IN THE SUPREME COURT OF APPEAL
OF SOUTH AFRICA

REPORTABLE
Case No: 443/97

In the matter of:

TICKTIN TIMBERS CC Appellant

and

THE COMMISSIONER FOR INLAND REVENUE Respondent

Coram: Hefer, Grosskopf, Marais, Zulman JJA et Madlanga AJA

Date of hearing: 16 August 1999

Date of delivery: 10 September 1999

Income tax - sec 11(a) and 23(g) of Income Tax Act 58 of 1962 - close corporation - distribution of profits to sole owner - amount distributed simultaneously lent by owner to corporation - whether interest on loan paid to owner by corporation deductible.

J U D G M E N T

Hefer JA

[1] This appeal is against the judgment in *Commissioner for Inland Revenue v Ticktin Timbers CC* 1997(3) SA 625 (C) in which the full court of the Cape Provincial Division upheld the Commissioner's refusal to allow the appellant, a close corporation, to deduct interest on capital borrowed from its only member from its income for the purpose of determining its taxable income during the 1985 to 1989 years of assessment. What has to be decided is whether the full court's finding that the interest did not constitute expenditure incurred in the production of the corporation's income as envisaged in s 11(a) of the Income Tax Act 58 of 1962, as amended, is correct.

[2] The general deduction formula of the Act and its precursors has received the attention of the courts on many occasions and, although problems arising from its application in particular cases still present themselves, its ambit is well-defined. For present purposes it suffices to record the following:

(a) S 11(a) which allows the deduction of non-capital "expenditure ... actually incurred ... in the production of the income" is subject to s 23(g) which (before its amendment during 1992) prohibited the deduction of moneys "not wholly or exclusively laid out or expended for the purposes

of trade".

The combined effect of the two sections is that

> "[i]f expenditure is incurred 'in the production of income' and 'wholly and exclusively for the purpose of trade' it is deductible, otherwise not."

(Per Watermeyer AJP in *Port Elizabeth Electric Tramway Co v Commissioner for Inland Revenue* 1936 CPD 241 at 245.) The enquiry must accordingly proceed by examining, on the facts of each case, firstly, whether the expenditure in question can be classified as expenditure actually incurred in the production of income and, secondly, whether its deduction is prohibited by s 23(g) (*Commissioner for Inland Revenue v Nemojim* 1983(4) SA 936 (A) at 947A).

(b) The purpose for which the expenditure was incurred is the decisive consideration in the application of s 23(g). As far as s 11(a) is concerned, Corbett JA said in *Commissioner for Inland Revenue v Standard Bank of SA Ltd* 1985(4) SA 485 (A) at 500H-J:

> "Generally, in deciding whether money outlayed by a taxpayer constitutes expenditure incurred in the production of income (in terms of the general deduction formula) important and sometimes overriding factors are the purpose of the expenditure

> and what the expenditure actually effects; and in this regard the closeness of the connection between the expenditure and the income-earning operations must be assessed."

(c) There can be no objection in principle to the deduction of interest on loans in suitable cases. Loan capital is the life blood of many businesses but the mere frequency of its occurrence does not bring about that this type of expenditure requires different treatment. (Cf the *Standard Bank* case and *Natal Laeveld Boerdery (Edms) Bpk v Kommissaris van Binnelandse Inkomste* 1989(1) SA 639 (A).)

[3] The interest which concerns us in the present case was credited annually on the accumulated balance in the loan account of the corporation's member, Dr David Ticktin. The sole issue is the purpose for which the loan was made. In order to decide it, it is necessary to deal briefly with the facts.

[4] The appellant came into being during 1985 when Dr Ticktin acquired the shares in a private company and converted the company into a close corporation. Among the company's assets was a substantial amount of distributable reserves which, in terms of s 40A of the Act (as it then read), were deemed to have been distributed to the

corporation. In the first entry in the loan account the balance of the reserves after tax was credited to Dr Ticktin. Thereafter the corporation's net income until 30 June 1985 was also credited to him; and so was its net trading income for every ensuing year until 1989. Dr Ticktin's explanation is to the effect that, as sole member of the corporation, he was entitled to whatever dividends he wished to declare; and that all the credits were passed in respect of dividends which he had declared but retained in the business as an interest bearing loan in order to finance its day to day operations.

