for example, a loan from a bank, in order to finance its financing activities. It follows that to the extent that these funds are acquired for its financing activities, it will be closely linked to the interest income it derives from the on-lend of the funds to its subsidiary.

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It follows that the comments in 4.3.2 are also applicable when the investment holding company's financing activities are considered. It follows that it is proper, natural or reasonable to expect that taxpayers such as an investment holding company in its trade of granting loans to intra-group companies will incur costs such as interest, raising fees and losses on irrecoverable loans. Thus, it is reasonable to regard these expenses as part of the cost of performing the financing activities of an investment holding company and that there is a sufficiently close link between these expenses and the financing activities that give rise to the investment holding company's interest income.

However, to the extent that such expenditure are incurred in respect of obtaining funds which are used to acquire new investments, the expenditure will not be linked to deriving interest, but in fact will be incurred to derive exempt dividend income. It will therefore not be in the production of income.

A further point to consider is section 23(f) of the Act, which states the following:

> "No deductions shall in any case be made in respect of the following matters, namely—
>
> (f) any expenses incurred in respect of any amounts received or accrued which do not constitute income as defined in section one;"

Section 23(f) of the Act specifically prohibits the deductions of expenditure incurred in respect of amounts that do not constitute income. As aforementioned, where an investment holding company receives a substantial amount of dividend income, which is exempt from taxation, as opposed to income as defined (for example interest), it is necessary to determine whether the expenditure was incurred to produce income, or exempt dividend income.

The same test for determining whether expenditure was incurred to produce income applies to expenditure incurred to produce exempt income. When considering whether moneys outlaid by the taxpayer constitute expenses incurred in respect of amounts received or accrued which do not constitute income as defined (exempt income), one must assess the closeness of the connection between the expenses incurred and the exempt income received or accrued (CIR v Nemojim (Pty) Ltd (1983)). Therefore there must be a

causal link between the expenses and exempt income. Again, the purpose of the income act needs to be determined.

The reason why section 23(f) of the Act is so important is that the working of the section allows for the apportionment of expenses between (taxable) income and exempt income (De Koker, 2012). In instances where taxpayers receive a substantial amount of dividend income the question of the apportionment of expenses arises.

Expenditure incurred by taxpayers (including investment holding companies) will generally be categorised in three ways (De Koker, 2012):

- Expenses incurred directly in the production of exempt income, such as dividends derived from its investing activities. Such expenditure is not deductible.

- Expenses incurred directly in the production of (taxable) income, such as interest income derived from its financing activities. These are deductible in full, subject to the other requirements of the general deduction formula.

- Other or general expenses which cannot be linked directly with any particular type of income, or are causally linked to both types of income and no one connection is more dominant than the other. These expenses must be apportioned (De Koker, 2012).

Where expenditure that may be causally linked to both types of income exists, it is necessary to apportion in order to calculate the allowable deduction. While the Act does not specifically cater for apportionment or any particular method thereof, apportionment is recognised by the courts (for example in Mobile Telephone Networks Holdings (Pty) Ltd v CSARS (2011)) and in practice.

It is submitted that taxpayers such as investment holding companies must ensure that it can clearly prove that the expenditure it incurs in respect of obtaining funds to use in its financing operation, is solely in respect of its financing activities.

On the premise that the investment holding company only incurs expenses such as interest, raising fees and losses on irrecoverable loans in its financing activities, and thus

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in the production of its interest income, the expenditure will satisfy the 'in production of income' requirement of section 11(a) and section 24J(2) of the Act.

4.4 The capital requirement

The deductibility of raising fees and losses on irrecoverable loans are considered in terms of section 11(a) of the Act, which means that the capital requirement of section 11(a) of the Act should be further considered.

Interest deductions are considered in terms of section 24J(2) of the Act, which does not include the capital requirement. The capital requirement will therefore not be considered any further for purposes of interest expenditure.

The capital requirement will therefore only be considered in relation to losses on irrecoverable loans and raising fees. A detailed capital vs revenue analysis is not the purpose of this research assignment.

4.4.1 General capital principles

The Act does not define when expenditure is of a capital nature. Consideration should therefore be given to the meaning the courts have ascribed to when expenditure is of a capital or revenue nature.

The question as to whether a particular payment constitutes expenditure of a capital or revenue nature for purpose of section 11(a) of the Act involves, ultimately, a value judgement. The courts have, however, developed various guidelines to assist in making this determination. None of these are however conclusive and each case should still be determined on its own merits or facts (De Koker, 2012).

The true nature of a transaction must be examined to determine the capital or revenue nature of the attendant expenditure. The purpose of the expenditure is an important factor to be taken into account, although it is not necessarily decisive (New State Areas Ltd v CIR (1946) [at p. 163, 164 and 170]).

The first test entails an assessment of the closeness of the connection of the expenditure with either the income-earning operations (on the one hand) or the income-producing structure (on the other hand) of the taxpayer's business. The courts in this regard will pay attention to the purpose of the expenditure and to what it affects (New State Areas Ltd v CIR (1946) [at p. 163, 164 and 170]).

