

**Deductibility of interest on the acquisition of shares when restructuring a
business: Alternatives for South Africa**

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ABSTRACT

Funding requirements is one of the first criteria to consider when restructuring a business. Companies and taxpayers would choose the best option when acquiring shares to minimise tax liabilities.

The purpose of this study is to formulate an interest deductibility test which provides guidance to taxpayers regarding the main criteria to investigate when restructuring a business transaction to ensure that interest will be deductible on the acquisition of shares with borrowed funds. The findings reveal the similarities and differences of the interest deductibility as seen by South Africa, Australia and Canada.

This study will present the legislation as well as court cases in South Africa, Australia and Canada to demonstrate the interest deductibility principles when funds are borrowed to acquire shares when restructuring a business. The focus will be on these principles to provide guidelines from which taxpayers can determine the interest deductibility with respect to share purchasing transactions. The study will indicate recommendations to South African legislation based on the findings of alternative treatments applied by Canada and Australia.

Key words used in this study

1. Interest
2. Tax-deductible
3. Shares
4. Loan
5. Dividend
6. Acquisition
7. Restructure
8. Borrowed funds
9. Investment
10. BEE

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CHAPTER 1 - INTRODUCTION TO INTEREST DEDUCTIBILITY

1.1 Background to the research area

Most corporations today are financed through debt or share capital. Every day shares are purchased through the finance of a loan. The tax deductibility of the interest on that loan makes the financing look attractive to corporations. But what really happens when a company wants to borrow money in order to purchase shares as part of a restructuring business initiative?

The dividend income received by shareholders from shareholding in South African resident companies and dual-listed companies is ordinarily exempt from tax as per section 10(1)(k) of the South African Income Tax Act (hereafter referred to as the South African Act due to more references also made to other countries' Income Tax Acts) (Income Tax Act, 1962:section 10(1)(k)). The interest will not be tax-deductible on the loan where the purpose of acquiring the shares is to receive exempt income in terms of section 10(1)(k) from the investment (Income Tax Act, 1962:section 10(1)(k); SARS, 2008:8).

Secondary Tax on Companies (STC) was a tax charge on the company declaring the dividend (Jones, 2009). The new dividends tax legislation came into operation on 1 April 2012. Secondary tax on companies has been superseded by the dividends tax. The following shareholders are exempt from dividends tax: South African resident companies, the Government, PBOs, certain exempt bodies, rehabilitation trusts, pension, provident and similar funds, shareholders in a registered micro-business, provided the dividend does not exceed R200 000 in a year of assessment, a natural person in receipt of an interest in a qualifying residence before 31 December 2012 and a non-resident receiving a dividend from a non-resident company which is listed on the JSE. Dividends tax will be borne by the shareholder at a rate of 10% (Pastel, 2011:3; Page Accounting, 2011:32).

Since 1 April 2012, a taxpayer will be liable for dividends tax. The dividend will not be tax-deductible in the hands of the distributing company. On the other hand, the receiver of a dividend will be liable for the withholding tax of fifteen percent on the dividend

received and may deduct the interest from the taxable income if the requirements of the general deduction formula and the new interest deductibility requirements applying to rollover relief transactions are met (Rudnicki, 2012:8). From this it can be concluded that there will be a direct link between the income in the form of dividends and the interest expense on the loan to acquire shares.

Section 11C(1) allowed a deduction for interest actually incurred in earning taxable foreign dividends, but limits the deduction to the amount of taxable foreign dividends received. If the interest expense is more than the taxable foreign dividends, the excess is carried forward to the following tax year and will be treated as an expense actually incurred for earning income (Income Tax Act, 1962:section 11C(2); SARS, 2008:9).

Restructuring activities in South Africa include mergers, amalgamations, take-overs and acquisitions, and special rules apply to these types of transactions. Tax always plays an important factor in the structuring of mergers and acquisitions. As these complex transactions occur on a worldwide basis, there is a need to identify how other countries treat these taxation issues in their jurisdictions.

South African tax treatment of interest was compared to only two other countries and the scope of this study is restricted, as it is only a mini-dissertation. "The Canadian and Australian legal systems have many similarities and, in particular, their respective tax systems reflect a commonality. However, the extent to which both jurisdictions have encountered similar problems in framing principles of interest deductibility might surprise many practitioners, judges, academics and policy makers" (Dabner, 1999:1).

The countries were selected on the basis that there are increased business transactions taking place between South Africa, Australia and Canada. The focus of this study is on a major South African company that has recently restructured business in both Canada and Australia and is known to the writer. A limitation in scope is due to the nature of this study, being a mini dissertation and limited to companies expanding into these two countries, as well as the writer's experience with the company and transactions in these countries (Sasol, 2011; South Africa.Info, 2011; Oil & Gas Eurasia, 2010).

It is important for financial people who emigrate or do business with these countries to be aware of the differences in the legislation. Canada has similar taxation legislation to South Africa (refer to section 2.2.1) whereas Australia's legislation is different. Canada has specific provisions in the Tax Acts (refer to section 4.2.1) to provide for interest expenses, while Australia uses a general provision clause in the Income Tax Act to deduct interest expenses (refer to section 3.2.1). This research will focus on the lessons learnt from both these countries and how the problems are sought to be resolved.

Australia and Canada were also selected on the basis that the tax legislation are different from South African tax legislation for interest deductibility and to demonstrate that investors would be in a more favourable tax position if restructuring takes place in countries other than South Africa. From the above it can be concluded that South Africa should consider changing legislation in order to attract more investors and promote economic growth by implementing an alternative treatment of interest deductibility when restructuring a business through the acquisition of shares when using a loan.

Mergers and acquisition transactions in South Africa have decreased in the current market crunch and lurking recession (Rudnicki, 2012:2). The uncertainty of the tax implications on these transactions are due to the latest developments of the new withholding tax on dividends and the pre-approval process which are required from tax authorities for the deductibility of interest costs in respect of leveraged buy-outs. The economic implications of these transactions will be considered to indicate the tax alternatives for South African legislation.

1.2 Literature review of the research area

Prior to the insertion of section 24J(1), "interest" was not defined in the South African Act, but a definition was given in the court case *CIR vs Genn & Co (Pty) Ltd* 1955 (3) SA 293 (A) (20 SATC 113). Schreiner J.A. stated that "the commission, together with the interest formed in effect one consideration which the company had to pay for the use of the money for the period of the loan". Huxham and Haupt (2009:112) appear to be of the opinion that all interest expenditure is of a revenue nature and they state as follows, "Interest is a payment for the use of funds and is therefore of a revenue nature.

It is equivalent to rent paid for the use of a capital asset. The cases that deal with the deductibility of interest have focused on whether the interest is incurred in the production of income.”

Section 24J of the South African Act was introduced in 1995 and addresses the incurral and accrual of interest on “instruments”. “An instrument is any form of interest-bearing arrangement, whether in writing or not, but excluding any lease agreement” (ENS, 2012).

Section 24J(1) defines interest as follows:

- “(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 the lending arrangement, have been entitled; and
- (c) absolute value of the difference between all amounts receivable and payable by a person in terms of a sale and leaseback arrangement as contemplated in section 23G throughout the full term of such arrangement, to which such person is a party, irrespective of whether such amount is—
 - i) calculated with reference to a fixed rate of interest or a variable rate of interest; or
 - ii) payable or receivable as a lump sum or in unequal instalments during the term of the financial arrangement”. (Income Tax Act, 1962:section 24J).

“The deductibility of interest has always been a vexing question” (Kharwa, 2010:iv). Will the court look at the purpose of the loan or the purpose of the expenditure? Several court cases have been identified that relate to interest deductibility. A distinction may in certain instances have to be drawn between the case where the taxpayer borrows a specific sum of money and applies it to an identifiable purpose, and the case where, as in the instances of *CIR vs Allied Building Society* 1963 and *CIR vs Standard Bank of SA*

Ltd 1985, the taxpayer borrows money generally and upon a large scale in order to raise floating capital for use in his business (Kharwa, 2010:57).

Section 24J(2) now provides for the deduction of interest. Prior to the Revenue Laws Amendment Act, No. 32 of 2004, section 24J merely regulated the timing of interest accruals and deductions (South Africa, 2005:44). Section 11(a) could still be applicable to transactions where interest is payable over a period shorter than 12 months.

Acquiring shares in a company results in dividend income being received by the taxpayer. A dividend is defined as “any amount distributed by a company to its shareholders, excluding an amount which results in a reduction of contributed tax capital” (Income Tax Act, 1962:section 1).

In Canada, one must consider the direct use of the borrowed money and the legal relations and effects created by the specific transactions. IT-533 of the Canada Revenue Agency (hereafter referred to as CRA) contains a discussion of rules to deduct interest on restructuring that apply in circumstances, for example borrowing to redeem shares, return capital or pay dividends (Canada, 2003). “Interest” is not defined in the Canadian Income Tax Act (hereafter referred to as the Canadian Act), but in the *Miller* case it was said that interest must be an amount calculated on a day-to-day accrual basis, the amount must be calculated on a principal sum, and the amount must be compensation for the use of the principal sum (Canada, 2003:2).

“Borrowed money” is defined in subsection 248(1) of the Canadian Act to include “the proceeds to a taxpayer from the sale of a post-dated bill drawn by the taxpayer on a bank”. Borrowed money requires a relationship of lender and borrower between the parties (Canada, 2003:3).

In Australia, interest is claimed under the general deduction section of the Income Tax Assessment Act, 1997 (hereafter referred to as the Australian Act), section 8-1, as there is no specific provision that provides for the deductibility of an interest expense (Australian Taxation Office (ATO), 1997). The “use” test or “tracing through purposes” test remains the primary criterion for determining the deductibility of an interest expense in Australia (Dabner, 1999:3-4).

Australian companies can declare either franked or unfranked dividends. Unfranked dividends are paid by an Australian resident company that has not yet paid Australian company tax, while franked dividends have already been partially taxed by the company issuing the dividend (Australian Government, 2012). As per the judgement from *Duke of Westminster vs IRC* 1953:520, it is every individual and company's right to manage and structure their affairs in a tax-efficient way. Taxpayers are advised to keep record of all documentation formulating the loan and all relevant provisions (TaxTips.ca, 2012).

"A merger or an amalgamation is a transaction in which the assets of two or more companies become vested in or come under the control of one company, the shareholders of which then consist of the shareholders (or most of the shareholders) of the companies that were merged" (Rudnicki, 2012:13). "An acquisition or takeover is a transaction in which control over the assets of a company is obtained by the acquisition of sufficient shares in the company to control it. The continued existence of the acquired company is not affected by the introduction of the new majority shareholder" (Rudnicki, 2012:13).

BEE as per the Broad-Based Black Economic Empowerment Act, no. 53 of 2003 (hereafter referred to as the BEE Act) means "the economic empowerment of all black people, including women, workers, youth, people with disabilities and people living in rural areas through diverse but integrated socio-economic strategies" (South Africa, 2004:4). The study will also consider the restructuring of a business in South Africa and the advantages that can be obtained when incorporating BEE transactions in section 2.4. BEE involves both statutory and non-statutory legislation.

New BEE legislation requirements will influence companies' decisions when restructuring the business. Companies can take advantage of the taxable benefits that can arise as a result of the business restructuring. From the above it can be concluded that BEE provides assistance to previously disadvantaged people in the sense that, where they are not able to afford the acquisition of shares, loans can be obtained. A third of the interest expense will be capitalised as part of the base cost of the shares, resulting in a larger base cost once the shares are sold, and a smaller profit which means less capital gains tax. (Income Tax Act, 1962: Eighth Schedule, paragraph 20(g); Dekker, 2007; Stiglingh *et al*, 2010:845; SARS, 2008:14)

1.3 Motivation of topic actuality

There appears to be a presumption that, since the expenditure is incurred in the production of income derived from carrying on of a trade, the interest will be tax-deductible (Gunn & Stack, 2006:1). It could benefit companies in future if they are aware of the legislation applicable in these types of transactions. Some companies would like to add the interest expense to the cost of the shares, but there is a specific provision for disallowance of such expenditure incurred in relation to exempt income (Nayak, 2011; Income Tax Act, 1962:section 23(g)).

Badenhorst (2008), corporate tax partner at PricewaterhouseCoopers SA, says that the income tax principle in this regard is straightforward. “If the taxpayer’s purpose in taking out the loan was to use the borrowed money for the purpose of producing income, then the interest is tax-deductible. If the purpose was not to produce income (or to produce income of a kind that is tax-exempt, such as dividends), then the interest is not tax-deductible.”

It was noted that the interest deduction on a loan incurred to acquire shares, the *Sallies Limited vs CSARS* judgment prescribed that the acquiring company or individual has to prove that the purpose in borrowing the funds was not to earn dividends, but to earn management fees to be entitled to the interest deduction (SAICA, 2008:4). If the dividends are only an additional result in respect of the acquisition of shares, and the main purpose was to earn management funds, why can the interest on the borrowed funds not be deductible? Management funds are earned by the acquiring company and included in gross income. Consequently, if a company then obtains dividend income as well as an increased amount in profits, would it not be appropriate to have a formula in the South African Act that catered for a proportional deductibility of interest, relating to the increased profit figure due to the restructuring?

Restructuring a business through the acquisition of shares could have numerous benefits for the company. Increased profits could be a result of increased market exposure obtained through the acquisition of shares, as well as elimination of competitors. The connection between the increased profits and the acquisition of shares can be demonstrated in the court of law by providing evidence of the increased

profits in the financial statements. The interest expense on the loan to acquire the shares is closely related to the additional profit earned from the shares acquired (Answers Corporation, 2012).

1.4 Problem statement

From the above, the following research question can be formulated as the problem statement:

Is there an alternative treatment for interest deductibility on the acquisition of shares while restructuring a business in South Africa, compared to Australian and Canadian tax legislation?

1.5 Objectives

To address the problem statement in section 1.4 above, the following objectives are formulated to answer the research question.

1.5.1 Main objective

To identify alternative treatments applicable in two other countries in respect of the allowable tax deductibility of interest cost when funds are borrowed to acquire shares. Restructuring a business in South Africa is compared to two other countries. This comparison will provide guidance to taxpayers when restructuring a business through the acquisition of shares and indicate the most tax-efficient country for restructuring when comparing South African tax with the two selected countries.

1.5.2 Secondary objectives

The main objective in section 1.5.1 above can be achieved by completing the following secondary objectives which provide guidance when restructuring a business through the acquisition of shares:

1.5.2.1 to identify and discuss the South African legislation applicable to the deductibility of interest when restructuring a business; (Chapter 2)

- 1.5.2.2 to compare the South African, Australian and Canadian legislation for the restructuring of the business through the acquisition of shares while using a loan; (Chapters 2, 3 and 4)
- 1.5.2.3 to identify sections in the Income Tax Acts that confirm when interest will be deductible and to identify sections in the Acts that are applicable to the restructuring of a business; (Chapters 2, 3 and 4)
- 1.5.2.4 to critically analyse relevant case law to provide guidance in terms of the application of principles of common law and the Income Tax Act; (Chapters 2, 3 and 4)
- 1.5.2.5 to analyse whether the interest on a loan is deductible where shares are purchased; (Chapters 2, 3 and 4)
- 1.5.2.6 to identify the effect on interest deductibility when a company incorporates BEE while restructuring a business; (Chapter 2)
- 1.5.2.7 to formulate a summary and provide recommendations regarding the interest deductibility on the restructuring of a business; (Chapter 5)
- 1.5.2.8 to provide a test to determine interest deductibility on the restructuring of a business that can be used as a reference. (Chapter 5)

1.6 Research method

A literature review will be performed. A critical analysis will be performed on articles published in newspapers, as well as on Internet sites by law firms and taxation consultants. The South African Act, as well as court cases will be consulted. International tax policies will also be researched and contribute to the information. A number of policy books will be used that are published in South Africa, Canada and Australia to gain an understanding of the fundamental principles applied in the different countries.