[5] It is quite clear that it was of Dr Ticktin's own doing that the appellant was in effect compelled to exist on borrowed capital. There was no obvious need for the diversion of money which had accrued to it and could have been used to finance its trade. The question is: Why did Dr Ticktin deprive the corporation of the benefit of using its own money and instead saddle it with the apparently unnecessary burden of paying interest?

[6] We have the answer from his own lips. His evidence is that it was agreed when he purchased the shares in the erstwhile company that the purchase price would not be payable immediately because the transaction was structured as a "loan". Asked about the way in which

the transaction was financed, he replied:

> "The purchase price was about R1.8 million. They gave me a loan in my personal capacity for which **I was going to service it via Ticktin Timbers."**

Elsewhere he said:

> "When I purchased the business and obtained a loan basically from the family represented by the trusts, it was agreed that I would pay them interest at 3 per cent below prime.
> MR EMSLIE: So, the interest on the loan account was pegged at a similar figure, similar rate. Would you agree with the statement then that from your point of view, **you wanted to be able to charge interest on the amounts standing to your credit in your loan account, so as to be able to pay interest to your brothers and sisters? ... Certainly, yes."**

Equally instructive is the answer to a question which the Commissioner posed in a letter to the appellant's accountants after the appeal to the Special Court had been noted. The Commissioner wanted to know what the purpose of the loan by the sellers of the shares was. The answer was as follows:

> "1. The purpose of the loans was to enable Dr Ticktin to acquire his interest in the companies which in terms of the agreement were to be converted into Close Corporations. **The agreement obliged Dr Ticktin to structure his interest in the form of loan capital (debt rather than equity)** to the extent that this was done, thereby ensuring that he would earn interest income.
>
> 2. **The agreement in terms of which Dr Ticktin was and is liable to pay interest to the trusts also obliged him [to] advance funds by way of loan capital.** The link between the interest paid/incurred and the interest earned is thus clear. **The payment of interest to the trusts was the sine qua non of the interest earned by Dr Ticktin."**

These extracts from the record, particularly the portions which I have

emphasized, reveal all that we need to know. It is plain that the whole scheme of diverting the corporation's funds and making them available again in the form of an interest bearing loan was devised and agreed upon when Dr Ticktin bought the shares. Its obvious aim was to ensure that he would be able to pay the interest on the purchase price (and possibly even the purchase price itself).

[7] Appellant's counsel argued that all this is irrelevant. The motive for Dr Ticktin's actions, he submitted, does not concern us; what has to be determined is the corporation's purpose in taking up the loan and on this we have Dr Ticktin's evidence which is confirmed by the fact that the money was used to finance the corporation's trading. I do not agree. When the corporation started trading it had already been agreed that a loan account would be opened. *Qua* member Dr Ticktin was aware of his personal contractual obligation and there is no reason to suspect, nor did he suggest in his evidence, that he did not intend to carry it out. As Nicholas AJA aptly remarked in *Commissioner for Inland Revenue v Pick `n Pay Wholesalers (Pty) Ltd* 1987(3) SA 453 (A) at 470J in dealing with a comparable situation, "a man does not change his mind when he changes his hat." I agree with the court *a quo* that the loan was not needed for the appellant's income producing activities

and that the intention was to increase Dr Ticktin's income, not that of the appellant. The liability for the interest was accordingly not incurred in the production of the latter's income. But, even if it was, the loan plainly served a dual purpose, one of which had no bearing on the appellant's trade. The deduction of the interest was thus prohibited by s 23(g) and the Commissioner rightly refused to allow it.

[8] There is another way of looking at the matter which leads to the same result. It is trite that interest paid on a loan which was raised in order to enable a dividend to be paid is not expenditure incurred in the production of income and is therefore not deductible. A company or corporation is not obliged to pay a dividend or make a distribution respectively irrespective of the financial circumstances in which it finds itself. If, after doing so, it will have the resources to enable it to continue its income earning activities without having to borrow simultaneously an equivalent amount no problem arises. When it will not, but none the less pays a dividend or makes a distribution and simultaneously raises a loan in exactly the same amount, it becomes a question whether or not the purpose of the loan was to enable a dividend to be paid or the distribution to be made or to provide the entity with liquid funds required to enable it to pursue its income earning

activities.