Expenditure incurred in establishing, creating, or improving or making additions to a capital asset will be regarded as expenditure of a capital nature. So too if an act was performed for the purpose of enhancing the income-producing structure of the taxpayer, the attendant expenditure will be of a capital nature, and hence not deductible. However, expenditure which forms part of the cost of performing the taxpayer's income earning operations (i.e. operating the income-earning structure) is of a revenue nature and, as such, deductible (New State Areas Ltd v CIR (1946) [at p. 163, 164 and 170] and CIR v African Oxygen Ltd (1963) [at p. 78]).

Another guideline laid down by the courts is whether the expenditure was incurred with a view of bringing into existence an asset or advantage for the enduring benefit of the trade of the taxpayer. In the absence of special circumstances leading to an opposite conclusion, such expenditure will be of a capital nature, and therefore not deductible (British Insulated and Helsby Cables Ltd v Atherton (1926) [at p. 213]).

The enduring-benefit test inevitably raises problems as to how long the asset or advantage must endure in order to constitute a capital asset. It was indicated in case law that enduring means "enduring in the way that fixed capital endures" (Anglo-Persian Oil Co. v Dale (1932) [at p. 145]).

Fixed capital may be described as capital that is not of a floating or circulating nature. When the capital employed in a business is frequently changing its form from money to goods and vice versa (for example, the purchase of raw material by a manufacturer for the purpose of converting it to a manufactured article – similar attributes of trading stock) and this is done for the purpose of making a profit, then the capital so employed is floating capital. Expenditure of a floating capital nature is of a revenue nature while expenditure of a fixed capital nature is of a capital nature (New State Areas Ltd v CIR (1946) [at p. 163 and 164]). Expenditure incurred in order to acquire floating capital is not made with a view to acquire an enduring benefit and is therefore of a revenue nature. The enduring-benefit

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test is a consideration of considerable importance but it is in itself not conclusive (Warner Lambert SA (Pty) Ltd v C SARS (2003) [at p. 352]).

A further guideline to determine the nature of expenditure is whether the expenditure is going to be spent once and for all, or if the expenditure is going to recur every year. Capital expenditure is usually spent once and for all, while expenditure or a revenue nature normally recurs every year. It is obvious that this criterion is not decisive for it is easy to imagine many payments made once and for all which would be of an income nature (British Insulated and Helsby Cables Ltd v Atherton (1926) [at p. 213]). When expenditure is made once and for all, but with a view of bringing into existence an asset or an advantage for the enduring benefit of a trade, it is likely that the expenditure is of a capital nature rather than revenue in nature.

4.4.2 Losses incurred on irrecoverable loans

4.4.2.1 Money-lenders

Usually, capital lent or advanced constitutes fixed capital in the hands of the person making the loan or advance (Stone v SIR (1974) [at p. 595 to 596]). However, capital used by a taxpayer that conducts a money-lending business comprising the making of loans and advances constitutes circulating or floating capital and consequently losses of such capital are on revenue account and therefore deductible (Stone v SIR (1974) [at p. 596]).

It was held by the majority in Sentra-Oes Koöperatief Beperk v KBI (1995) [at p. 117] that where the taxpayer can show that he has been carrying on the business of banking or money-lending, then losses incurred by him as a result of loans, made during the course of his business, become irrecoverable are losses of a non-capital nature and deductible.

In other words, it is similar in the case where a retailer of goods loses its stock in trade. The loss incurred by the goods or stock so lost is of a revenue nature and is an inherent risk of the retailers trade – the same applies to money-lenders as there funding capital is there stock in their trade.

However, when a money-lender seeks to deduct any of its losses on irrecoverable loans for tax purposes, it must consider the principles that were laid down in the court in Solaglass Finance Company (Pty) Ltd v CIR (1991). After the court considered the trade requirement in section 11 of the Act, it continued and considered the trade requirement of section 23(g) of the Act, which at the time was still cast in its restrictive mould, requiring exclusive "trade" purposes. It was concluded that for the deduction to pass the test of section 23(g) of the Act, it must be able to show that the amounts of the loans made by the taxpayer were wholly and exclusively lay out or expended for the purposes of trade.

The majority of the court found that on the facts, the taxpayer's trading activities were geared to the achievement of a dual purpose of (1) furthering the interests of the group's subsidiaries and thus of the group itself, and (2) making a profit for the taxpayer (from its money-lending business) (Solaglass Finance Company (Pty) Ltd v CIR (1991) [at p. 26]). Therefore, the court had to determine, in the context of section 23(g) of the Act then in existence, the relationship of the taxpayer's business of borrowing and lending money, i.e. the promotion of the group interests, on the one hand, and the making of a profit, on the other hand.

The court then held that the expenditure in the form of loans advanced to subsidiaries in the group is part and parcel of the very activities which were designed and carried out in order to benefit the group, through the subsidiaries concerned. Therefore, there was a direct link between these losses incurred and the furthering of the group's interest. It was found on the facts of the case that "furthering the group's interest" was not part of its money-lending business (Solaglass Finance Company (Pty) Ltd v CIR (1991) [at p. 29]). The result was that, based on the wording of section 23(g) of the Act then in existence, the taxpayer forfeited the entire deduction.

In its current format, section 23(g) of the Act is expressed in language which allows for expenditure or a loss to be apportioned into a deductible and non-deductible expenditure where it was incurred partly for the purposes of the taxpayer's trade and partly for other purposes. Therefore, if a case involving the same facts as Solaglass Finance Company (Pty) Ltd v CIR (1991) were to be decided in the court at present, the loss from the irrecoverable loan would, in principle at least, be open to apportionment, with part qualifying as an allowable deduction and part not.