1.7 Overview

The following chapter layout is proposed for the research.

1.7.1 Chapter 1 - Introduction to interest deductibility

The objective of this chapter is to provide background and a literature review relating to the problem statement and list the research objectives that are achieved through this study.

1.7.2 Chapter 2 - Overview of the interest deductibility on the acquisition of shares in South Africa

Sections in the South African Act that confirm when interest will be deductible, as well as the rules when restructuring a business were identified and scrutinised. The impact of court cases on interest deductibility when acquiring shares were analysed and discussed. The objective of this chapter was to test whether interest cost in respect of funds borrowed to purchase shares is deductible on restructuring in South Africa. The effects of incorporating BEE while restructuring a business were identified.

1.7.3 Chapter 3 - Overview of the interest deductibility on the acquisition of shares in Australia

Sections in the Australian Act that confirm when interest will be deductible were identified and scrutinised. Relevant Australian court cases were analysed and discussed. The objective of this chapter was to test whether interest cost in respect of funds borrowed to purchase shares is deductible on restructuring in Australia. This chapter compared the Australian and South African legislation for the restructuring of the business through purchasing shares while using a loan.

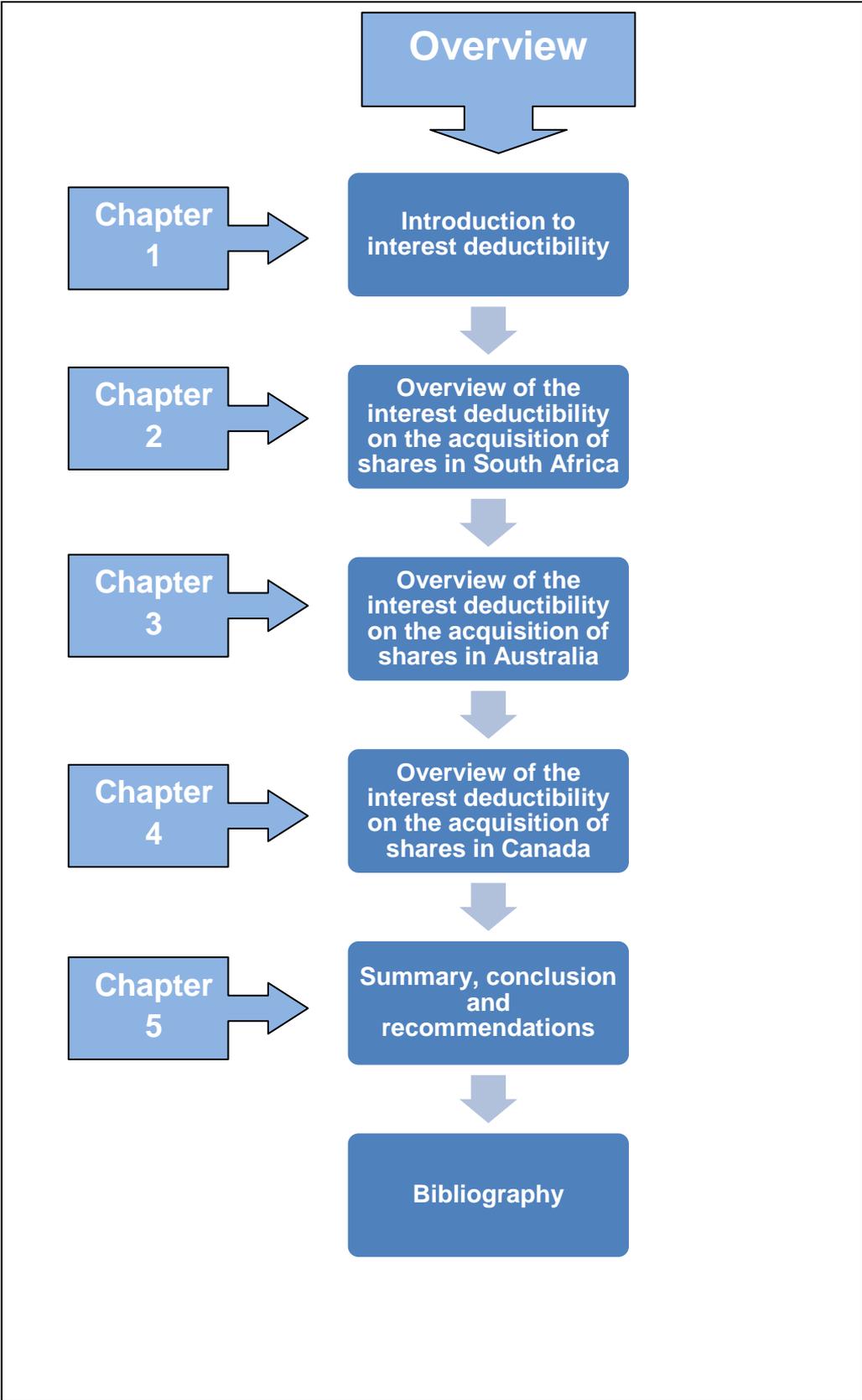
1.7.4 Chapter 4 - Overview of the interest deductibility on the acquisition of shares in Canada

Sections in the Canadian Act that confirm when interest will be deductible were identified and scrutinised. Relevant Canadian court cases were analysed and discussed. The objective of this chapter was to test whether interest cost in respect of funds borrowed to purchase shares is deductible on restructuring in Canada. This chapter compared the Canadian and South African legislation for the restructuring of the business through purchasing shares while using a loan.

1.7.5 Chapter 5 - Summary, conclusion and recommendations

This chapter provides a summary of the findings of chapters 2 to 4 regarding the interest deductibility on the restructuring of a business. This chapter provides readers with enough detail to make insightful decisions when purchasing shares through the use of a loan in a tax-efficient way. A test was formulated in this chapter to provide a taxpayer with guidance for determining interest deductibility on the restructuring of a business in South Africa, Australia and Canada. The test indicates the alternative criteria applicable in Canada and Australia from the South African interest deductibility considerations. The conclusion and recommendations result in identifying the alternatives for South Africans

Table 1 - Overview graph



CHAPTER 2 - OVERVIEW OF THE INTEREST DEDUCTIBILITY ON THE ACQUISITION OF SHARES IN SOUTH AFRICA

2.1 Introduction

The previous chapter provided an overview of the study that will be conducted and listed the objectives in section 1.5 to answer the problem statement in section 1.4. In this chapter, the secondary objectives as listed in section 1.5.2.1 to section 1.5.2.5 will be discussed which identify sections in the South African Act that confirm when interest will be deductible as well as prescribe the rules for restructuring a business. The impact of relevant court cases on interest deductibility is also discussed. The effect of BEE on these types of transactions will be identified (refer to the secondary objective in section 1.5.2.6).

2.2 South African principles and practice for interest deductibility

2.2.1 Background

Previous South African tax legislation allowed interest as a deduction in terms of “the general deduction formula” in section 11(a) of the South African Act:

“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 ...”

(Income Tax Act, 1962:section 11(a)).

One however had to consider section 23(g), which prohibited the deduction of “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 purpose of trade” (Income Tax Act, 1962:section 23(g)). “Trade” is defined in the South African Act and 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 ...” (Income Tax Act, 1962:section 1). Characteristics of carrying on a trade include the continuity of activities taking place and a long-term objective to obtain a profit. It was noted in *ITC 1275*, 1978 40 SATC 197(C) that “[a] person who accumulates his savings and invests them in interest-bearing securities or shares held as assets of a capital nature does not derive the income from carrying on any trade”. Expenditure will only be deductible in terms of section 11(a) if the expense results in income derived from carrying on a trade.

In *ITC 1476*, 1989 52 SATC 141(T) it was held that “the carrying on of a trade involves an ‘active step’, something more than watching over existing investments that are not income-producing and are not intended or expected to be so”. In this relevant case for a specific period, the shares and investments did not produce dividends or income and were merely investments in other companies to enable the speculation in immovable property. The company failed to prove that the company was carrying on a trade (Stiglingh *et al*, 2010:115).

In *ITC 770*, 1953 19 SATC 216 the judge referred to the definition of trade in Act 31 of 1941 and stated at 217 that the definition of trade is “obviously intended to embrace every profitable activity and which I think should be given the widest possible interpretation.” From this case it can be deduced that “trade” involves an active step where the taxpayer is taking a chance by acquiring shares in companies. Undertaking a risk can be viewed as an act of carrying on a trade. Investing in other companies requires involvement in the investment from the taxpayer’s position. A taxpayer’s main purpose in acquiring shares is to receive maximum benefits in the form of dividends and/or capital gains on sale of the shares.

In *Port Elizabeth Electric Tramway Co Ltd vs CIR* 1936:247, Watermeyer AJP said: “Chance, in other words, increases the expenses, or makes additional expenses, but though chance causes them to arise they nevertheless remain expenses so closely linked to a necessary business operation that they can be regarded as part of the cost of performing such operation. In this case the potential liability is there all the time and is inseparable from the employment of drivers – that is to say, inseparable from the carrying on of the business.”

The taxpayer need to consider how closely connected the risk of the acquisition of shares is to the performance of the business operation. Risk is inherent to restructuring a business, and many barriers exist when restructuring a business. Risk considerations include the calculation of the cost of borrowing as well as the likelihood of financial distress. The company should also consider whether there will be any revenue enhancement from the acquisition of shares or any changing capital requirements that will affect tax. Acquiring companies might be able to better utilise working capital in the target company, thereby reducing capital requirements and enhance profits for the group (Answers Corporation, 2012).

“Section 24J(2) states that the issuer is deemed to have incurred an amount of interest during his year of assessment equal to

- the sum of all accrual amounts in relation to all accrual periods falling, whether in whole or part, within the year in respect of the instrument, or
- an amount determined in accordance with an alternative method in relation to the year in respect of the instrument.

The amount deemed to have been incurred must be deducted from the issuer’s income derived from carrying on a trade, if the amount is incurred in the production of income” (Income Tax Act, 1962:section 24J(2); Silke, 2012:737).

Section 24J allows an interest deduction when income is derived from the carrying on of a trade and the interest was incurred in the production of income. Section 24J has no requirement that interest must not be of a capital nature in order for the interest to be deductible. The amount of interest which can be deducted is calculated by using the yield to maturity rate. This is the rate of compound interest in each accrual period at which the present value of all amounts payable or receivable in relation to the instrument during the “term” of such instrument equals the issue price or transfer of the instrument. The intention of the legislature by the amendment of section 24J is to establish that all interest is of a revenue nature.

Section 24J allows interest as a deductible expense if it was incurred “in the production of income” and the “trade” tests are satisfied. In *CIR vs Shapiro* 1928:35, Matthews J stated “[t]he payment of interest on borrowed money obviously not being an outgoing of a capital nature, the contention was that it was an outgoing actually incurred during the

year of assessment in the production of the taxpayer's income" (Gunn & Stack, 2006:26).

2.2.2 Principles

After listing the general legislation for interest deductibility and concluding that interest is deductible if it is incurred in the production of income while carrying on a trade, the following principles and court cases will provide additional requirements to determine if the interest on the acquisition of shares will be deductible in South Africa.

The first issue to consider when determining if the interest will be deductible is to establish if the interest is directly or indirectly incurred to generate taxable income. Interest will be deductible where money is borrowed, invested and then taxable returns are received. When a person indirectly invests in an asset that produces taxable income, the interest is deductible where money is borrowed to invest (Jones, 2009).

The second issue is to prove a clear link exists between the taxable income received and the interest incurred on the finance that was raised. SARS attempts to link the borrowing of money by a company to the dividend declaration. If it succeeds, then the interest cost is not deductible, since it is not incurred in order to produce income, but rather to declare the dividend. If the interest cost is linked to the income earned by the company from running its business operations, it will be deductible (ENS, 2011).

Matthews (2011) discussed the different ways of structuring a transaction. In transaction one, Holdco acquires plant and machinery from its competitor to produce income. With transaction two, Holdco acquires the share capital in a company that owns the plant and machinery from a competitor and that company continues to use it to produce income. In both transactions Holdco funds the acquisition with bank loans on which it pays interest.

When considering all the issues listed in the previous paragraphs to determine if interest will be deductible, it is clear that the interest under transaction two should be as deductible for tax purposes as the interest expense under transaction one is. Matthews

(2011) argues that under both situations the expense is being incurred to generate taxable income for the group.

Current legislation in South Africa view the proceeds received in the form of dividends from the shareholding under transaction two as a tax free income item, and interest will not be deductible in this instance. From this scenario we can identify that the main purpose/intention should be an important factor to consider when determining if the interest will be deductible. It is obvious that transaction one will entitle the taxpayer to deduct the interest payable with the purchase of plant and machinery. The expense was incurred for the purpose of producing income. Although the intention of transaction two was to improve business income, the result from the purchase of shares was that exempt dividend income was also obtained.

From a South African perspective, an investment in shares could result in exempt dividend income as well as taxable capital gains when shares are eventually sold (Income Tax Act, 1962:section 10(1)(k); Income Tax Act, 1962: Eighth Schedule, paragraph 3). Another interest deductible treatment which can be considered is where interest can be apportioned to the taxable capital gains portion and then be allowed as a deduction from income or as a deduction from capital gains. Consequently, if a share is sold without having obtained any dividend, and then obtained a capital gain, the entire interest should be allowed as a deduction against the gains as base cost. Share traders buy and sell shares to earn profits. Interest incurred on borrowed funds to acquire shares is an expense incurred in the production of income. The interest portion relating to the profits earned should be allowed as a deductible expense.

2.2.3 Nature of interest expense

Before the introduction of section 24J, the nature of the expense had to be determined as either of capital or revenue nature. This would then determine whether the interest expense qualified for a deduction under the general deduction formula stated in section 2.2.1. In the following section the study will focus on what is classified as “incurred in the production of income”.

2.2.4 “In the production of income”

If proven that expenditure was incurred “in the production of income”, expenditure will be deductible. Trade and investment activities produce income. Therefore the interest incurred for these activities will be deductible. Because dividends are exempt from income in terms of section 10(1)(k), they do not form part of income and thus the interest can not be claimed as a deduction in terms of section 11(a) (Stiglingh *et al*, 2010: 120).

Integritax discussed the interest on purchase of company shares. It was stated that if you borrow money to buy shares, preparatory to a take-over of the target company, you will ordinarily be denied a tax deduction for the interest paid on the loans. But the question was raised, “What if your purpose in buying the shares is, in short order, to strip the assets out of the target company?” One can say that the purpose behind the loan was not to acquire the shares, but to gain the income-producing assets of the target company. “And if the assets of the target company will produce taxable income, why should the interest incurred on your borrowings then not be deductible?” (SAICA, 2010:4).

The following court decisions will specifically confirm what is meant by “in the production of income”. They do not refer to interest deductibility, but assist with providing guidance to identify what the expense is used for.

2.2.4.1 *Port Elizabeth Electric Tramway Co Ltd vs CIR* 1936 CPD 241

In *Port Elizabeth Electric Tramway Co Ltd vs CIR* 1936 CPD 241, the court held that in determining whether expenditure is incurred in the production of income two questions need to be answered:

- is the act to which the expenditure is attached performed in the production of income?
- is the expenditure closely linked to it?