[9] What happened in this case? Simply put it amounts to this. Appellant had enough money in its coffers to finance its income earning operations without borrowing and incurring an obligation to pay interest. It was under no obligation to use that money to make a distribution and its controlling mind (that of Dr Ticktin) was well aware that, if it was used for that purpose, it would be necessary to borrow simultaneously an equivalent amount and pay interest on the loan. It is quite clear that the relevant transactions, namely, the making of the distribution on the one hand, and the making of the loan, on the other, were not intended to be separate and unconnected transactions. They were plainly interdependent and neither was intended to exist without the other. It is this linkage which, to my mind, is fatal for appellant's case for it shows that the true reason why appellant had to borrow back at interest from Dr Ticktin money which it had had in its own coffers and was under no obligation to part with, was because it wanted to make a distribution to Dr Ticktin. The fact that he was the sole owner of the corporation makes it clearer still. On that view of the matter, Dr Ticktin's personal obligations to his siblings are of little moment. What is of moment, as counsel for appellant rightly emphasised, is why

appellant incurred the interest bearing debt. As I have said, the answer seems plain: because it wished to make a distribution to Dr Ticktin. The interest was therefore not deductible.

[10] The criticism in 1997 SALJ 645 by Associate Professor Dendy of the decision of the Court *a quo* is, in my view, misplaced and stems from a failure to appreciate the significance of the linkage to which I have referred and from an analysis of the transactions as if they were not interdependent. They obviously were and the conclusion of the court *a quo* did not (as is suggested in the article) rest upon a wrong assumption that the money in question was borrowed in order to finance the making of the distribution. It rested upon a correct finding of fact on the evidence before the court that that was indeed the purpose for which the appellant undertook to incur a liability to pay interest which would not otherwise have existed.

[11] It is of course so that the answer to the question whether or not a loan is "needed" is not by itself conclusive in deciding whether interest paid is deductible but it is certainly a highly relevant factor to be weighed in conjunction with other relevant factors when examining transactions in order to ascertain the real purpose driving them.

The concluding remarks in the article in question are

symptomatic of what I consider to be the faulty analysis of the problem by its author:

> "If Inland Revenue is not prepared to countenance the treatment of interest on borrowed money as tax-deductible in any situation in which a dividend has been declared, then Parliament must be asked to amend the Income Tax Act. For, having allowed taxpayers to claim deductions from gross income in respect of interest on money borrowed for the purpose of producing income, the fisc cannot be heard to cry foul if taxpayers so arrange their financial affairs as to run their businesses on borrowed money, and withdraw the profits earned by those businesses in order to meet their personal debts. (That principle, indeed, was recognized as sound by Brand J (Friedman JP and Farlam J concurring) in *Van Blommestein v Kommissaris van Binnelandse Inkomste* 1997 (1) JTLR 13 (C) at 21-23E, in which judgment was delivered on the same day as the decision in *Ticktin Timbers.* The *Van Blommestein* judgment on the point was incompatible with the test applied in *Ticktin Timbers* (see 1997 (1) JTLR at 4C-D, 1997 (3) SA at 629A-B). Farlam J, who concurred in the judgments in both matters, apparently failed to see the inconsistency.)" (At 651.)

[12] The court *a quo* did not suggest that interest on borrowed money is not tax-deductible "in any situation in which a dividend has been declared". The second sentence conflates the identity of two separate and distinct taxpayers (the business on the one hand and its owner on the other) and begs the question. If the business borrows money at interest in order to distribute profits without a commensurate loss of liquidity and it does so only because its owner needs money to

settle a personal debt, then the business has not in truth borrowed money for the production of income.

[13] There is a clear conceptual distinction between, on the one hand, a case in which a company in good faith and on the strength of inaccurate financial statements furnished by employees declares and pays a dividend, but shortly thereafter learns the true financial position of the company and realises that the dividend should not have been paid and that an equivalent sum will have to be borrowed to finance the company's trading activities and, on the other, a case such as the present. In the present case the purpose of the loan was to enable a distribution to be made to Dr Ticktin. Without the loan there would have been no distribution; without the distribution there would have been no loan. In the former case the interest paid will be deductible for the loan was not procured in order to pay the dividend. The fact that the payment of the dividend was the historical cause of the company needing to borrow is irrelevant. The purpose of the borrowing was to finance the company's trading operations after it had parted with its own resources while under the misapprehension that it could afford to do so. The Van Blommestein case is quite distinguishable and I see no inconsistency in the approach of the court which decided it and the

approach of the court *a quo*.

The appeal is accordingly dismissed with costs.

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JJF HEFER JA

CONCURRED:

Grosskopf JA
Marais JA
Zulman JA
Madlanga AJA