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Following from the above, there is a risk that a money-lender's losses on irrecoverable loans to group companies may not be allowed as a deduction due to the application of section 23(g) of the Act. Should SARS be able to successfully argue that, on the facts, a money-lender's loans to group companies are not monies so expended for purposes of its trade, then any losses incurred on any irrecoverable loans will not be allowed as an income tax deduction.

Again, this raises the question whether a money-lender that merely grants loans to group companies will be seen to carry on the trade as a money-lender. Please refer to the risks and reservations submitted in this research assignment in 3.6.3 with regards to this point.

For purposes of a money-lender whose sole business is that of granting loans to group companies for purposes of maximising its own profit (i.e. for purposes of its own trade separate to that of the group's and is not a mere conduit), and simultaneously satisfying the "money-lender test", the above principles in Solaglass Finance Company (Pty) Ltd v CIR (1991) should not find application. See (De Koker, 2012) in this regard:

> "The significance of the Billiton judgment[3] in a South African context is that, in a tax jurisdiction closely akin to our own, a strong judgment in the modern era has recognised that one company in a group could qualify as carrying on business as a banker or money-lender to the others in the group without being regarded, for tax purposes, as a mere 'conduit' or 'appendage'. Moreover, that this can be so even where such a corporate banker to the group does not have its own staff and pays management fees for accessing the expertise of employees of other companies in the group, and even where decisions in regard to its borrowing and lending activities are made by the parent company, and not by itself. But, it is submitted, such a banker to the group must conduct itself so as to advance its own purpose of profit-making as a company in its own right."
>
> [Own emphasis]

[3] The decision of Australia's Full Federal Court in FC of T v BHP Billiton Finance Ltd (2010) ATC 20-169 as referred to by De Koker (2012) was a case involved in similar facts to that of Solaglass Finance Company (Pty) Ltd v CIR (1991) - a wholly-owned subsidiary established for the purpose of acting as money-lender to the group. The issue before the court was whether the subsidiary was entitled to a loss incurred from writing-off as bad debts two irrecoverable loans to group companies. The judgment records that "virtually all external borrowings of the group to fund activities and projects of the group were undertaken by the subsidiary". The subsidiary did not have its own staff, but utilised the services of the holding company, for which it paid management fees. The subsidiary made loans to group companies, charging them a higher rate of interest than the cost of its borrowing, thus earning interest income and a substantial taxable income.

It follows that the court should determine, in such cases, that the act of granting loans to group companies did form part of the taxpayer's trade as a money-lender. The potential losses that may be incurred if loans become irrecoverable will then be deductible for tax purposes.

If, however, SARS can prove that the taxpayer was not pursuing its own self-interest, but was subjugating its profit-making potential to the interests for the wider group, then section 23(g) of the Act may find application and the taxpayer will not be allowed a deduction in respect of losses incurred on irrecoverable loans granted to group companies.

4.4.2.2 Investment holding companies

With regards to losses incurred on irrecoverable loans made by investment holding companies (i.e. in cases where there are no specific reference to money-lenders), the question is whether or not the deductibility of a loss incurred on an irrecoverable loan will depend solely on the "money-lender test", i.e. whether it is always necessary to be a money-lender, to obtain an income tax deduction of expenditure incurred on irrecoverable loans or whether being a money-lender is merely a relevant factor, as the true enquiry is the function of the money in the taxpayer's hands.

In Plate Glass & Shatterprufe Industries (Finance Company) (Pty) Ltd v SIR (1979) the court ultimately found that the taxpayer was not conducting a business as a money-lender, yet it did specifically confirm that the nature of a taxpayer's business is only a factor (albeit an important one) in considering the deductibility of the losses suffered. The true enquiry was the function of the money in the taxpayer's hands (Plate Glass & Shatterprufe Industries (Finance Company) (Pty) Ltd v SIR (1979) [p. 112]). It was held on the facts that the money was nothing more or less than capital in the hands of the taxpayer (and not working capital as such), thus the court concluded that the losses suffered were of a capital nature, and therefore not deductible.

This approach can be contrasted with the approach taken in Stone v SIR (1974), namely to consider the nature of the money lost, i.e. either fixed or floating capital. The case of Stone v SIR (1974) can also be contrasted with other cases, such as Burman v CIR (1991), namely whether the "money-lender test" is the sole and ultimate test in this regard, i.e. whether capital lent or advanced is circulating or floating capital only in the hands of a

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person conducting a money-lending business. According to Stone v SIR (1974) [at p. 596], there is no warrant for extending the principle (namely, that losses incurred as a result of loans made in the course of a business as money-lender are losses of a non-capital nature and therefore deductible) to loans by persons who are not conducting a money-lending business. However, the minority in Burman v CIR (1991) seems to question this view. Per Nicholas AJA:

> "the case of the money-lender is merely one example, and the question in every case is whether the loss is a loss of fixed capital or floating capital." (Burman v CIR (1991) [at p. 80])

and per Nestadt:

> "there is no reason in principle why, even though appellant was not a money-lender, they should not qualify as expenditure of a non-capital nature." (Burman v CIR (1991) [at p. 83])

If one follows the approach taken in Plate Glass & Shatterprufe Industries (Finance Company) (Pty) Ltd v SIR (1979), i.e. that is to consider the function of the money in the hands of the taxpayer as important and not to consider the business of the taxpayer as conclusive but to regard it as a mere guideline (albeit an important one), it is considered that the mere fact a taxpayer is not conducting an out-and-out money-lending business (such as a bank, for example, would), will not prevent losses sustained on advances made to its clients from being tax deductible.