(Jones, 2009; *Port Elizabeth Electric Tramway Co Ltd vs CIR* CPD 241 1936:17)

If the act is for the purpose of carrying on the trade which earns the income, the expenditure on it will be deductible. All expenses connected to the performance of a business operation or incurred to ensure more efficient performance of such operation may be regarded as part of the cost of performing it.

2.2.4.2 *Commissioner of Taxes vs Rendle* 1965 (1) SA (SRAD)

The Watermeyer AJP test for determining interest deductibility in the *Port Elizabeth Electric Tramway Co Ltd vs CIR* 1936 CPD 241 case was modified by the Appellate Division and this test provides that:

“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 it would be proper, natural or reasonable to regard the expenses as part of the cost of performing the operation”
(*Commissioner of Taxes vs Rendle*, 1965 (1) SA (SRAD)).

Commissioner of Taxes vs Rendle 1965 (1) SA (SRAD) summarised three types of expenditure which are deductible, provided that they are closely connected with the performance of the business operation:

- expenses that are necessary for the performance of the business operation;
- expenses that are attached to the performance of the business operation by chance; or
- expenses that are *bona fide* incurred for the more efficient performance of such business operations.

When classifying the type of expense, it will assist with identifying the relevant tax allowance, deduction and relief available. If the business success is dependent on the expenditure a close connection will be present between business operations and the expense. From the above it can be deduced that when the expense is connected to the performance of the business it will be deductible. A company will look for ways to minimise expenditure and maximise income. When it is restructuring a business by way

of acquiring shares in other businesses, it should first identify funding opportunities and secondly ensure that improved performance will be achieved.

2.2.5 Purpose test for interest deductibility

A dominant test applied by South African courts concerning the deductibility of interest payable on a loan is to establish the purpose of borrowing the money. The following court cases specifically relate to the purpose test applied in practice. Section 24J(2) allows interest to be deductible from a taxpayer's income if the amount has been incurred in the production of income from carrying on a trade. The purpose test has been considered by numerous court cases to identify if the trade and production of income requirement has been met.

2.2.5.1 CIR vs Shapiro 1928 NPD 436, 4 SATC 29

CIR vs Shapiro 1928 NPD 436, 4 SATC 29 applied the purpose test. A taxpayer borrowed money to acquire shares in the company he worked for. He claimed that the interest on the loan should be allowed as a deduction against his salary and commission he received from the company. The court held that the salary and commission were not produced by his shareholding in the company, but by his duties as manager. The interest paid on the money borrowed to buy the shares was not incurred in the production of income. The shares produced exempt dividend income.

The connection between the interest and the salary income for the managing director was not sufficiently close. It follows from this case that, if the taxpayer's purpose in buying shares was to ensure the continuance of the income from business operations and gaining an increased income, the interest paid on the money borrowed to acquire the shares is properly deductible from that income (*CIR vs Shapiro* NPD 436 4 SATC 29 1928:38).

The fact taken from this case is to make the proper connection between the income that will be received by acquiring the shares and the interest expense. This case has shown that self-interest will not be supported and only business benefit will suffice.

2.2.5.2 *ITC 1089, 28 SATC 208*

In *ITC 1089, 28 SATC 208* case, the taxpayer acquired shares in a company at a premium of over 100% to enable the individual taxpayer to acquire certain facilities to ensure continuous trading. The main purpose was to obtain the use of the facilities and not to produce exempt income. The connection between the shareholding and the production of income was very close and the interest expenditure was allowed as a deduction due to this connection.

2.2.5.3 *ITC 873, 23 SATC 89*

In *ITC 873, 23 SATC 89:32*, an accountant borrowed money with the view to acquire shares. The court identified three purposes for the transaction:

- to earn dividends, which is exempt income;
- to obtain qualification shares so that on his retirement from the partnership he would become a director in the company; and
- to secure work from the company for the partnership.

The income earned from the borrowed funds in respect of the acquisition of the shares resulted in exempt dividends. The taxpayer was unable to prove that the acquisition of the shares was directly linked to the production of income. The court disallowed the interest deduction on the borrowed funds for the acquisition of the shares.

2.2.5.4 *Producer vs COT 1948 SR 62, 15 SATC 405*

The *Producer vs COT* case dealt with a trading company. In *Producer vs COT 1948:233*, a taxpayer borrowed money for the ordinary purposes of his business, but later invested the money in shares that did not produce taxable income. Tredgold J concluded the following: “Where the taxpayer borrows a specific sum of money and applies that sum to a purpose unproductive of income and not directly connected with the income-earning part of the business, then the interest paid on the borrowed money cannot be deducted as expenditure incurred in the production of income” and, “Where a taxpayer has for good and sufficient reasons borrowed money for use in the business

producing his income and in pursuit of that legitimate business purpose, he subsequently invests such money in an investment which does not produce taxable income, the interest is still deductible for income tax purposes” (Stiglingh *et al*, 2010:136). The Commissioner disallowed only a portion of the interest payable which did not reflect interest incurred in the production of income.

A taxpayer is required to clarify at the beginning of the transaction if the money is borrowed for a specific purpose or whether money is borrowed in order to fund general business operations. The court held that there has to be a direct link between the borrowing and the acquisition of shares. In this court case, the original purpose of the loan took preference. If loans were originally raised to fund income-producing business operations and were then subsequently used to invest in an asset which produces exempt income, the interest will still be deductible. The subsequent application of the money should however continue for a business purpose.

2.2.5.5 *Financier vs COT* 1950 (3) SA 293 (SR), 17 SATC 34

In *Financier vs COT* 1950 (3) SA 293 (SR), 17 SATC 34:35, the case dealt with an investment company. It was emphasised that the test to be applied is *the purpose* for which the money is borrowed. In this case a taxpayer borrowed a sum of money which was used for the general purposes of his business. A part of his investments produced no income. The portion of the interest that he paid on the loan relating to the non-productive investments was disallowed as a deduction by the Commissioner (Stiglingh *et al*, 2010:136). The court held in the *Financier* case that the interest was not deductible because the taxpayer could not indicate that it originally borrowed the money for general productive purposes.

2.2.5.6 *ITC* 1356, 1981

In *ITC* 1356, 1981, the taxpayer, which was an investment holding company, appealed against the disallowance by the Commissioner of deductions of certain interest expenditure incurred on borrowed money, which was borrowed for the purpose of acquiring shares and interests in subsidiary companies and to make interest-free loans to these subsidiaries. The court held that the purpose in acquiring the shares in the

subsidiary companies was not what it alleged to be. It was held that the appellant's intention was to acquire capital assets to obtain a source of income and the interest was not deductible. "The connection between the acquisition of subsidiary holdings and the production of such income was not sufficiently close as to render the loan interest deductible" (Gunn & Stack, 2006:17).

2.2.5.7 *ITC 1126, 1968*

It was stated in *ITC 1126, 1968* that "the overall intention of the appellant appears to have been to acquire capital assets to obtain a source of income". In that case, the expenditure incurred in acquiring the shares was of a capital nature, and the interest paid thereon likewise capital expenditure, and therefore not tax deductible (Gunn & Stack, 2006:17).

The new application of section 24J(2) has been altered to stimulate business growth. There is no longer a requirement to distinguish between an income of revenue and capital nature. From the above it can be concluded that, in future, courts will distinguish between personal and business investments, revenue income and restructuring.

2.2.6 *South African Revenue Service rulings*

2.2.6.1 Binding Private Ruling 058

Binding Private Ruling 058 (SARS, 2009a:1) issued by South African Revenue Service (hereafter referred to as SARS) provides specific guidance regarding the acquisition of shares as a result of company restructuring and the interest on a loan created in the restructuring process. The applicant, who is a resident company, intended to restructure its business operations by way of identifying the key individuals who would ensure continuation of business operations and allow them to acquire an interest in the business through the acquisition of shares in Company A (which is a dormant resident company wholly owned by the applicant).

To make the shares affordable to the directors, the applicant proposed to restructure its business operations by the proposed sale of its business as a going concern to

Company A. The market value of the shares in Company A after the restructuring would be less, due to the fact that Company A would owe a substantial amount to the applicant (SARS, 2009a:2). The applicant would retain 70% of the shares in Company A and 30% would be owned by the directors. Company A would be funded by the applicant with a portion of interest-bearing debt and a portion of interest-free debt (SARS, 2009a:3).

The ruling was made that the provisions of section 45 of the South African Act would apply to the sale of business by the applicant to Company A and that Company A would be entitled to the deduction under section 24J of the Act read with section 23(f) and (g) of the South African Act in respect of the interest incurred on the interest-bearing debt made available by the applicant (SARS, 2009a:3).

2.2.6.2 Binding Private Ruling 063

Binding Private Ruling 063 (SARS, 2009b:1) was issued by SARS to confirm that, where a purchase of shares is a prelude to an “asset strip” (distributing all the assets obtained from the target company), interest on money borrowed to acquire the shares may indeed be deductible. The applicant in this ruling was a newly formed company that had been constituted to acquire and hold the entire shareholding in the target company. The applicant would purchase all the shares in the target company, which would be funded by external loans raised by the applicant from a bank and the balance being funded by loans from the shareholders of the applicant. After the sale of all the shares had taken place, the target company would distribute all its assets held by it and claims against it to the applicant in specie, as contemplated in section 47. Thereafter the target company would be liquidated or deregistered, as the parties would decide (SARS, 2009b:1-2).

The ruling made for the proposed transaction was as follows:

- The interest incurred on the bank and shareholder loans would be regarded as expenditure incurred in the production of income and would not be expenditure of a capital nature. The provisions of section 23(f) and (g) would not be applicable; and

- The interest incurred in terms of the bank loans would be deductible under the provisions of section 24J and the loans owing to the shareholders would be deductible under the provisions of section 11(a) (SARS, 2009b:3).

Binding private rulings provide guidance to similar transactions in practice. From the binding private ruling above, if you acquire a company's shares and shortly after the take-over strip the assets out of that company, the profits will be taxable and therefore the interest will be deductible. After identifying all the relevant sections in the South African Act and the main requirements for an interest expense to qualify for tax deductibility, court cases specifically relating to the interest expense on the acquisition of shares will now indicate how the legislation and requirements are applied in South Africa.

2.2.7 Court cases specifically relating to interest deductibility when acquiring shares

The following court cases relate specifically to interest deductibility when acquiring shares with borrowed funds in South Africa:

2.2.7.1 CIR vs G Brollo Properties (Pty) Ltd 1994 56 SATC 47

In *CIR vs G Brollo Properties (Pty) Ltd 1994 56 SATC 47:152 J – 153 B*, the court summarised the principles as follows: “In a case concerning the deductibility or otherwise of interest payable on money borrowed, the enquiry relates primarily to the purpose for which the money was borrowed. That is often the ‘dominant’ or ‘vital’ enquiry, although the ultimate user of the borrowed money may sometimes be a relevant factor. Where a taxpayer’s purpose in borrowing money upon which it pays interest is to obtain the means of earning income, the interest paid on the money so borrowed is prima facie an expenditure incurred in the production of income ... If, on the other hand, the purpose of the borrowing was for some other purpose than obtaining the means of earning income (e.g. to pay a dividend), the interest is not deductible” (ENS, 2011).

2.2.7.2 *CIR vs Ticktin Timbers CC 1999 61 SATC 399*

In the *CIR vs Ticktin Timbers CC 1999* case, it was held that the purpose of the loan was to enable a dividend to be paid to Dr Ticktin. The court held that the interest was not deductible in the hands of the taxpayer (ENS, 2011).

Dr Ticktin's father sold his shareholding in a timber merchant company to four trusts for the benefit of his four sons. It was then decided that the equity of the business would be acquired by the one son, Dr Ticktin. The trust was dissolved, Dr Ticktin bought the shares owned by the other three trusts for R1,8 million and the company was converted to a close corporation. The purchase price for the shares plus interest thereon remained payable to the trusts by Dr Ticktin. The company then declared dividends which were not paid, but credited to Dr Ticktin's loan account in the books of the company. Interest would be charged by Dr Ticktin in respect of the companies' use of the money owed to him (Williams, 2009:470; *CIR vs Ticktin Timbers CC 1999 61 SATC 399*).

The court case concluded that:

- a corporation cannot borrow money to pay a dividend and then deduct the interest to arrive at its taxable income;
- money borrowed by a company to finance a dividend is not money borrowed in order to produce income;
- the *onus* was on the company to prove that the loan had been incurred in the production of income and hence that the interest expense was deductible in terms of section 11(a) of the South African Act;
- based on *CIR vs Standard Bank of South Africa Ltd 1985*, the question to be asked is: what is the purpose for which the money has been borrowed? The answer is that the Company's purpose was to discharge the distribution debt. The court will not look at why the loan is not being repaid. In this case it might have been that the company wished to retain capital for use in its business, making it look as if the expenditure is incurred in the production of income (Williams, 2009:471);

- the purpose of structuring the transaction this way ensured that the company assisted Dr Ticktin to pay the interest owed to the trusts. The intention was to increase Dr Ticktin's income and not that of the Company; and
- the loans that were created were not necessary, since there was an excess of cash available. By the creation of these loans, only the company's expenses were increased

(Williams, 2009:470-472; *CIR vs Ticktin Timbers CC* 1999 61 SATC 399).

It was clear in the income tax special court that the Commissioner should not have disallowed interest on salary not paid to Dr Ticktin and on cash advanced by him to the respondent (*CIR vs Ticktin Timbers CC* 1999 59 SATC 260, 1999 par 263). From this can be concluded that the link between the loan and the dividend could not be sufficiently established.

2.2.7.3 *CSARS vs Scribante Construction (Pty) Ltd* 2002 (4) SA 835 (SCA)

In the *CSARS vs Scribante Construction (Pty) Ltd* 2002 (4) SA 835 (SCA) case, it was held that the purpose of a loan from shareholders of money which the company did not need, was to enhance the already healthy position of the company and to earn interest for the company (ENS, 2011).

The company declared dividends of R6 573 076. Of this amount R3 199 834 was allocated to the shareholders' loan accounts on the understanding that no interest would be paid. The balance of R3 373 242 was likewise credited, but on the basis that it would bear interest at an agreed rate. The company then sought to deduct the interest which it had credited to its shareholders' loan accounts in respect of the dividends as expenditure incurred in the production of income according to section 11(a) of the South African Act in the 1991, 1992 and 1993 tax returns. The appellant disallowed the deductions (Williams, 2009:473).

It held that "the distribution of previously produced income in the form of dividends can in no way be seen to produce income or increase the income-producing capacity of an operation. *CSARS vs Scribante Construction (Pty) Ltd* 2002 (4) SA 835 (SCA) makes it

clear that the interest was incurred as a result of the dividend declaration and consequently is not-productive” (Williams, 2009:473).

The court had to determine whether the interest paid by the company to the shareholders for the years in question was expenditure incurred in the production of income as contemplated by section 11(a) and whether the interest was laid out or expended by the company for the purposes of trade within the meaning of section 23(g). “In regard to the general deduction formula, it is settled law that generally, in order to determine in a particular case whether moneys outlaid by the taxpayer constitute ‘expenditure incurred in the production of income’, important, sometimes overriding, factors are the purpose of the expenditure and what the expenditure actually effects. And in this connection the Court has to assess the closeness of the connection between the expenditure and the income-earning operations” (Williams, 2009:474).

The court held that:

- the interest paid to the shareholders on their loan accounts was plainly an actual expense;
- the availability of profits in the form of surplus cash existed;
- the evidence was that the cash generated in the course of the company’s business would have been sufficient for its operating requirements even if the dividends had not been lent to it;
- as a result of this arrangement the company benefited by the loan;
- the interest was paid by the company to enable it to secure the shareholders funds which could otherwise have been moved elsewhere;
- the availability to the company of the funds substantially increased its competitiveness and its income in the form of the interest which it retained;
- this provided a sufficiently close link between the expenditure and the income-earning operations having regard to the purpose of the expenditure and what it actually effects;
- section 11(a) was thereby satisfied;
- the only purpose of paying interest on the loan accounts was to secure for the company the benefit of the continued availability of the funds for use in its trading activities;

- borrowing money and re-lending it at a higher rate of interest, thereby making a profit, constitutes the carrying on of a trade; and
- thus the deductions which the company claimed were not struck by section 23 (g) (SAFLII, 2002:7-12).

2.2.7.4 *CSARS vs BP South Africa (Pty) Ltd* 2006 68 SATC 229; (5) SA559 (SCA)

In the *CSARS vs BP South Africa (Pty) Ltd* 2006 68 SATC 229; (5) SA559 (SCA) case, the taxpayer declared a dividend to its holding company and simultaneously entered into a loan agreement. At the time of declaring the dividend, the company had cash reserves in excess of the dividend and would have been able to continue with its normal business activities but required funding towards the end of the following year (ENS, 2011).

The principles resulting from *CSARS vs BP South Africa (Pty) Ltd* 2006 68 SATC 229; (5) SA559 (SCA) are as follows:

- determine the purpose for which the money was borrowed. If the purpose of the loan is to obtain the means of earning income, the interest paid on the loan is expenditure incurred in the production of income and thus deductible;
- consider the intention of the company for raising the loan;
- if a dividend is declared and a loan agreement is simultaneously entered into by a taxpayer, determine whether the dividend and the loan are interdependent and whether one can exist without the other;
- consider whether the company has sufficient cash available to pay the dividend and to continue its normal business operations without an immediate need to procure finance by way of a loan; and
- consider whether the income-earning capacity of the taxpayer declaring the dividend has been increased by the loan funding obtained (ENS, 2011; Williams, 2009:475-484).

The main piece of information taken from the above case is that, when formulating the purpose of the loan, it should be to enable the company to carry on its business operations and not to pay a dividend to ensure that the interest will be deductible. SARS will gather evidence to substantiate whether a company in fact had enough

capital to pay out dividends without taking a loan, because formally the loan was the difference between being able to take a deduction or not.

2.2.7.5 *ITC 1820, 2007 69 SATC 163*

The *ITC1820, 2007 69 SATC 163* case dealt with whether the taxpayer was entitled to deduct the interest incurred by it in respect of an amount borrowed in order to acquire certain shares. The case was considered by the High Court and published as *Sallies Ltd vs C:SARS*. The court found, in both judgements, that Sallies had not incurred the interest expense in the production of income (Badenhorst, 2008).

2.2.7.6 *Sallies Ltd vs CSARS*

Sallies, a listed but dormant public company, concluded an agreement with a US company, to purchase all of the shares in a South African mining company, Phelps Dodge Mining (Pty) Ltd, for R74,75 million. The acquisition was financed with a loan of US\$6,5 million, obtained from RMB Australia. Sallies' wholly-owned subsidiary then changed name to Witkop Fluorspar Mine (Pty) Ltd ("Witkop"). Sallies was appointed as Witkop's marketing agent, for which Witkop had to pay Sallies an initial fee of R3 million and an annual fee of R200 000. As at 30 June 2000, Sallies earned R5 million in respect of these marketing fees (SAICA, 2008; Desmond, 2008).

Sallies claimed a deduction for the interest paid on the loan from the Witkop income it received by way of marketing fees. SARS disallowed the interest as a deduction and Tax Court ruled in favour of SARS. Sallies appealed to the High Court who then analysed whether the interest expense satisfied the criteria for deductibility in section 11(a), 23(f) and 23(g) of the Income Tax Act (PWC, 2008:8).

Goldstein J quoted from the *CIR vs Allied Building Society 1963* case that "the ultimate use or destination of the borrowed money could not be elevated into a decisive factor in determining its deductibility under the South African Act. The dominant question was: what was the true nature of the transaction, and the most important factor in that inquiry was the purpose of the borrowing" (PWC, 2008:8-9).

The court was required to determine whether Sallies acquired the Witkop shares in order to produce income. If Sallies acquired the Witkop shares for the purpose of earning the taxable marketing fee income, the interest would be deductible. If the purpose of the acquisition was the earning of exempt dividend income, then this would result in no deduction of the interest (SAICA, 2008).

The court considered the following issues:

- the purpose of a loan at the time of the borrowing of the funds;
- the company's intention at the time of the borrowing;
- expected dividends from Witkop;
- Goldstein J said that "a shareholder is rewarded for his investment by the receipt of dividends. This fundamental factor had to be provided not to operate in the present case";
- the onus was for the company to prove that the purpose in borrowing the funds was not to earn dividends, but management fees;
- one witness testified that Sallies' purpose, in acquiring the shares in Witkop was to generate income in Sallies by charging Witkop fees for services provided by Sallies, including technical, management, and marketing services;
- one witness' testimony of the company's intention was not enough and the court looked at the language of the circular to shareholders;
- the fee income which was small compared to dividends that were actually anticipated;
- the company's circular to its shareholders stated that the projected profits of Sallies and Witkop for the tax year were R17,85 million. The substantial portion of Sallies projected profit was derived from the Witkop fees and the balance consisted of a dividend;
- paragraph 7.11 of the circular said explicitly that Sallies intended to pay its shareholders' dividends. Such dividends could only come from the dividend income it received from Witkop; and
- Sallies' income and expenditure statement for the year reflected a profit of only R31 028, which represented a return of about 0,43% on the borrowed money, and the purpose of the loan could not have been to generate such a small return (SAICA, 2008).

The court held that Sallies had not proved that it had acquired the shares in Witkop “in the production of income”; the appeal failed and the interest was thus not deductible. The court stated that the purpose of the loan was primarily to generate dividend income from Witkop (SAICA, 2008).

Sallies raised one loan and the courts considered the taxpayer’s dominant purpose in borrowing the money to determine whether the interest is deductible. If Sallies had negotiated two separate loans for this transaction, the first loan could have been structured for the purpose of earning dividends, and Sallies would have no deductible interest for this loan. The second loan could have been structured for the purpose of generating fee income from Witkop and the interest would be deductible for this (PWC, 2008:11).

2.2.7.7 *CIR vs Drakensberg Garden Hotel (Pty) Ltd 1960 (2) SA 475 (A)*

In *CIR vs Drakensberg Garden Hotel (Pty) Ltd 1960 (2) SA 475 (A)* a husband and wife were running a hotel on property which was leased from the Stiebel company. In order to obtain absolute control of the leased premises, funds were borrowed to purchase the share capital in Stiebel company to secure the occupation and hence the income from the business on the property. The court found that they were allowed to deduct the interest on the loan on the grounds that their intention had not been to earn dividend income, but to ensure continuance of its own income from sub-letting the hotel and trading at the store and secure an increased income therefrom (Williams, 2009:458; Deneys Reitz, 2001).

The principles from the above case are as follows:

- the taxpayer’s purpose in purchasing the shares in the Stiebel company was not to derive dividends, but to gain security of tenure of the premises that the taxpayer had;
- the purpose was thus to ensure a continuing rental income from the ties to whom the premises were sub-leased and to derive income from the trading store on the hotel premises.

- the respondent had a capital asset, the leases, which the acquisition of the shares would help protect and preserve (*CIR vs Drakensberg Garden Hotel (Pty) Ltd* 1960 (2) SA 475 (A) at 259);
- the Special Court found that the object of the purchase was to obtain absolute control in order to ensure security of tenure and the right to make improvements as desired (*CIR vs Drakensberg Garden Hotel (Pty) Ltd* 1960 (2) SA 475 (A) at 258);
- certain buildings were obsolete and required improvements, which the Stiebel company was not prepared to finance;
- the transaction accordingly took the form it did;
- interest paid on moneys borrowed to purchase a capital asset is deductible because the interest satisfies the section 11(a) criteria. (refer to section 2.2.2);
- the interest was deducted from the income derived from rent and business profits;
- if the taxpayer company had purchased the land on which the hotel and trading store had been situated, the interest would have been deductible;
- the taxpayer wanted to avoid the transfer duty that is payable on the purchase of the land and instead purchased the shares; and
- the connection between the purchase of the shares and the production of income was clear
(Williams, 2009:458-461).

2.2.8 BEE advantages

The objective in section 1.5.2.6 will now be elaborated by identifying the effect on interest deductibility when a company incorporates BEE while restructuring a business. BEE is an important criterion for businesses in South Africa and a unique distinction. This section will provide detail on the BEE advantages received in South Africa. Structuring a BEE transaction it is important to understand the tax implications when negotiating a business deal to ensure that maximum tax efficiency is achieved.

BEE refers to the people listed in section 1.2 of this dissertation “One of the elements of a BEE score-card is a compliance target of 25,1% black equity participation. Although there is not any specific tax incentives aimed at BEE deals, the change to the definition of ‘group of companies’ from a 75% to 70% shareholding means that the corporate

restructuring rules may now be made use of in structuring BEE transactions. The corporate rules provide for a tax-neutral transfer of, inter alia, assets between companies, subject to a certain level of shareholding” (Dekker, 2007).

Section 45 is applicable to inter-group transactions where

- “ a) in terms of which any asset is disposed of by one company (hereinafter referred to as the ‘transferor company’) to another company which is a resident (hereinafter referred to as the ‘transferee company’) and both companies form part of the same group of companies as at the end of the day of that transaction; and
 - b) as a result of which that transferee company acquires that asset from that transferor company –
 - i) a capital asset, where that transferor company holds it as a capital asset; or
 - ii) as trading stock, where that transferor company holds it as trading stock”
- (Income Tax Act, 1962: section 45(1))

The section 45 roll-over relief is also useful for BEE transactions, where the BEE partners do not have sufficient funds to acquire the shares (Income Tax Act, 1962: section 45; Mazansky, 2009). The effect of section 45 is that for any capital gain or capital loss in respect of a disposal of an asset, the transferee and the transferor company will be deemed one and the same person with respect to the transaction. If the asset is held as a capital asset, the transferor company must be deemed to have disposed of that asset for an amount equal to the base cost of that asset. If the asset is held as trading stock, the transferor company must be deemed to have disposed of that asset for an amount equal to the amount taken into account by that transferor company in respect of that asset in terms of section 11(a) or 22(1) or (2) (Income Tax Act, 1962:section 45(2)).

Black Economic Empowerment was implemented by the South African government to address the inequalities of Apartheid by giving previously disadvantaged groups economic privileges not previously available to them (South Africa, 2004:2). Restructuring a business with the acquisition of shares to comply with BEE legislation will provide benefits to a company. BEE compliance levels are indicated on a

company's profile and when a company acquires shares to enhance these levels there is legislation applicable for tax purposes. The tax advantages will be described in the following paragraphs.

Corporations can consider structuring a BEE deal to obtain the deductibility of financing costs. Where the shares are listed, one third of the interest incurred can be capitalised to the base cost of the shares for CGT purposes, minimising the potential taxable capital gain upon the disposal of the shares. (Income Tax Act, 1962: Eighth Schedule, paragraph 20(g); Dekker, 2007; Stiglingh *et al*, 2010:845; SARS, 2008:14)

For example, when a taxpayer acquires shares with a base cost of R100 000, at 10% interest, the taxpayer can also capitalise a third of the interest portion of the borrowed funds. If a third of the interest cost equals R3 333, the base cost will increase to R103 333 which will, at the disposal of the shares, result in a smaller capital gain being generated.

Another advantage for promoting BEE in a company will be in a case where the BEE level of a company is given a higher rating (South Africa, 2007:11). This will then give the benefit to all the directors of the company with the BEE level obtained reference (South Africa, 2007:87).

2.3 Mergers and acquisitions in South Africa

During 2012, KPMG issued a document regarding the taxation of cross border transactions for South Africa. The use of debt instead of equity to fund acquisition transactions is still the most preferred choice, as debt is a more flexible funding instrument. "The consideration of the tax treatment of interest and dividends plays an important role in the choice between debt and equity funding" (Rudnicki, 2012:8). Dividends attract tax in the form of dividend withholding tax from 1 April 2012 and is not tax-deductible by the distributing company, while interest may be tax-deductible if section 24J(2) and the roll-over relief requirements are met (Rudnicki, 2012:8).

The South African Companies Act 71 of 2008 recognises the following ways in which mergers and takeovers are effected:

- Sale of Company's assets; and
- Scheme of arrangement by way of restructuring the debt or equity of a company (Rudnicki, 2012:11).

Intragroup transactions are addressed in the South African Income tax legislation which provides for roll-over relief on the tax consequences of intragroup transfers of assets. Certain requirements need to be met, resulting in the purchaser becoming liable for all the tax that was deferred and effectively rolled over in the intragroup transfer (Rudnicki, 2012:5).

Interest will no longer be automatically deductible in respect of debt used to procure certain roll-over relief transactions. Taxpayers are required to apply for a directive in order to obtain approval from SARS for the deductibility of interest expenses (Rudnicki, 2012:6).

2.4 Summary

Chapter 2 provided the taxpayer with guidelines and principles to consider when determining interest deductibility when borrowing funds to purchase shares in South Africa. Court cases were analysed to confirm the application of South African legislation.

From the South African legislation and practice in section 2.2 to section 2.4 above, we can conclude that for interest expenditure to be deductible there must be a link or connection between the incurring of the interest expenditure and the profit producing business of the taxpayer. Loans obtained for the purpose of paying dividends and the interest expenses attributable to the dividend payment cannot be said to be incurred in the production of the taxpayer's profits.

Section 24J(2) was a necessity to stipulate the requirements for interest deductibility. The legislation provides the two main criteria to determine the deductibility of interest namely:

- Has the interest been incurred in the production of income?
- Has the interest been incurred in carrying on a trade?

The following questions identified in section 2.2.1 to section 2.2.7.6 will provide guidance and direction to a taxpayer to determine whether interest on funds borrowed is deductible for the acquisition of shares:

- Is the company carrying on a trade?
- Are there any funding opportunities?
- What is the purpose and intention of obtaining a loan?
- Will improved performance be achieved?
- Is the interest expense directly or indirectly incurred in the production of income?
- Is there a clear link between the interest expense and the income earned from the acquisition of the shares?

If the purpose is to hold the shares and derive dividend income, the purchase price of the shares is not deductible because of the capital nature, but the interest will be deductible under section 24J(2). When a taxpayer purchases shares to trade with

them, the purchase price of the shares are deductible under section 24J, and then interest would be deductible too (refer to section 2.2.1).

The next chapter will consider the secondary objectives listed in section 1.5.2, which entail analysing whether the interest on a loan is deductible where shares are purchased in Australia.

CHAPTER 3 - OVERVIEW OF THE INTEREST DEDUCTIBILITY ON THE ACQUISITION OF SHARES IN AUSTRALIA

3.1 Introduction

In the previous chapter, the South African legislation was discussed and this will form the base of the research. Interest incurred on the acquisition of shares is only deductible when the interest is incurred in the production of income and the main purpose was to earn income from the restructuring transaction.