Of particular importance in this regard is the following conclusion in Solaglass Finance Company (Pty) Ltd v CIR (1991) [at p. 16 and 18]:

> "There is no gainsaying the fact that appellant does not fall within the ambit of the guidelines referred to above. It does not, for example, lend to all and sundry, it does not seek to obtain security for the loans which it advances,…"

and

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> "…because of these constraints, there are features of appellant's business which are not normally found in an ordinary, commercial money-lending business. Non constat, however, that the business conducted by appellant is not that of money-lending. To my mind, that is exactly what appellant is doing. In the circumstances the capital utilised by appellant for this purpose is, in my judgment, not fixed, but circulating capital. …The losses deducted were accordingly deductible in terms of s11(a)"

Furthermore, Olivier (2001) analysed the relevant case law on the aspect of money-lending, specifically in the context of the general impression that a loss in this context will only be deductible if the taxpayer carried on the business of money lending. After a detailed comparison of the principles emanating from *inter alia* Stone v SIR (1974), Burman v CIR (1991) and Sentra-Oes Koöperatief Bpk v KBI (1995) she arrives at the conclusion that the deductibility of a loss incurred on an irrecoverable loan will not necessarily depend solely on the money-lender test.

In her view, if the facts indicate that loans were made as part of a profit-making scheme, the money-lending test would not be the sole test. According to her, the correct approach in such an instance involves two steps:

- in the first instance, enquiring whether the taxpayer is carrying on a trade (where the existense or absence of a money-lending business, as defined, could play a role – thus if a trade is carried on by the investment holding company this will help); and

- in the second instance, enquiring whether the loss was a loss of fixed or floating capital.

On the basis that an investment holding company will carry on a trade (as discussed in chapter 3), the first step in the above approach is arguably met. To answer the second step in the above approach, it should be determined whether the funding capital in the hands of an investment holding company is fixed or floating capital.

If the nature of the funding capital in the hands of the investment holding company is compared to the nature of the funding capital in the hands of a money-lender, it is arguable that the funding capital in the hands of the investment holding company is more capital in

nature. The funding capital in the hands of the money-lender is construed as floating capital (see the comments earlier).

An investment holding company grants loans to its subsidiaries and is thus actively involved in the business of its subsidiaries. The financing activities will be linked to its investing activities (which are capital investments and a trade for tax purposes as discussed in chapter 3), thus the investment holding company carries on a trade for purposes of its financing activities. The fact that it is carrying on a trade in its financing activities, does not necessarily mean that the capital it on-lends to its subsidiaries (in its trade) is in fact floating capital. If the facts of the taxpayers in CSARS v Tiger Oats Ltd (2003) and ITC 11329 (2010) are used, the funding capital the investment holding company on-lends to its subsidiaries will be fixed capital and not floating capital (there is no frequent turnover of capital as envisaged in Solaglass Finance Company (Pty) Ltd v CIR (1991) when an investment holding company grants the loan) and the loans will be seen as enhancing the income-producing structure of the investment holding company which creates an enduring benefit for the future.

It follows that there is a real risk that SARS will view the capital, in the hands of an investment holding company, as being fixed capital in nature. As a last note, it will be difficult for a taxpayer to rely on the principles in CSARS v Tiger Oats Ltd (2003) and ITC 11329 (2010) and argue that it is carrying on a trade in its financing activities by linking the financing activities to its (capital in nature) investing activities, but at the same time argue that the capital used in its financing activities are floating capital (when it is clear that the capital used in its investing activities are fixed capital in nature). The other argument that SARS may have is that the investments of the investment holding company forms part of its income producing structure, the loans the investment holding company is granting to its subsidiaries is therefore a cost to enhance the income-producing structure of the investment holding company, thus creating an enduring benefit for the future, thus fixed capital in nature.

It is thus submitted that the funding capital in the hands of an investment holding company is fixed capital in nature, thus non-deductible for tax purposes. Should an investment holding company seek a deduction in respect of its losses on irrecoverable loans, then its financing activities so conducted must be more aligned to the “money-lender test”, so that

its funding capital may be construed as floating capital in nature (i.e. the capital must be frequently turned over).

4.4.3 Raising fees

There is a view by some tax scholars that raising fees form part of 'related finance charges' in the definition of 'interest' in section 24J of the Act, therefore constitutes 'interest' for purposes of section 24J (De Jager (1987)). If this is the case, then there is no need for raising fees to satisfy the capital requirement of section 11(a) as the deductibility will be governed by section 24J(2) of the Act, which does not contain the capital requirement.

However, should a court find that a particular portion of raising fees is not a 'related finance charge', thus not interest for purposes of section 24J of the Act, the general principles on the deductibility of expenses would find application. It follows that the capital requirement will then need to be considered in further detail.

The disallowance of raising fees on the ground that it is of a capital nature is a contentious matter in tax law. Case law dealing with the deductibility of raising fees should therefore be considered and, on the basis that raising fees and interest are related, also case law dealing specifically with the deductibility of interest. In anticipating which tests a court may apply to raising fees in particular, case law should be considered to identify the tests that could possibly find application to raising fees.