Sections in the Australian Act that confirm when interest will be deductible will be identified and scrutinised in this chapter. Relevant Australian court cases as listed by the Australian Taxation Office (hereafter referred to as ATO) website will be analysed and discussed. The objective of this chapter will be to test whether interest cost in respect of funds borrowed to purchase shares is deductible on restructuring in Australia to achieve the secondary objectives listed in section 1.5.2.2 to section 1.5.2.5. This chapter will compare the Australian and South African legislation for the restructuring of the business through purchasing shares while using a loan.

Australia was selected as part of this research based on current expansions taking place in Australia by a major company from South Africa, and the study is focused on this company's transactions as a limitation of scope. Newsletters inform taxpayers and provide detail regarding current restructuring transactions (Oil & Gas Eurasia, 2010).

Based on the thesis, it is apparent that South Africa has one of the best taxation systems with benefits for BEE companies. It is also apparent that finance is not as important as wellbeing, and emigration figures to Australia confirm this. From the above it can be concluded that the government would be well advised to look at the safety of its citizens, as this goes hand in hand with the financial benefits. Two countries were selected based on the popularity of people selecting to go elsewhere. Based on immigration statistics, South Africa was one of the top ten source countries that contributed to the Australian immigration figures from the year 2000 to 2011 (Australian Government, 2011:27).

Table 2 - Immigration statistics for Australia from South Africa (2010-2011)

Number of settler arrivals in Australia from South Africa	Immigration % from South Africa
7 201	4.6%
7 153	5.1%
4 752	3.7%

3.2 Australian principles and practice

3.2.1 Background

There is no specific provision in the Australian Income Tax Assessment Act 1997 (hereafter referred to as the Australian Act) that provides for the deductibility of an interest expense. Prior to 1 July 1997, interest was deductible under the general deductions provision contained in section 51(1) of the Income Tax Assessment Act 1936 (hereafter referred to as the previous Australian Act) (Dabner, 1999:1).

Section 51 (1) provided that there would be an allowable deduction for: “all losses and outgoings to the extent to which they are incurred in gaining or producing the assessable income, or are necessarily incurred in carrying on a business for the purpose of gaining or producing such income, shall be allowable deductions except to the extent to which they are losses or outgoings of capital, or of a capital, private or domestic nature, or are incurred in relation to the gaining or production of exempt income” (ATO, 1936).

This provision has been re-enacted as section 8-1 of the Australian Act which was effective from 1 July 1997. Section 8-1 (1), which is applicable to individual taxpayers, states the positive parts which allow taxpayers to deduct from their assessable income any loss or outgoing to the extent that:

- it is incurred in gaining or producing your assessable income; or

- it is necessarily incurred in carrying on a business for the purpose of gaining or producing your assessable income
(ATO, 1997; Dabner, 1999:2; ATO, 1995).

Section 8-1 (2) provides that you cannot deduct a loss or outgoing under this section to the extent that:

- it is a loss or outgoing of capital, or of a capital nature; or
- it is a loss or outgoing of a private or domestic nature; or
- it is incurred in relation to gaining or producing your exempt income; or
- a provision of this Act prevents you from deducting it
(ATO, 1997; Dabner, 1999:2; ATO, 1995).

This second subsection provides a less restrictive deduction principle and is applicable to businesses. Interest will be deductible where the borrowing is undertaken to sustain or preserve the assets of the business which are solely directed to earning assessable income (Dabner, 1999:2).

Although there is no specific legislation relating to the interest deductibility as with South African section 24J, the above sections does address the same principles as section 24J. Both South Africa and Australia requires the interest expense to be incurred in the production of income. In section 3.2.2 the nature of interest in Australia will be discussed. By identifying the nature, Australian treatment of interest is compared to the South African treatment.

3.2.2 Principles

After listing the Australian general legislation and the four tests for interest deductibility, the conclusion is that interest will be deductible if it is incurred in the production of income and not of a capital nature. The following principles and court cases will provide additional requirements to determine if the interest on the acquisition of shares will be deductible in Australia.

Australia follows a principle-based approach in relation to the deductibility of the interest expense. If you borrowed money to buy shares, you are allowed to claim a deduction for the interest incurred on the loan in deriving your income from those shares (Richardson & Devos, 1999:3).

It was stated that, when one borrows money to buy a share portfolio, one is allowed to claim a tax deduction for the loan interest, provided it is reasonable to expect that assessable income (dividends or capital gains) will be derived from the share investment (Mr Taxman, 2011). In Australia, dividends are included in the taxpayer's assessable income and are taxed at the recipient's marginal tax rate (Australian Government, 1997). Australia makes use of a dividend imputation system allowing franking credits to be attached to dividends. The recipient of the franking dividends imputes a corporation tax paid by the paying company. Franking credits are thus passed on to the shareholder along with dividends (Deloitte, 2012).

3.2.3 Nature of interest expense

Interest has traditionally been viewed as a revenue expense in Australia, but court decisions have cast some doubt on this aspect. The nature of an interest expense was considered by the Full High Court in *Steele vs DC of T* 1999 ATC 4249 (29) (refer to section 3.2.4). The Court stated that "where interest is a recurrent payment to secure the use for a limited term of loan funds, it is proper to regard the interest as a revenue item and its character is not altered by reason of the fact that the borrowed funds are used to purchase a capital asset" (Richardson & Devos, 1999:5).

In *Australian National Hotels Ltd vs FC of T* 19 FCR 234 1988:239-241, interest was described as a recurrent payment which secures the use of borrowed money during the term of the loan and not the enduring benefit. In Australia interest is seen as a revenue expense (*Sun Newspapers Ltd* 61 CLR 337 1938:359-363); *Associated Newspapers Ltd vs FC of T* 5 ATD 87 1938:93-96).

But it is not always appropriate to classify interest as a revenue expense. With restructuring transactions, there are more complex issues to consider. Investments in the form of finance arrangements could result in interest being classified as of a capital

nature (Thersby, 2006; *Macquarie Finance Ltd vs Commissioner of Taxation* 2004 210 ALR 508). If the expense results in an asset that provides an enduring benefit to the company it will be classified as capital. In section 3.2.4, the South African criteria that the expense must be incurred in the production of income (as discussed in section 2.2.2) will be compared to the Australian application of this rule.

3.2.4 “In the production of income”

The question in Australia whether money is intended to be used for a capital or revenue purpose is dependent on whether the receipt is of a revenue or capital income nature. The principal issue addressed in the *Steele vs DC of T 99 ATC 4242; 41 ATR 139* case is the deductibility, for income tax purposes, of interest where the borrowed money has been used to purchase and hold a capital asset intended to be developed for income-producing purposes (ATO, 2000:2). The South African legislation no longer requires a distinction between revenue and capital income to be gained whilst determining the interest deductibility on borrowed funds.

In the *Steele vs DC of T 99 ATC 4242; 41 ATR 139* case, the loan was applied for the purpose of acquiring and creating a capital asset rather than holding it as an income-producing investment. From this fact the interest was held to be of a capital nature (*Steele vs DC of T AC 505 1997:512; Steele vs DC of T ATC 1997:4225-4228*).

3.2.5 Australian tests to determine interest deductibility

Over the years Australian case law have developed tests to determine the deductibility of an interest expense. The tests are used as tools and will assist the parties to consider all the facts relevant for a case. The four unlegislated tests are:

- the “use” test or “tracing through purposes” test;
- the “subjective purpose” or “motive” test;
- the “substitution of funds” test; and
- the “timing” test

(Richardson & Devos, 1999:4).

The “use” test will determine the use of borrowed funds obtained by companies and shareholders. This contributes to establishing the purpose of acquiring shares with borrowed funds. Situations where the objective purpose is unclear will move the focus to the subjective purpose of acquiring shares with borrowed funds. The “substitution of funds” is applicable where capital is repaid and loan capital replaces it. The result is that interest payable on the loan capital will be deductible. The timing test is applicable for this study, as the use can change over a period of time which can affect the interest deductibility (Richardson & Devos, 1999:4).

These tests will now be elaborated by referring to relevant Australian court cases. The tests will provide direction to determine if the interest will be deductible.

3.2.5.1 The “use” test

To determine the purpose for which funds were borrowed, a taxpayer should consider the use of these funds. This process can be followed by tracing the proceeds of the relevant transaction. The application of the use test will now be discussed in the following court cases:

3.2.5.2 *Munro vs FCT* 1926 38 CLR 153

Most Australian court cases refer to the “use” test or “tracing through purposes” test to determine the interest deductibility. The root of the “use” test came from the Full High Court decision of *Munro vs FCT* 1926 38 CLR 153. It is the basic test for the deductibility of interest, and looks at the application of the borrowed funds as the main criterion. The interest incurred will be deductible to the extent that the property is used to produce assessable income. This case was decided under section 23(1)(a) and section 25(e) of the Income Tax Assessment Act 1922 (Richardson & Devos, 1999:3).

Section 23 (1)(a), permitted a taxpayer to deduct from his total assessable income “all losses and outgoings (not being in the nature of losses and outgoings of capital) including ... interest and expenses actually incurred in gaining or producing the assessable income,” and section 25 (e) prohibited any deduction in respect of “money

not wholly and exclusively laid out or expended for the production of assessable income” (ATO, 1926).

Munro carried on a business of a manufacturer and indenter in Elizabeth Street, Melbourne, occupying for that purpose part of land and a building belonging to him. Parts of the building he let at rentals amounting to £2 000 a year. This sum was included in the assessable income of the respondent. He started a company in Sydney with similar business to that in Melbourne, with a capital of 20 000 shares of £1 each. 2 000 shares were allotted to himself and 9 000 shares to each of his two sons (ATO, 1926).

He borrowed the sum of about £33 000 from a bank, of which £20 000 represented the payment for all the shares and £13 000 the amount he advanced to the Sydney company free of interest. To secure to the bank the repayment of his loan he mortgaged the Elizabeth Street property and he paid interest upon his mortgage. The respondent claimed to deduct the interest paid to the bank from his total assessable income during the relevant periods on the amount so borrowed. The Commissioner disallowed this deduction but a Board of Appeal or Review allowed it. The only reason given for this decision is that a member of the Board stated that the taxable income from the property in Melbourne was what was left after all necessary outgoings had been discharged (ATO, 1926).

Judgment delivered by Isaacs J noted that he was unable to see how the interest referred to was “actually incurred in gaining or producing the assessable income”. The taxpayer already had rent-producing property to the full extent. Nothing more was necessary to gain or produce that income. Munro had his own reasons to incur an obligation to repay it with interest. Munro contended that the discharge of the obligation was “actually incurred in gaining or producing” the rentals it yielded. But the Melbourne business and the rental income existed before the loan and were unaffected by the loan (ATO, 1926).

The production of “assessable income” was not the only purpose of the loan. The interest paid on moneys borrowed was for the purpose of contributing capital for a newly formed company. It was not an outgoing to procure the use of money whereby income

was earned. If the money borrowed had been spent on the property resulting in increased rentals, it could be said that the interest was incurred for the gaining or producing of assessable income. Under these circumstances the deduction was not allowed (ATO, 1926).

The question raised by Knox J was whether the amounts which the respondent claimed the right to deduct were wholly and exclusively laid out or expended for the production of his assessable income. £18 000 of the amount borrowed was for the benefit of his two sons' shares. It was said that, because Munro gave a mortgage over his rent-producing property to secure payment of principal and interest to the bank, the payment of interest was necessary in order to enable him to receive the rents of the property and the amount paid was therefore wholly expended for the production of assessable income. It was contended that, when money was borrowed by a taxpayer on the security of a rent-producing property, the interest paid under the mortgage should be deducted from his assessable income, irrespective of the purpose to which the money borrowed was applied (*Munro vs FCT* 1926 38 CLR 153).

Knox J stated that, "The interest was incurred for the purpose of satisfying a debt, not for the production of his assessable income. The debt having been incurred for a purpose wholly unconnected with the production of assessable income of the respondent, I think it impossible to say that the interest paid on the amount of the debt was money wholly and exclusively laid out or expended for the production of his assessable income" (ATO, 1926).

The fact taken from this case is that an interest expense on borrowed funds is not deductible where it is incurred for the benefit of other people earning assessable income. A connection is required between the interest expense and the right to income which a taxpayer or others obtain. This case lacks the requirement listed in section 8-1, which states that the expense must be incurred in gaining or producing your own assessable income, and section 8-2, which states that the interest expense must be of a private or domestic nature.

3.2.5.3 Interpretative Decision 2001/79

The ATO's Interpretative Decision 2001/79 discussed the issue of whether interest on borrowed funds to acquire shares for investment purposes was deductible. The taxpayer and the spouse owned a property as joint tenants. The taxpayer borrowed funds to purchase the spouse's share in the property. After the acquisition of the spouse's share the taxpayer intended to let the property to tenants. The interest was found to be deductible under section 8-1 to the extent that the borrowed funds were used for the purposes of producing assessable income. Determining the use of the funds looks at the application of the borrowed funds as the main criteria (ATO, 2001:1).

The Interpretative decision was based on the "use" test, established in *Munro vs FCT* 1926 38 CLR 153, and is the main criterion to determine interest deductibility. To establish whether interest was incurred in the production of income normally depends on the use of the borrowed funds.

3.2.5.4 *Kidston Goldmines Ltd vs FC of T* 91 ATC 4538

In *Kidston Goldmines Ltd vs FC of T* 91 ATC 4538:4545-6, Hill J stated, "in most cases, the purpose of the borrowing will be ascertained from the use to which the borrowed funds were put ... To be deductible the outgoing, or in a case of apportionment, a part of an indivisible outgoing must be seen to be incidental and relevant to the activity which is directed to the gaining or production of assessable income. In the normal case, the fact that funds borrowed have been borrowed for the purpose of that activity and can still, in the year of income in which the deduction is claimed, be seen as having that purpose, will lead readily to the conclusion that the interest will be incidental and relevant to the income-producing activity. Again, in the usual case the application of funds for an income-producing purpose will demonstrate the relevant connection between the outgoing and the income-producing activity. Indeed, there is much to be said for the view that the tests of purpose and application of funds are but two sides of the one matter".

From this case, the relevant criteria is that where funds are borrowed to use in a business to secure capital or working capital and to ensure that assessable income is

gained, the interest expense will be deductible. This case from Australia is similar to section 24J of the South African Act which allows the interest deduction where it is incurred in the production of income whilst carrying on a trade.

3.2.5.5 *Begg vs FCT 1937 4 ATD 257*

In the *Begg vs FCT 1937 4 ATD 257* ruling, the taxpayer was allowed a deduction for interest where a “real and substantial relationship” was proved between the interest expense incurred by the taxpayer and the production of assessable income. The onus of proof will be on the taxpayer to substantiate that the interest expense was incurred to produce assessable income.

3.2.5.6 The “subjective” purpose test

Courts will also consider the subjective or indirect intentions of a taxpayer with transactions involving restructuring the business through the acquisition of shares. The “subjective” purpose test or “motive” test will be applicable where the objective facts regarding a case do not provide sufficient details why interest is incurred.

3.2.5.7 *Ure vs FCT 1981 50 FLR 219*

The “subjective purpose” test or “motive” test is used to establish the character of interest on borrowed money. A court case where this test was applied is *Ure vs FCT 1981 50 FLR 219*. All direct and indirect objectives and advantages must be considered. A deduction will be allowed for the interest on borrowed funds if the funds are used in an assessable income-producing activity. If there are multiple objectives to a transaction, then the interest expense must be apportioned between the pursuit of assessable income and the other objectives.