In CIR v Genn & Co (Pty) Ltd (1955), the court held that interest paid on money borrowed and used for the purposes of a business would appear to be expenditure actually incurred in the production of income of the business, whether or not the loan was for the acquisition of fixed or floating capital.

In ITC 882 (23 SATC 239), it appears that the judge refused to apply the principle set out in CIR v Genn & Co (Pty) Ltd (1955) on the basis that the loan was for the purpose of enabling the taxpayer to acquire a capital asset. In ITC 995 (25 SATC 137), the same judge as in ITC 882 (23 SATC 239) disallowed raising fees incurred to obtain a new bond in respect of property it let out.

Academic writers have criticised the decisions in ITC 882 (23 SATC 239) and ITC 995 (25 SATC 137), and the view is held that it is not consistent with the principles laid down by the Appellate Division in CIR v Genn & Co (Pty) Ltd (1955) and that taxpayers should challenge the disallowance of such raising fees by SARS (Kruger, 2003 [at p. 112]).

Another potentially problematic judgment was handed down by the Tax Court in ITC 1019 (25 SATC 411), where the court distinguished the facts from CIR v Genn & Co (Pty) Ltd (1955) and concluded that raising fees paid to arrange bonds to fund the purchase price of properties to be rented out is not deductible.

In ITC 1723 (64 SATC 165) the taxpayer obtained a bank loan and on-lent the monies to a newly formed company. The court reasoned that, because the taxpayer did not carry on the business of a money-lender, the money on-lent by it formed part of its fixed capital. Accordingly, the costs to raise this capital were of a capital nature. The reasoning of the court in ITC 1723 (64 SATC 165) has also been questioned by academic writers (Brincker, 2011). The view is held that the case cannot be interpreted to mean that, other than in the case of a bank, the raising of loans will always result in the raising of fixed capital, and raising fees are therefore not deductible. Perhaps a more appropriate ground for not allowing the deduction would have been that the raising fees were not expended for purposes of the taxpayer's trade. It follows that even though the raising fee may be paid once and for all, a raising fee should nevertheless be regarded as part of the cost of performing the income earning operations and therefore be of a revenue nature.

The question arises what tests a court is likely to apply to determine the capital or revenue nature of a raising fee, taking all of the above into account. It is submitted in this research assignment that the test envisaged by Olivier (2001) should apply to raising fees (i.e. the same test as in the case of losses on irrecoverable loans).

It follows that the first enquiry is whether the taxpayer is carrying on a trade? This was already answered in the affirmative in chapter 3 for both money-lenders and investment holding companies.

The second enquiry is whether the raising fee was a cost to acquire fixed or floating capital? In the case of a money-lender, it is arguable that the raising fee is incurred to

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acquire floating capital in the taxpayer's trade. The raising fees should then be revenue in nature, and deductible if the other requirements of section 11 of the Act are met.

However, with regards to investment holding companies, it is arguable that the raising fee is incurred to acquire fixed capital used in the company's financing activities (see the comments in 4.4.2.2 above). The raising fees will then arguably be capital in nature and not tax deductible.

4.5 Conclusion

In summarising, the requirements for losses on irrecoverable loans and raising fees to be deductible for tax purposes, the trade requirement, the in production of income requirement and capital requirement must be satisfied in terms of section 11(a) of the Act. For interest to be deductible in terms of section 24J(2) of the Act, the same requirements apply, except for the capital requirement.

4.5.1 Money-lenders

In terms of chapter 3, a money-lender must satisfy the "money-lender test" to carry on a trade for tax purposes. Assuming it satisfies the above test, then the in production of income and capital requirements of section 11 and section 24J(2) of the Act should be considered further when seeking to deduct interest, losses on irrecoverable loans or raising fees.

4.5.1.1 Interest

It is submitted in this research assignment that interest expenditure will meet the in production of income requirement on a two-fold basis – (1) it is reasonable to regard the interest as part of the cost of performing the trade of a money-lender, and (2) the expense is incurred to derive income as defined.

In other words, there is a sufficiently close link between the interest expense and the activities that give rise to the money-lender's interest income. Thus, the interest expense incurred by a money-lender will be deductible for tax purposes in terms of section 24J(2) of

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the Act (the capital requirement is not a requirement when considering the tax deductibility of interest).

4.5.1.2 Losses on irrecoverable loans

With regards to losses on irrecoverable loans, it is submitted that the in production of income requirement is satisfied for the same reasons as in the case with interest expenditure (as described above), i.e. there is a close link between the loss and the activities that give rise to the money-lender’s interest income.

It is further submitted that the losses on irrecoverable loans will be revenue in nature as the losses are incurred in the taxpayer’s business of making loans and advances, and these loans and advances constitute “circulating or floating capital”.

Concerns are however raised in cases where money-lenders incur losses on irrecoverable loans made to group companies. However, it is submitted that these concerns are mitigated when the money-lender’s sole business (of granting loans to group companies) is for purposes of maximising its own profit (i.e. for purposes of its own trade separate to that of the group’s and is not a mere conduit).

Following from above, it is submitted in this research assignment, that losses on irrecoverable loans will be deductible for tax purposes in terms of section 11(a) of the Act.

4.5.1.3 Raising fees

The in production of income requirement in the case of raising fees is satisfied for the same reasons given for interest expenditure and losses on irrecoverable loans (as described above), i.e. there is a close link between the raising fees and the activities that give rise to the money-lender’s interest income.

It is further submitted that the raising fee is incurred to acquire floating capital in the money-lender’s trade, thus the raising fees should be revenue in nature. Therefore, the raising fees will be deductible for tax purposes in terms of section 11(a) of the Act.

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4.5.2 Investment holding companies

In terms of chapter 3, there is sufficient support in case law that the investment activities of an investment holding company could be regarded as a trading activity. It is further submitted that loans by an investment holding company to fund the activities of its subsidiaries will constitute a trade on the basis that these loans may be viewed as an active commercial participation by an investment holding company in the affairs of its subsidiaries.

It follows then that the in production of income and capital requirements of section 11 and section 24J(2) of the Act should be considered further when seeking to deduct interest, losses on irrecoverable loans or raising fees.

4.5.2.1 Interest

It is submitted in this research assignment that interest expenditure will meet the in production of income requirement on a two-fold basis – (1) it is reasonable to regard the interest as part of the cost of performing the financing activities of the investment holding company, and (2) the expense is incurred to derive income as defined.

In other words, there is a sufficiently close link between the interest expense and the activities that give rise to the financing activities' interest income.

However, to the extent that such expenditure are incurred in respect of obtaining funds which are used to acquire new investments, the expenditure will not be linked to deriving interest, but in fact will be incurred to derive exempt dividend income. It will therefore not be in the production of income. When expenditure is causally linked to (taxable) income and exempt income, it is necessary to apportion the expenses in order to calculate the allowable deduction.

It is submitted that taxpayers such as investment holding companies must ensure that it can clearly prove that the expenditure it incurs in respect of obtaining funds to use in its financing operation, is solely in respect of its financing activities, thus to receive interest income. If so, the interest expense will be deductible in terms of section 24J(2) of the Act.

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4.5.2.2 Losses on irrecoverable loans

With regards to losses on irrecoverable loans, it is submitted that the in production of income requirement is satisfied for the same reasons as in the case with interest expenditure as described in 4.5.2.1 above, i.e. there is a close link between the loss and the activities that give rise to the investment holding company's interest income, and the loss is incurred solely to produce income as defined (i.e. interest income).

It is further submitted that the deductibility of a loss incurred on an irrecoverable loan will not solely depend on the "money-lender test", but that the true enquiry is the function of the money in the taxpayer's hands (being a money-lender is merely a relevant factor).

The correct approach in such an instance, according to Olivier (2001), involves two steps:

- the first, enquiring whether the taxpayer is carrying on a trade; and
- the second, enquiring whether the loss was a loss of fixed or floating capital.

Although an investment holding company will carry on a trade (as discussed in chapter 3) for tax purposes, it is submitted that the loss of the funding capital will be construed as a loss of the company's fixed capital (as opposed to floating capital) as part of its financing activities. Thus, it is submitted in this research assignment, that losses on irrecoverable loans made by investment holding companies will not be deductible for tax purposes in terms of section 11(a) of the Act.

4.5.2.3 Raising fees

The in production of income requirement in the case of raising fees is satisfied for the same reasons given for interest expenditure (as described in 4.5.2.1) and losses on irrecoverable loans (as described in 4.5.2.2 above), i.e. there is a close link between the raising fees and the activities that give rise to the investment holding company's interest income, and the raising fees is incurred solely to produce income as defined (i.e. interest income).

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It is further submitted that the raising fee is incurred to acquire fixed capital in the investment holding company's trade, thus the raising fees will be capital in nature. Thus, the raising fees will not be deductible for tax purposes in terms of section 11(a) of the Act.

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CHAPTER 5
Conclusion

5.1 Comparison of the trade requirement

The following summarises the positive and negative aspects of the trade requirement for both money-lenders and investment holding companies:

5.1.1 Money-lenders

It is concluded in chapter 3 that the “money-lender test” is a mere guideline of when companies will be viewed as money-lenders (which act as bankers or financiers). It is further concluded that the “money lender test” merely contains features which are normally found in an ordinary, commercial money-lending business, but whether or not a taxpayer can be said to be carrying on the business of a money-lender (or banker or financier), is in each case a question of fact to be decided on the circumstances of each case.

A positive point is that taxpayers have clarity regarding the requirements for a money-lender to carry on a trade for tax purposes. If a taxpayer satisfies all the requirements of the “money-lender test” on the facts of the specific case, then a court is likely to interpret, on the facts, that the taxpayer is carrying on the business of a money-lender (or banker or financier). The trade requirement of section 11 of the Act will then be satisfied.

A negative aspect, however, is that when a money-lender only transacts with its group companies, it may be at risk to prove that it carries on the business of money-lending. The money-lender test is very onerous, and sometimes difficult to satisfy. It follows that, it may be difficult to prove (in these circumstances) that the money-lender lends to “all and sundry”, and has a “system and plan” and that there is “degree of continuity” to lending to its fellow group companies. It follows that where the taxpayer only grants funding to its fellow group companies, the burden of proof (placed on the taxpayer) will be difficult in the case where the taxpayer must prove that it is in fact carrying on a business of money-lending.