3.2.5.8 *Fletcher vs FCT 91 ATC 4950 1991 22 ATR 613*

Fletcher vs FCT 91 ATC 4950 1991 22 ATR 613 noted that the purpose of a borrowing can be determined from the use of borrowed funds and the accrual of interest draws its character from that use. From this case one can establish that, when the assessable

income is greater than the interest expense incurred, the expense will in total be characterised as incurred for the purpose of producing assessable income. Once the expense is characterised as incurred in producing assessable income, the Commissioner cannot question how you carry on your business or whether the expenditure was necessary (Khoo, 1993).

3.2.5.9 *FC of T vs JD Roberts* 92 ATC 4380 and *FC of T vs Smith* 92 ATC 4380 1992 23 ATR 494

In the cases of *FC of T vs JD Roberts* 92 ATC 4380 and *FC of T vs Smith* 92 ATC 4380 1992 23 ATR 494, it was established that the tracing of funds will not always be appropriate. In *Roberts* and *Smith*, section 8-1 was considered and it was concluded that interest on borrowed funds will be fully deductible provided the amount of “capital” attributable to the borrower at the time of the borrowing is equal to or greater than the amount borrowed. If the amount of capital attributable to the borrower is less than the amount borrowed it will be necessary to apportion the interest expense. Generally, the proportion of interest deductible will be equal to the proportion of capital that had been used to derive assessable income (Richardson & Devos, 1999:4; ATO, 1995:5).

3.2.5.10 The timing test

The timing of the interest expense deduction is also a relevant factor with respect to previous and later years. The purpose of the loan can change in the future, and interest paid in respect of acquiring a capital asset could later be incurred for the use of income-producing activities.

3.2.5.11 *FC of T vs Brown* 99 ATC 4600

The timing of the deduction for an interest expense is also a relevant consideration in Australia. The deductibility of interest expense in relation to later years of income was examined in *FCT vs Brown* 99 ATC 4600:4608. The court stated that, where interest is a recurrent payment to secure the use for a limited term of loan funds, it is proper to regard the interest as a revenue item, and its character is not altered by reason of the

fact that the borrowed funds are used to purchase a capital asset (Richardson & Devos, 1999:5).

Brown's case was similar to the Steele case where interest was incurred in a year subsequent to the relevant year's assessable income that was derived. In Brown's case the interest was incurred at a time after the borrowed funds had been lost to the taxpayer. It was said that the interest is not incurred in gaining or producing the assessable income of that period or any future period. Brown's case concluded that interest will have been incurred in gaining or producing the assessable income only where:

- the funds were borrowed for an income-earning purpose and not used for any other purpose; and
- the taxpayer has no legal entitlement to repay the principal and as a result is saddled with an unavoidable stream of interest outgoings (ATO, 2000:4).

Mr Brown complied with the above conditions and the interest deduction was allowed. Although Mr Brown made early repayment because of an indulgence extended by the bank, the court found that "... the cessation of business did not have the consequence that the 'occasion' for the liability to pay interest no longer remained the original liability to pay that interest under the Bank loan" (ATO, 2000:8).

The conclusion is that any taxpayer who has borrowed for income-earning activities and later ceased the relevant income-earning activities will be entitled to deductions for the interest incurred subsequent to the cessation of those activities. The deduction will be allowed only up to the amount of interest that the taxpayer is legally powerless to prevent from accruing after the business ceased (ATO, 2000:8). The next section will identify specific taxation rulings that were issued for transactions relating to the acquisition of shares using borrowed funds.

3.2.6 Taxation rulings

The taxation rulings provide relevant Australian transactions for this study, the applicable legislation and state the principles that were concluded.

3.2.6.1 Taxation Ruling 2000/17

Taxation Ruling 2000/17 discussed *Steele vs DC of T 99 ATC 4242; 41 ATR 139* and concluded that interest incurred in a period prior to the derivation of relevant assessable income will be “incurred in gaining or producing the assessable income” under certain circumstances:

- the interest is not incurred “too soon”, it is not preliminary to the income-earning activities and it is not a prelude to those activities;
- the interest is not private or domestic;
- the period of interest outgoings prior to the derivation of relevant assessable income is not so long, taking into account the kind of income-earning activities involved, that the necessary connection between outgoings and assessable income is lost;
- the interest is incurred with one end in view, the gaining or producing of assessable income; and
- continuing efforts are undertaken in pursuit of that end. It was stated that “continuing efforts” require that, if a venture becomes truly dormant and the holding of the asset is passive, relevant interest will not be deductible, even if there is an intention to revive that venture some time in the future (ATO, 2000:3).

Steele vs DC of T 99 ATC 4242; 41 ATR 139 met all the conditions above and it was concluded that interest on borrowed funds which have been expended upon any aspect of the development of a property which is solely intended to be employed in income-earning operations would qualify for an interest deduction against taxable income (ATO, 2000:6-7).

3.2.6.2 Taxation Ruling 95/25

This taxation ruling was issued in connection with the *FC of T vs JD Roberts* 92 ATC 4380 and *FC of T vs Smith* 92 ATC 4380; 1992 23 ATR 494 court cases.

As per Taxation Ruling 95/25, “Interest on a borrowing by a company may be deductible where the borrowing is used to fund a repayment of share capital to the shareholders in circumstances where the repaid capital was employed as capital or working capital in the business carried on by the company for the purpose of deriving assessable income. Apportionment may be necessary where exempt income is also derived from the business activities” (ATO, 1995:5).

Interest on a borrowing by a company is likely to be deductible where the borrowing is used to fund the payment of a declared dividend to the shareholders where the funds representing the dividend are employed as capital in the business for the purpose of deriving assessable income (ATO, 1995:5).

Taxation Ruling 95/25 lists the general principles relevant to interest deductibility under section 8-1:

- there should be a sufficient connection between an interest expense and the activities of a business which will generate the taxpayer’s assessable income and not be of a capital nature;
- the character of an expense should be determined. The character of interest on money borrowed is established by considering all the circumstances, which include the character of the taxpayer’s business, the objective and subjective purpose of the borrowing, the intention or motive of the borrowing, and the nature of transactions of which the borrowing of funds is an element;
- a tracing of the borrowed money which establishes that it has been applied to an income-producing use may demonstrate the relevant connection between the interest and the income-producing activity;
- whether borrowed funds are being used to replace another source of funding for business purposes;

- interest on borrowed funds will not be deductible simply because it can be said to preserve assessable income-producing assets;
- interest on borrowings will not continue to be deductible if the borrowed funds cease to be employed in the borrower's business or income-producing activity. (This principle was adjusted in *FCT vs Brown* 99 ATC 4600, section 4.2.4, where the deduction will still be allowed but limited to the interest that is legally obliged to be paid); and
- the interest will not be deductible, to the extent to which it is private or domestic in nature, or is incurred to produce exempt income.
(ATO, 1995:2-3).

The taxation rulings reconfirm the interest deductibility principles identified in the South African legislation as well as in the Australian legislation. The most important factors to consider when acquiring shares with borrowed funds are stated above and is a quick reference to determine interest deductibility.

3.2.7 Court cases specifically relating to interest deductibility when acquiring shares

The following Australian court case relates specifically to interest deductibility when acquiring shares with borrowed funds. *Spassked Pty Ltd vs FC of T* was possibly the biggest tax case in Australian history (Teo, 2005). The case concerned the effectiveness for taxation purposes of a corporate restructure with the purpose of eliminating "dividend traps" within the Industrial Equity Ltd (hereafter referred to as IEL) group. The aim of the restructure was to determine whether interest expense deductions could be used to reduce non-dividend income that was not effectively exempt from taxation. *Spassked* essentially considered the question of whether interest expenses incurred on loans taken out by an in-house finance company are deductible under section 51(1) of the previous Australian Act (ATO, 2003 ATC 5099 (3)).

Dextran (Pty) Ltd, a company owned by the Adsteam Group purchased all the shares, acquiring ownership and control of the IEL group of companies listed on the Australian Stock Exchange. The Adsteam Group experienced difficulties thereafter in meeting its debt commitments. This resulted in a restructure of the financial and capital base of the

IEL group and a borrowing by Dextran from IEL of a figure in excess of two billion dollars (ATO, 2003 ATC 5099 (7)).

IEL's main activity was to acquire companies which sometimes became wholly owned subsidiaries and then either to realise the assets of the companies acquired or sometimes to retain those assets. The acquisitions were financed by borrowings from an in-house finance company and interest was incurred. Industrial Equity Finance Limited (IEF) was classified as an in-house financier (ATO, 2003 ATC 5099 (9)).

A large number of individual dividend traps existed within the IEL Group, meaning there was a large number of corporate taxpayers which had incurred interest to acquire dividend-producing shares in a company which became a subsidiary and which, if dividends were declared to it by the subsidiary, would result in the loss of the section 46 rebate: the inability to transfer to other group companies a loss which would be brought about if no dividend was derived and which did not have profits out of which it could pay franked dividends to its immediate shareholder. Spassked was a wholly owned shelf company of IEL. Spassked incurred interest in the IEL Group prior to the takeover by the Adsteam Group (ATO, 2003 ATC 5099 (9); Greenwoods & Freehills, 2004(1)).

Mr Daniels, a management accountant employed by IEL, stated that he was aware that the structure of the IEL group did not readily support the flow of dividends up to IEL, even though IEL was still able to pay dividends. Mr Daniels' role was also to minimise the incidence of dividend traps so that dividends could be passed up to IEL to enable it to meet expenses and pay dividends (ATO, 2003 ATC 5105 (19)).

The holding company acquired equity in subsidiaries and lent money to subsidiaries on a regular basis using borrowed funds. The result was that the parent company ended up with losses due to interest on the borrowings, while the subsidiaries would use the funds to acquire income-producing assets. The parent company did not have funds available to declare a dividend. This led to "dividend traps" across the IEL group. Mr Daniels noted that, "This occurred because a dividend paid to a loss-making parent company by a profitable subsidiary, could not be passed on to shareholders, until such time as it had a fund of distributable profits available" (ATO, 2003 ATC 5104 (19)).

The Spassked structure was formulated and entailed that:

- Spassked would borrow funds from IEF at a commercial rate of interest, which was capitalised by way of adding the interest incurred on the loan to the principal. Spassked would use these funds to subscribe for “A” class shares that would be issued by GIH, which was a wholly owned shelf subsidiary of Spassked;
- the articles of association of GIH would be changed so that it could allot “A” class shares that would carry the right to both franked and unfranked dividends, and “B” class shares that carried the right to franked dividends only;
- IEL would subscribe for “B” class shares in GIH, entitling IEL to franked dividends only;
- GIH would use the subscription moneys received from Spassked and IEL to acquire shares in either:
 - (i) shelf companies or entities already held by the IEL group, or newly incorporated shelf companies; or
 - (ii) IEL group companies with existing assets, by subscription or purchase, which were expected to produce a franked dividend stream; and
- these companies would deposit their funds with IEF at interest, until such time as the funds were required for a specific offer, acquisition or investment (ATO, 2003 ATC 5106 (25)).

The main reasons for the Spassked structure were that:

- it enabled franked dividends to be streamed up to IEL without being subsumed in a dividend trap;
- it enabled unfranked dividends to be streamed up to GIH without being subsumed in a dividend trap; and
- it enabled maximisation of the amounts of losses available to be transferred to members of the Group (ATO, 2003 ATC 5112 (11)).

The following facts were considered with this case:

- if the expenditure can be characterised as expenditure incurred in the course of gaining or producing assessable income, it will be deductible;

- section 51(1) involves a process of identifying the essential character of the expenditure to determine whether it is an outgoing incurred in gaining or producing assessable income;
- the subjective state of mind of the taxpayer has to be considered;
- the subjective purpose of the directors was relevant in the present case;
- the direct and indirect objects and advantages which the taxpayer has in mind with borrowing and thereby incurring interest need to be considered; and
- whether assessable income was received; it was noted that, except for two years, the shares which Spassked acquired received no assessable income at all (ATO, 2003 ATC 5121 (75)).

If a taxpayer borrows money for the purpose of acquiring shares carrying rights to a dividend, the interest on the funds borrowed will be deductible. Where no dividends are derived by the taxpayer from the investment and where there was no intention of a dividend to be paid on those shares, the result would be that the interest is not incurred in gaining or producing assessable income (ATO, 2003 ATC 5121 (76)).

The Commissioner disallowed the interest deduction for Spassked based on two facts:

- the interest in question was not incurred by Spassked in gaining or producing the assessable income or necessarily incurred by Spassked in carrying on a business for the purpose of gaining or producing the assessable income; and
- if the interest in question was an allowable deduction under section 51(1) of the previous Australian Act, Part IVA of the Act (the general anti-avoidance provisions of the Act) operated to permit the Commissioner to disallow the deduction and assess it accordingly (ATO, 2003 ATC 5099 (5)).

Although dividend traps are now less of a problem following the introduction of the tax consolidation regime, Spassked remains relevant in relation to the guidance that it provides on the application of the general deduction provision in section 8-1 of the Australian Act (Teo, 2005).

3.3 Mergers and acquisitions in Australia

On-going changes to the tax legislation in Australia are affecting mergers and acquisitions in Australia. The following important developments have been noted in the document by KPMG relating to the mergers and acquisitions in Australia:

- Legislative amendments to the dividend requirements were enacted in the Australian Corporations act. Circumstances in which dividends would be unfrankable are laid down, for example dividends would be unfrankable under the dividend imputation system where the company has accumulated losses;
- The ATO has made the following determinations that affect Australian investments by resident and non-resident private equity funds:
 - Profits that arise from the sale of shares in a company acquired in a leveraged buy-out are assessable on the revenue account and are not capital gains, and are subject to Australian tax on the basis that the gains have an Australian source;
 - Domestic general anti-avoidance rules would apply to inward investment private equity structures designed with the dominant purpose of accessing treaty benefits; and
 - a recognition that non-resident limited partners of a fiscally transparent vehicle may access treaty benefits, where their country of residence has negotiated a tax treaty with Australia.
- The government has made technical amendments to the income tax-consolidation and group restructure rules, in order to align the rules with other parts of the tax legislation, minimise tax consequences on genuine group reorganisations, and make other technical corrections; and
- The taxation of financial arrangements regime was introduced to govern the taxation of gains and losses arising from financial arrangements commencing on or after 1 July 2010, principally on an accruals basis (Linke, 2012:1).

Australia has many small and medium entities which are not operated by companies. The preferred choice of restructuring in Australia is not acquiring shares in a company, but rather acquiring the assets of the business. The taxing effect of acquiring shares or

acquiring assets in a company is irrelevant in Australia, as the treatment is the same for both these restructuring transactions (Linke, 2012:3).

The acquisition of shares with the intention to resell could be characterised as a revenue transaction. Generally, interest is deductible for tax purposes if the borrowed funds are used in receiving assessable income-producing activities. The following exemptions apply:

- A portion of the interest is not deductible where thin capitalisation rules are breached;
- Interest is not deductible relating to the production of exempt taxable income; and
- Interest expenses incurred in the holding of a capital asset are not deductible where the only prospective assessable income is the capital gain only available upon sale (the interest expenses may be included in the cost-base for CGT purposes) (Linke, 2012:10).

The checklist for debt funding includes:

- Withholding tax of 10% is charged on cross-border interest payments, except to banks in the UK and US;
- Third party and related party debts are treated in the same manner for Australian thin capitalisation purposes; and
- Interest expense in a financing vehicle can be offset against income of the underlying Australian business when it is part of an Australian tax-consolidated group (Linke, 2012:10).

Additional costs incurred during the borrowing will be deductible over the lesser of five years or the term of the borrowing. These costs include brokerage, legal and underwriting fees (Linke, 2012:10).

3.4 Summary

Chapter 3 listed guidelines and principles to consider when determining interest deductibility when borrowing funds to purchase shares in Australia. Section 3.2.1 listed the legislation and section 3.2.4 discussed the four tests that Australia use to determine whether interest expenditure will be deductible. Legislation requires that the expense must result in producing assessable income or that it must be incurred in carrying on a business with the purpose of producing assessable income.

Section 3.3 listed the practice and principles currently applicable in Australia. It also discussed the biggest court case in Australia, *Spassked*, which involved the borrowing of funds to acquire shares in subsidiaries.

Principles to establish whether the interest will be deductible:

- Was the interest incurred in gaining or producing assessable income?
Section 3.2.1 provided the legislation requirement; section 3.2.4 listed the court cases; section 3.2.5 listed Taxation Ruling 2000/17 and Taxation Ruling 95/25.
- What is the purpose in borrowing the money?
Section 3.2.3 listed the relevant court cases. Taxation Ruling 95/25 in section 3.2.5 applied the assessable income requirement. *Spassked Pty Ltd vs FC of T* in section 3.3.2 disqualified the interest expense from being deductible, mainly because it was not incurred in gaining or producing assessable income.
- What is the use to which the borrowed funds were put?
The court cases in section 3.2.4 applied the “use” test.
- Is there a connection between the interest paid on borrowed funds and the income derived by its use?
The connection principle in section 3.2.4 and section 3.2.5 also noted the requirement.

The following table will highlight the main differences and similarities between the Australian and South African legislation concerning the deductibility of interest. This comparison shows that Australia does not have specific interest taxation legislation as

South Africa has, but applies general principles in the legislation to determine interest deductibility.

Table 3 - Comparison between the legislation relating to interest deductibility of South Africa and Australia

Country		South Africa	Australia
Interest definition	Definition in Act	Yes Section 24J(1) (Section 2.2.1)	No
	Court cases	<i>CIR vs Genn & Co (Pty) Ltd</i> 1955 (3) SA 293 (A) (20 SATC 113) (Section 1.2)	<i>Australian National Hotels Ltd vs FC of T</i> 1988 19 FCR 234 (Section 3.2.3)
Provision dealing with deductibility of expenses	Applicable	Yes Section 11(a) and Section 24J(2) of the South African Act (Section 2.2.1)	Yes <ul style="list-style-type: none"> • Section 51(1) of the previous Australian Act • Section 8-1 of the Australian Act (Section 3.2.1)
	Court cases	<ul style="list-style-type: none"> • <i>ITC 1275</i>, 1978 40 SATC 197(C) (Section 2.2.1) • <i>ITC 1476</i>, 1989 52 SATC 141(T) (Section 2.2.1) • <i>Port Elizabeth Electric Tramway Co Ltd vs CIR</i> 1936 CPD 241 (Section 2.2.1) 	<ul style="list-style-type: none"> • <i>Munro vs FCT</i> 1926 38 CLR 153 (Section 3.2.5.1.2) • <i>Kidston Goldmines Ltd vs FC of T</i> 91 ATC 4538; 1991 22 ATR (Section 3.2.5.1.3) • <i>Ure vs FCT</i> 1981 50 FLR 219 (Section 3.2.5.2.1)

Country		South Africa	Australia
Provision dealing with deductibility of expenses	Court cases		<ul style="list-style-type: none"> • <i>FC of T vs JD Roberts</i> 92 ATC 4380 (Section 3.2.5.2.3) • <i>FC of T vs Smith</i> 92 ATC 4380 1992 23 ATR 494 (Section 3.2.5.2.3) • <i>FCT vs Brown</i> 99 ATC 4600 (Section 3.2.5.3.1)
Provision dealing with non-deductibility of expenses	Applicable	Yes	Yes
	Legislation	Section 23(g) of the South African Act (Section 2.2.1)	Section 8-2 of the Australian Act (Section 3.2.1)
Nature of interest expense	Principle	Not applicable as interest deductibility is determined by section 24J(2) (Section 2.2.1)	In general interest is classified as a revenue expense. (Section 3.2.3)
	Court cases	Not applicable	<ul style="list-style-type: none"> • <i>Australian National Hotels Ltd vs FC of T</i> 1988 19 FCR 234 • <i>Associated Newspapers Ltd vs FC of T</i> 1938 5 ATD 87 • <i>Steele vs DC of T</i> 99 ATC 4242; 41 ATR 139 (Section 3.2.3)

Country		South Africa	Australia
“In the production of”	Applicable	Yes	Yes
	Court cases	<i>Port Elizabeth Electric Tramway Co Ltd vs CIR</i> 1936 CPD 241 (Section 2.2.4.1)	<i>Steele vs DC of T 99</i> ATC 4242; 41 ATR 139 (Section 3.2.4)
	Court cases	<i>Commissioner of Taxes vs Rendle</i> 1965 (1) SA (SRAD) (Section 2.2.4.2)	
Taxation Rulings	Relevant Rulings	<ul style="list-style-type: none"> • Binding Private Ruling 058 (Section 2.2.6.1) • Binding Private Ruling 063 (Section 2.2.6.2) 	<ul style="list-style-type: none"> • Taxation Ruling 2000/17 (Section 3.2.6.1) • Taxation Ruling 95/25 (Section 3.2.6.2)
Tracing test	Applicable	Yes	Yes
	Description	<ul style="list-style-type: none"> • What is the purpose and intention of obtaining a loan? • Is there a clear link between the interest expense and the income earned from the acquisition of the shares? (Section 2.2.2 and Section 2.2.5) 	<p>Four tests:</p> <ul style="list-style-type: none"> • the “use” test • the “subjective purpose” test • the “substitution of funds” test • the “timing” test (Section 3.2.5)

Country		South Africa	Australia
Tracing test	Court cases	<ul style="list-style-type: none"> • <i>CIR vs Shapiro</i> 1928 NPD 436, 4 SATC 29 (Section 2.2.5.1) • <i>New State Areas Ltd vs CIR</i> 1946 AD 610 (14 SATC 155) (Section 2.2.3) • <i>ITC 1089</i>, 28 SATC 208 (Section 2.2.5.2) • <i>CSARS vs Scribante Construction (Pty) Ltd</i> 2002 (4) SA 835 (SCA) (Section 2.2.5.2) 	<ul style="list-style-type: none"> • <i>Munro vs FCT</i> 1926 38 CLR 153 (Section 3.2.5.1.2) • <i>Kidston Goldmines Ltd vs FC of T</i> 91 ATC 4538; 1991 22 ATR (Section 3.2.5.1.3) • <i>Begg vs FCT</i> 1937 4 ATD 257 (Section 3.2.5.1.4) • <i>Ure vs FCT</i> 1981 50 FLR 219 (Section 3.2.5.2.1) • <i>FCT vs Brown</i> 99 ATC 4600 (Section 3.2.5.3.1) • <i>Fletcher vs FCT</i> 91 ATC 4950 1991 22 ATR 613 (Section 3.2.5.2.2)

The objectives listed in section 1.5.2.2 to section 1.5.2.5 were achieved in this chapter. The Australian alternative treatment and applicable legislation requirements to ensure that interest cost in respect of funds borrowed to purchase shares will be deductible on restructuring in Australia were listed.

We can conclude from this chapter that Australian legislation lacks a few important principles to ensure a clear understanding of the interest deductibility relating to the restructuring of a business. The fact that there is no specific legislation for interest deductibility is a disadvantage for the country. The Australian Government needs to revisit their legislation and incorporate this aspect. Another feature that Australia can learn from the South African legislation is the BEE requirements which assist previously

disadvantaged taxpayers to also participate in business restructuring in a tax-efficient way. There is also no definition in the Australian Act and only one court case, *Australian National Hotels Ltd vs FC of T* 1988 19 FCR 234:239-241, is used as a base for determining what interest includes (refer to section 3.2.3).

The alternative South Africa can incorporate in their legislation and practice from Australia, is the fact that tests are used to determine the interest deductibility. The tests provide an easy structure for taxpayers to follow to assist in determining interest deductibility. Tests can be formulated to be used as a base and assist in proving that section 24J(2) requirements are met. The test can for example include specifications which determine whether the taxpayer or business is carrying on a trade and whether the expense is incurred in the production of income.

CHAPTER 4 - OVERVIEW OF THE INTEREST DEDUCTIBILITY ON THE ACQUISITION OF SHARES IN CANADA

4.1 Introduction

In the previous chapter, the Australian legislation was identified, discussed and compared to the South African legislation. As per the summary in section 3.4, Australia and South Africa apply some similar principles, and in chapter 4 the Canadian legislation will contribute further to this study by identifying any additional criteria that can assist with determining the deductibility of interest on borrowed funds to acquire shares in Canada as well as between Canada and South Africa.

A reason for choosing Canada is the current increased business expansion by a major South African company in Canada (Sasol, 2011; SouthAfrica.Info, 2011). Canada applies similar tax legislation to South Africa. Both countries have specific legislation for interest deductibility and the principles applied in Canada will now be discussed.

Sections in the Canadian Act that confirm the deductibility of interest will be identified and discussed. Relevant Canadian court cases on the Canadian Legal Information Institute (hereafter referred to as CLII) website will be identified and analysed. The objective of this chapter will be to test whether interest cost in respect of funds borrowed to purchase shares is deductible on restructuring in Canada.

This chapter addresses the secondary objectives that are listed in section 1.5.2.2 to section 1.5.2.5. This chapter will also provide a comparison in the summary section 4.4 regarding the Canadian and South African legislation for the restructuring of the business through purchasing shares while using a loan.

4.2 Canadian principles and practice

The Canadian legislation is used to form a baseline for this part of the research. Canada applies the tracing test as well as the direct and indirect use test to determine interest deductibility.

4.2.1 Background

Section 18 in the Canadian Act is similar to section 8-1 of the Australian Act, but reversing the positive and exclusionary limbs. Section 18(1) provides that

“... in computing the income of a taxpayer from a business or property no deduction shall be made in respect of:

- (a) an outlay or expense except to the extent that it was made or incurred by the taxpayer for the purpose of gaining or producing income from the business or property;
- (b) an outlay, loss or replacement of capital, a payment on account of capital or an allowance in respect of depreciation, obsolescence or depletion except as expressly permitted by this part ...”

(CLII, 1985:section 18; Dabner, 1999:2).

Interest is deductible according to section 20(1)(c) of the Canadian Act in four circumstances:

- on borrowed money used for the purpose of earning income from a business or property;
- on an amount payable for property acquired for the purpose of gaining or producing income from the property or from business;
- on amounts paid to a taxpayer under an Appropriation Act for the purpose of advancing or sustaining scientific research and development of the manufacturing industry, or for prospecting, drilling, and exploring for minerals; and
- on money to acquire an interest in certain annuities

(CLII, 1985:section 20(1)(c); Marquis, 2003:3).

In *Ludco Enterprises Ltd. et al vs The Queen* 2002 2 CTC 95, 2001 DTC 5505 (SCC) it stated that “... the requisite test to determine the purpose for interest deductibility under section 20(1)(c)(i) is whether, considering all the circumstances, the taxpayer had a reasonable expectation of income at the time the investment is made.” The court further stated that “... it is clear that ‘income’ in section 20(1)(c)(i) refers to income generally, that is an amount that would come into income for taxation purposes, not just

net income”. Income must not be interpreted as ‘profit’ or ‘net income’ (CLII, 2001:4). The *Ludco* case will be further discussed in section 4.3.2.

To comply with the Supreme Court’s decision, Interpretation Bulletin IT-80 dealing with the deductibility of interest on money borrowed to redeem shares or pay dividends was withdrawn (Tamaki, 2010:11). Income tax interpretation bulletins are issued by the Canada Revenue Agency (hereafter referred to as the CRA) to provide technical interpretations regarding certain provisions contained in income tax law. Interpretation bulletins are mainly used by tax specialists, but they also assist taxpayers by way of providing a technical explanation of the law. This is similar to South African Revenue Service rulings issued in South Africa.

IT-80 confirmed that interest was deductible on money borrowed to pay a dividend, unless a substantial portion of the “accumulated profits” of the business was not used for a purpose as specified under paragraph 20(1)(c). The transaction in this interpretation bulletin related to a taxpayer who borrowed funds to pay dividends after profits were used for expansion (Tamaki, 2010:10).

On 2 June 1987 the Canadian Department of Finance introduced a “notice of ways and means motion” which was intended to preserve Revenue Canada’s administrative practices as they existed before the *The Queen vs Bronfman Trust* 1987 1 CTC 117; 1987 DTC 5059 (SCC) decision (refer to section 4.2.3) (Tamaki, 2010:11).

On 20 December 1991, draft legislation was introduced in Canada. The draft legislation noted that the Canadian Government does not consider the “tracing” test as the only criterion for determining the deductibility of interest (Tamaki, 2010:11).

IT-533 was issued 31 October 2003 which discussed the CRA’s interpretation of the deductibility of interest expenses. This draft legislation did not affect section 20(1)(c), but “add(ed) a new rule which would deny the deductibility of losses from the deduction of interest and other expenses in some cases, where there is no reasonable expectation of profit” (Tamaki, 2010:3).

4.2.2 Principles

The general principle is that interest is not deductible by a taxpayer declaring a dividend that is received “tax free” by a Canadian corporate shareholder. Canadian shareholders who are individuals also receive beneficial treatment of dividends through the gross up treatment. Interest is deductible by the taxpayer who incurs the expense and includes it in the income of a recipient (Tamaki, 2010:3).

The principle of interest being deductible in Canada is different to South African practice mainly due to the dividends being included in taxable income in Canada, whereas in South Africa dividends are currently classified as exempt income in section 10(1)(k) of the South African Act.

When applying the purpose test to determine whether interest will be deductible the following questions must be answered:

- Is it the objective or subjective purpose of the taxpayer that is relevant?
- How will the purpose be ascertained - is it by reference to the use of the borrowed funds and if so, is a tracing of those funds through to their use required?
- If the borrowed funds are provided to other entities or persons, is it permissible to trace through these entities to identify the ultimate application of the funds?
- Is it only the immediate purpose that is relevant, or may subsidiary or indirect purposes also be referred to?
- What is the purpose of the funds? - is the initial purpose for which they were borrowed or only the current purpose relevant due to changes which occurred?
- In the event of refinancing, do the new borrowings embrace the same purpose as the original?
- What if there is a multitude of purposes - is an attempt to identify the dominant purpose required, or is an apportionment approach envisaged?
(Dabner, 1999:3).

Maroney identified three further issues to consider when determining the tax deductibility of an interest expense based on income-yielding investments as defined by the CRA. They are as follows:

- Do you intend to earn income?
- Are you running your activities in a business-like manner?
- How much borrowed funds have been invested?

(Maroney, 2005).

The word “income” refers to any return received by a taxpayer, which includes dividends. Section 18(1) requires that the interest expense must be incurred in the production of income from a business (CLII, 1985:section 18). Business would require that a taxpayer or company conduct transactions to generate profits. Business should be restructured to receive maximum income and ensuring that costs are deductible for tax purposes.