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5.1.2 Investment holding companies

One of the negative aspects are the contradictory case law on whether investment holding companies' investing activities (i.e. the mere holding of investments in subsidiary companies) could be regarded as a trading activity. However, there is enough proof that the investment activities could be regarded as a trading activity (ITC 770 (19 SATC 216), Burgess v CIR (1993), CSARS v Tiger Oats Ltd (2003) and ITC 11329 (2010)). Similarly, there is also limited case law which can be used to base the argument that intra-group loans by an investment holding company to its subsidiaries may be regarded as the carrying on of that holding company's enterprise (or business, or trade) (CSARS v Tiger Oats Ltd (2003) and ITC 11329 (2010)).

But, CSARS v Tiger Oats Ltd (2003) and ITC 11329 (2010) were discussed in detail in this research assignment, and there appears no reason why these principles may not be relied upon by other taxpayers in the future. Consequently, there is a strong argument that the trade requirement will then be satisfied in this instance.

Although the principles laid out by our courts are clear and sound in determining whether investment holding companies carry on a trade, and to link the financing activities to the investment holding company's trade, it remains up to the taxpayer to prove that this was in fact the case. Taxpayers should guard against trying to retrospectively prove that a trade was carried on (as what appears, with respect, to be the case in ITC 11329 (2010)). It is submitted that taxpayers should rather ensure that there affairs are properly arranged from when trade commences, with proper supporting documentation proving the same.

In concluding on the principles that should be in place when an investment holding company would like to prove that it carries on a trade for tax purposes, it is submitted that the following should be considered and backed-up by substantial evidence:

- The specific activities performed by the taxpayer should be documented in its articles of association, minutes of meetings and other documentation. Documentation should be as detailed as possible.

- The functions the taxpayer performs must once again be documented in detail in relevant documentation, such as shareholder agreements, management agreements, loan agreements and minutes of meetings.

- The impact that of any of the above activities and functions have on the activities of its subsidiaries should also be documented in minutes of meetings and other supporting documentation. In this regard, minutes of meetings and other documentation of the subsidiary company should also reflect the impact of decisions that were made by the holding company.

- Continuing activities relating to the granting of loans to subsidiaries, including the continual review of terms and conditions, interest policies, and considering other financing options. These decisions and thought processes must be documented in minutes of meetings and other supporting documentation.

- The nature of its expenditure and income, especially if it was derived or incurred in the production of income – see the comments later in this research assignment; and

- Any benefit derived by the group from the taxpayer's activities must be clearly documented and proved.

Following from the above, and practically speaking, it is submitted that for taxpayers that grant intra-group loans to be deemed to carry on a trade for tax purposes, it is easier to satisfy the above investment holding company requirements than to satisfy the onerous guidelines of the "money-lender test". From a pure trade perspective, it is submitted that taxpayers should rather pursue the investment holding company argument (and arrange their affairs accordingly) as opposed to the money-lender argument.

5.2 Tax treatment of the various expenditure

In terms of chapter 4, it appears that if the money-lender satisfies the "money-lender test", then interest expenditure, losses on irrecoverable loans, and raising fees are arguable all tax deductible on the basis that the various requirements of section 11(a) and section 24J(2) of the Act are satisfied.

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Similarly, if the investment holding company carries on a trade (and its financing activities form part of that trade), then interest expenditure will be tax deductible in terms of section 24J(2) of the Act. However, losses on irrecoverable loans and raising fees are not tax deductible on the basis that these types of expenditure are arguably capital in nature (note that the in production of income requirement is satisfied).

The funding capital will be seen as fixed capital in an investment holding company's hands due to the following:

- The investment holding company argues that it is carrying on a trade in terms of its financing activities by linking the financing activities to its (capital in nature) investing activities. It is therefore difficult to argue at the same time that the capital used in its financing activities are floating capital, when it is clear that the capital used in its investing activities are fixed capital in nature.

- The investments of the investment holding company forms part of its income producing structure, the loans the investment holding company is granting to its subsidiaries is therefore a cost to enhance the income-producing structure (its very nature of its link to the investing activities is to aid the subsidiaries in their operations).

- The investment holding company is creating an enduring benefit for the future through the granting of loans to the subsidiaries, therefore the funding capital will be fixed capital in nature.

Should an investment holding company seek a deduction in respect of its losses on irrecoverable loans and raising fees, then its financing activities so conducted must be more aligned to the "money-lender test", so that its funding capital may be construed as floating capital in nature (i.e. the capital must be frequently turned over). If this is achieved, the lending operations should then be aimed at making profits, which should then reduce the risk of the courts taking the view that an enduring benefit is created.

This then brings us to the question – to what extent must the "money-lender test" be satisfied in the context of South African investment holding companies?

5.3 To what extent must the "money-lender test" be satisfied in the context of South African investment holding companies?

The answer will ultimately depend on what the taxpayer would like to achieve.

If the investment holding company seeks full interest deductions from the loans granted to its subsidiaries, the answer is clear. There is no need for the onerous "money-lender test" as the investment holding company will be allowed to claim tax deductions in respect of the full interest expense.

However, if the investment holding company, in addition to interest, seeks full tax deductions for any losses on irrecoverable loans and raising fees, then the answer is more complicated. In this instance, the aim of the investment holding company is to ensure that the funding capital is floating capital in its hands.

This is then a good stage to revisit the "money-lender test" guidelines (as set out in chapter 3) and see which elements of the "money-lender test" will be needed by the investment holding company to ensure that its funding capital may be seen as non-capital in nature (thus floating capital).

Note that the investment holding company is already carrying on a trade (through its financing activities which are linked to its investing activities). Thus, the aim of revisiting the guidelines of the "money-lender test" is not to see whether the investment holding company is conducting a trade or not (which is what the test was developed for in the case of money-lenders), but it is to see which elements of the test will help in determining that the investment holding company's funding capital is construed as floating capital in its hands.

The following are the guidelines of the "money-lender test", and it is also indicated which guidelines will assist in determining whether the funding capital is floating capital, or not:

- There must be an intention to lend to all and sundry provided they are eligible – this guideline is focused more on the trade requirement to see whether the taxpayer is

actually in the business of lending money, thus not applicable as the investment holding company is already deducting a trade for tax purposes.

- The lending must be done on a system or plan which discloses a degree of continuity in laying out and getting back the capital for further use and which involves a frequent turnover of the capital – if this guideline is present in an investment holding company, then it is arguable that the funding capital will be construed as floating capital on the basis that there is a system and plan to get the capital back, and that there is a frequent turnover of capital. In this case the funding capital in the hands of an investment holding company will be seen as its stock in trade, therefore floating capital in nature.

- The obtaining of security is a usual, though not essential, feature of a loan made in the course of a money-lending business – this guideline will not assist in changing the nature of the funding capital to being floating capital in the investment holding company's hands.

- The fact that money has on several occasions been lent at remunerative rates of interest, is not enough to show that the business of money-lending is being carried on; there must be a certain degree of continuity and system about the transactions – as is the case with money-lenders, the fact that the loans will be lend to its subsidiaries at favourable interest rates will not be the defining guideline, but it will help in showing that the investment holding company is in the business of making a profit from its loans, which will help when arguing that the funding capital is its stock in trade from which profits are made.

- The proportion of the income from loans to the total income: the smallness of the proportions cannot, however, be decisive if the other essential elements of a money-lending business exist – this will similarly not help the investment holding company in its quest to argue that its funding capital is floating capital.

It follows that the major guideline to be used from the “money-lender test” is guideline 2, i.e. the lending must be done on a system or plan which discloses a degree of continuity in laying out and getting back the capital for further use and which involves a frequent turnover of the capital.

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When this guideline was discussed in detail in chapter 3, Judge Roper, J was quoted in ITC 812 (20 SATC 469) [at p. 472] as follows:

> "The main difference between an investor and a money-lender appears to consist in the fact that the latter aims at frequency of turnover of his money, and for that purpose usually requires borrowers to make regular repayments on account of principal. This has been described as a "system or plan in laying out and getting in his money …". The question whether a money-lending business is being carried on is always a matter of fact … consequently, a person may be a money-lender even though he does not advertise or hold himself out as such."
>
> [Own emphasis]

From above it appears we are faced with the real substance of the issue – will an investor (such as an investment holding company) on the facts ever be able to show that it will frequently turnover its money?

5.4 Final remarks

The question whether a taxpayer carries on a trade will ultimately be a question of fact, based on the facts of the case at hand. Taxpayers should therefore beforehand consider the route they would like to take – whether the company should be classified as a money-lender or whether it should use the investment holding company form. This will wholly depend on the situation that the specific taxpayer finds itself in at the time of making such a decision. The requirements for both alternatives are detailed in this research assignment, and it is therefore up to each taxpayer to determine which set of requirements will suit it the best, and which will be the easiest reached.

It can therefore not be said that the one alternative is better than the other, it is thus submitted that both alternatives are of equal value in the current tax system. What is important though is that taxpayers who will fit the mould of an investment holding company will now be able to use these requirements to prove that it is in fact carrying on a trade for tax purposes, something that taxpayers are generally reluctant to pursue. If this is pursued, taxpayers may have the added tax benefit of tax deductible interest expenditure

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(in full) in cases where this was not previously the norm (and an investment holding company will not have to satisfy any of the guidelines of the "money-lender test" when it seeks to deduct its interest expense in full).

However, if an investment holding company seeks to deduct losses on irrecoverable loans and raising fees for tax purposes, it will not have to satisfy all the guidelines of the "money-lender test", but it will have to satisfy one guideline, that being the "system or plan" and "frequent turnover of capital" guideline. It will be very difficult for an investment holding company to prove this on the facts of the case – it will arguably take a special set of facts to accomplish this mean feat.

5.5 Further issues to be researched

Firstly, it will need to be considered whether the raising fees could form part of 'related finance charges' in the definition of 'interest' in section 24J of the Act, therefore constitutes 'interest' for purposes of section 24J of the Act. If this forms part of 'related finance charges' then the capital argument surrounding raising fees becomes redundant as no capital requirement exist in section 24J of the Act. It follows that the only contentious issue will then be the deductibility of losses on irrecoverable loans in the hands of investment holding companies.

The second issue which will need to be considered is the carry forward of assessed losses in terms of section 20 of the Act. One of the requirements for an assessed loss to be carried forward to the next year is the trade requirement. On the basis that it was submitted in this research assignment that a trade is carried on by an investment holding company it should further be considered whether any losses that arise may be carried forward – it is arguable that this should be the case, but it should be considered in more detail.

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