4.2.3 Nature of interest expense

In *Gifford vs The Queen* 2004 DTC, the Supreme Court of Canada prescribe that the test to determine the nature of interest was to establish the nature of the proceeds of the loan to the borrower. “If the proceeds of a loan are inventory to the borrower, such as in the case of a money lender (i.e. where the borrowing is part of the day to day business), then interest expense would be deductible” (Tamaki, 2010:2). Where borrowed money is not inventory to the borrower, it will usually be a capital expense

Section 20(1)(c)(i) provides that interest is only allowed as a deduction when borrowed money is used for the purpose of earning income. Interest will not be deductible if the borrowed money is used for the purpose of making a capital gain (Tamaki, 2010:2). This principle is different from South Africa after the introduction of section 24(J), which no longer requires a distinction between the revenue or capital attainable income. If the expense is incurred in the production of income from carrying on a trade, the interest will be deductible.

After identifying the general and specific legislation applicable in Canada with respect to interest deductibility, section 4.2.4 will discuss the tracing test that is applied in the Canadian practice, and section 4.2.5 will discuss the direct and indirect use test. Court cases where the tests were applied are also discussed in the following paragraphs.

4.2.4 Tracing test

The tracing test implies the tracing of borrowed funds to an income-producing use. The main principles from the tracing test were identified in the *Shell Canada Limited vs The Queen* 1999 4 CTC 313, 1999 DTC 5669 (SCC) and *The Queen vs Bronfman Trust* 1987 1 CTC 117; 1987 DTC 5059 (SCC) cases.

In *Judgments of the Supreme Court of Canada, 1999:4* (refer to section 4.3.2), the Court said that if a direct link can be drawn between the borrowed money and an eligible use, then the money was used for the purpose of earning income from a business or property. It was concluded that, “interest is deductible only if there is a sufficiently direct link between the borrowed money and the current eligible use ...”.

In *The Queen vs Bronfman Trust* 1987 1 CTC 117; 1987 DTC 5059 (SCC) (refer to section 4.2.3), the court stated, “... the text of the Act requires tracing the use of borrowed funds to a specific eligible use ...” and also stated, “The onus is on the taxpayer to trace the borrowed funds to an identifiable use which triggers the deduction.” The Court disallowed the deduction for interest because the direct use of the borrowed money was to effect a distribution rather than being retained by the trust to earn income (CLII, 2001:24).

4.2.5 Direct and indirect use test

In Canada the following questions are raised when the use of borrowed funds are considered:

- Does the use refer to the direct and indirect use?
- Does the use refer to the first use or the current use?

(Canada IT-533, 2003:5).

The direct and indirect use of the borrowed money must be determined. One should test whether the use gave effect to a legal relationship. A taxpayer is allowed to restructure borrowings to meet the direct use test. The *Canada Safeway, The Queen vs Bronfman Trust* 1987 1 CTC 117; 1987 DTC 5059 (SCC) and *Shell Canada Limited*

vs The Queen 1999 4 CTC 313, 1999 DTC 5669 (SCC) court cases have made it clear that the relevant use is the current use and not the original use of borrowed money (Canada IT-533, 2003:5).

Where borrowed money ceases to be used for the purpose of earning income, there is no longer a trace to an income-earning use. If, however, there is still a partial link for the purpose of earning income, a portion of interest will continue to be deductible (Canada IT-533, 2003:5).

Trans-Prairie Pipelines Ltd vs M.N.R. 1970 CTC 537, 1970 DTC 6351 (Ex Ct) and *The Queen vs Bronfman Trust* 1987 1 CTC 117; 1987 DTC 5059 (SCC) applied the direct and indirect use test.

4.2.5.1 *Trans-Prairie Pipelines Ltd vs M.N.R.* 1970 CTC 537, 1970 DTC 6351 (Ex Ct)

The indirect use test will be used in special circumstances. In *Trans-Prairie Pipelines Ltd vs M.N.R.* 1970 CTC 537, 1970 DTC 6351 (Ex Ct), the Court concluded that interest was deductible where the taxpayer borrowed money to redeem preferred shares. There was no current and direct income-earning purpose for the borrowed funds. P Jackett held that the words, “money used in a business to earn income” refer to the mass of capital dedicated to that business through different forms while it remains in the business. The borrowed funds were used to fill in the hole left by the redemption of the shares. Thus the interest should be deductible (Tamaki, 2010:10).

4.2.5.2 *The Queen vs Bronfman Trust* 1987 1 CTC 117; 1987 DTC 5059 (SCC)

In *The Queen vs Bronfman Trust* 1987 1 CTC 117; 1987 DTC 5059 (SCC), the Trust used borrowed money to make capital distributions to the beneficiaries. Was the Trust entitled to deduct interest on this borrowed money? The Trust argued that the borrowed money was used to pay the distribution and support the purpose of earning income from the Trust’s property, since it allowed the Trust to retain income-producing investments. In the Supreme Court of Canada, it was held that the interest was not deductible, on the basis that the direct use of the borrowed money was not for an eligible income-producing purpose. *Bronfman Trust* stated, “... there are exceptional circumstances in

which, on a real appreciation of a taxpayer's transactions, it might be appropriate to allow the taxpayer to deduct interest on funds borrowed for an ineligible use because of an indirect effect on the taxpayer's income-earning capacity .". Revenue Canada's administrative practices sanctioned this exception (Canada, 2003:6).

Exceptions to the direct use test are when borrowed money is used by a corporation to redeem shares, return capital or pay dividends. The purpose test will be met if the borrowed money replaces capital (contributed capital or accumulated profits) that was being used for purposes that would have qualified for interest deductibility, had the capital been borrowed money (Canada IT-533, 2003:6).

It is said in IT-533 that in situations where some proportion of shares is being replaced with borrowed money, only the capital of those shares, computed on a pro-rata basis, would be considered to be replaced with the borrowed money. "Similarly, with regard to the payment of dividends, borrowed money used to replace the accumulated profits of a corporation that have been retained and used for eligible purposes can be an exception to the direct use test. The accumulated profits of a corporation do not track any particular shareholdings" (Canada IT-533, 2003:6).

There are two types of borrowing rates, either loans with a fixed or variable interest rate, while preference shares used for financing purposes could be at a fixed or variable dividend rate. Where a fixed interest or dividend rate is determined at the beginning of a transaction, the reasonable expectation of income is clearer than when it is a variable rate. Interest incurred at fixed interest rates will be fully deductible for tax purposes. Common shares are an example of interest and dividend rates which are variable. The CRA does allow a deduction for interest in respect of funds borrowed to purchase common shares, as there is some reasonable expectation of dividends to be received from the shares (Canada IT-533, 2003:7).

4.3 Court cases specifically relating to interest deductibility

The following Canadian court cases relate specifically to interest deductibility when acquiring shares with borrowed funds:

4.3.1 Ludco Enterprises Ltd. et al vs The Queen 2002 2 CTC 95, 2001 DTC 5505 (SCC)

In *Ludco Enterprises Ltd. et al. vs The Queen 2002 2 CTC 95, 2001 DTC 5505 (SCC)*, several Canadian individuals and private corporations borrowed money to purchase shares of two Panamanian investment companies. Ludco deducted \$6 million in interest on funds borrowed. The investment strategy of the offshore companies was to acquire debt securities and reinvest most of their profits, with a relatively small amount of earnings being paid out as dividends. The company received \$600 000 in dividend income. The shares were later sold resulting in a capital gain of \$9,2 million. The CRA disallowed the interest deduction. The Supreme Court however allowed Ludco's appeal, indicating that the interest costs were deductible under subparagraph 20(1)(c)(i) of the Income Tax Act (CLII, 2001:2-3).

The issues considered in this case were the following:

- section 20(1)(c)(i) which required that borrowed money must be used for the purpose of earning income from a business or property. The court looked at the current use of the borrowed funds (CLII, 2001:35);
- J Iacobucci referred to the following quotation from *Tennant vs The Queen 1996 1 CTC 290, 1996 DTC 6121 (SCC)*, "as long as the taxpayer establishes a link between the current shares, the proceeds of disposition of the original shares, and the money that was borrowed to acquire the original eligible use property, it is in keeping with the interest-deduction provision to permit the taxpayer to continue to deduct the interest payments for the full amount of the original loan, regardless of the value or costs of the newly acquired shares" (CLII, 2001:35);
- taxpayers had to prove a link between the borrowed money and its current use. The Court stated, "although earning income was not the principal factor that motivated Ludco to invest in the foreign companies, Ludco anticipated the receipt of dividend income, and the objective documentary evidence indicates that the

appellants had a reasonable expectation of earning income. Furthermore, dividend income was actually received” (CLII, 2001:5);

- the use of the borrowed funds was linked to both the dividend income and the capital gain that the taxpayer realised on the subsequent sale of the shares (CLII, 2001:25);
- Was income earned from a business or property? Yes;
- Did the company have a reasonable expectation of profit? Yes; and
- Ludco had a reasonable expectation of earning income from its foreign investments (CLII, 2001:32).

The main principle taken from the case is that a link must be established between the borrowed money and the current use thereof. The borrowed funds must be used for earning income from a business. In this case the borrowed funds were used to purchase shares in foreign companies with the purpose of using the funds to earn income.

4.3.2 *Tennant vs The Queen* 1996 1 CTC 290, 1996 DTC 6121 (SCC)

In *Tennant vs The Queen* 1996 1 CTC 290, 1996 DTC 6121 (SCC), the taxpayer borrowed \$1 000 000 which he used to invest in shares of a corporation. After a decline in the value of the shares to \$1 000 the taxpayer rolled the investment into a holding company under section 85 of the Canadian Act, taking back shares of the holding company. The Tax Court and the Federal Court of Appeal ruled that interest on only \$1 000 of the original loan was deductible after this transaction. The Supreme Court of Canada rejected this and stated that the ability to deduct interest was not lost simply because the taxpayer sold income-producing property, as long as the proceeds were reinvested in eligible-use property (Tamaki, 2010:9).

In this case the interest was still deductible after the section 85 roll-over that took place. As long as there is a link between the borrowed funds and the use thereof, the interest will be deductible. The original and current use must be linked to ensure that deductibility of interest will continue after a business restructuring took place. Tracing the funds is a principle that is also applied in Australian practice.

4.3.3 *Emerson vs The Queen* 86 D.T.C. 6184 (FCA)

The problem with the current use test was confirmed in *Emerson vs The Queen* 86 D.T.C. 6184 (FCA). The taxpayer borrowed money to purchase shares, thereafter disposing of the shares at a loss and borrowing a second loan in order to repay the balance of the previous loan. The interest on the second loan was not deductible. The source of income did no longer exist, as the shares were no longer held by the taxpayer which previously provided income. Section 20.1 of the Canadian Act now deems the original use of borrowed money to be continued under certain circumstances after a taxpayer ceases to use borrowed money for the purpose of earning income from a capital property or from a business (Dabner, 1999:13).

4.3.4 *Ludner vs The Queen* 98 DTC 6045

In *Ludner vs The Queen* 98 DTC 6045, an interest deduction was denied on funds borrowed to acquire shares in certain foreign companies on the basis that there was no possibility that the investment proceeds would exceed carrying costs. The draft legislation issued in 1991 permitted a deduction in terms of section 20(1)(qq) for interest on borrowings to acquire shares where the return from the shares will be less than the interest outlay. The deduction is limited to the total of all amounts included in computing the taxpayer's income for the year from the shares. Where interest on the borrowed money exceeds income from the shares, the non-deductible excess may be carried forward and deducted in the following year (Dabner, 1999:11).

4.3.5 *Shell Canada Limited vs The Queen* 1999 4 CTC 313, 1999 DTC 5669 (SCC)

Shell Canada Limited vs The Queen 1999 4 CTC 313, 1999 DTC 5669 (SCC) looked at the four characteristics that need to be present to qualify for the interest deduction. The elements are:

- the amount must be paid or payable in the year in which it is deducted;
- it must be paid pursuant to a legal obligation;
- the borrowed money must be used for the purpose of earning income from a business or property; and

- the amount must be calculated at a reasonable rate (Marquis, 2003:7).

4.4 Mergers and acquisitions in Canada

Mergers and acquisitions in Canada describe combinations of business enterprises by way of acquisition or amalgamations allowed under the corporate law. “The M&A market in Canada have maintained steady slow growth” (Blanchet, 2012:1).

Rules were proposed in 2011 to restrict the use of loans from a foreign affiliate subsidiary company to its parent. The use of upstream loans was a planning strategy and an alternative to the distribution of funds earned by the foreign affiliate where the distribution would have been taxable when received by the Canadian parent. The proposed rules also appear to prevent certain cash-pooling methods used by Canadian corporations that are part of multinational groups (Blanchet, 2012:2).

In Canada a purchaser would prefer to acquire assets in a business rather than acquire the shares. Acquiring assets results in the purchaser obtaining a higher tax shield, as the assets are equal to fair market value and shares are valued at an historical tax shield. From this can be concluded that the cost base of the asset will increase to represent the fair value of the asset, which in return will result in a lower capital gain once the asset is sold. The value of shares purchased will always remain the historical ones, and once the asset is sold, this results in a bigger capital gain on which capital gains tax has to be paid. The vendor needs to indemnify any undisclosed tax liabilities that may exist or generate in the period prior to the date of closing (Blanchet, 2012:2).

The advantage of acquiring shares in a Canadian company by borrowing funds is the tax deductibility of the interest and related finance expenses. The deductible interest expense is limited to the generated profit income by the business. Financing details of the acquisition are significant in Canada, as the combined federal and provincial corporate tax rates in Canada are higher (Blanchet, 2012:8).

The checklist for debt funding in Canada includes the following:

- The use of bank debt is advantageous due to no thin capitalisation rules, no transfer pricing problems on the interest rate, and no withholding tax on interest payments;
- If the debt is funded from a related party in Canada, they must consider whether the 2:1 debt-to-equity thin capitalisation restrictions will apply. Withholding tax may apply on the interest paid.
- Consider whether the level of profits would enable tax relief for interest payments to be effective;
- Consider whether interest-free loans would have interest imputed if loans from a Canadian corporation to a non-resident are outstanding for more than one year;
- Consider whether a deemed dividend exists when debt is borrowed to make a distribution;
- Consider whether there is an income inclusion to the Canadian corporation on upstream loans made by its foreign affiliates;
- If the debt is borrowed by the Canadian target company to redeem shares that is in excess of paid-up capital and retained earnings or dividends are paid in excess of retained earnings, interest expense incurred to fund the excess amounts relating to such distributions may not be tax-deductible;
- Consider whether transfer pricing principles could apply to interest rates charged on related party debts; and
- Consider cashflow issues and whether interest payments made on related party debt may be deferred for two years

(Blanchet, 2012:9).

4.5 Summary

Where borrowing is undertaken to purchase common shares in Canada, the primary issue is whether the objective of borrowing is to earn income. Common shares will generate dividend income and this fact satisfies the income-earning test. The CRA states “where evidence from corporate officials indicates that dividends are not expected to be paid and that shareholders are required to sell their shares in order to realise their value, the purpose test would likely not be met” (Maroney, 2005).

Another situation is “where a corporation is silent with respect to its dividend policy, or where the dividend policy is that dividends will be paid when operational circumstances permit, the purpose test will likely be met”. The interest expense incurred should be deductible for income tax purposes in this case (Maroney, 2005).

As per the guidance provided on the CRA website for Line 221 - Carrying charges and interest expenses, an individual can claim the interest paid on money borrowed for investment purposes, but generally only as long as its use is to try to earn investment income, including interest and dividends. However, if the only earnings the investment can produce are capital gains, one cannot claim the interest paid (Canada Line 221). The CRA states in IT-533 that “... the onus is on the taxpayer to trace or link the borrowed money to a specific eligible use, giving effect to the existing legal relationships.” (Canada, 2003:4).

The Canadian Act requires tracing the use of the borrowed funds to a specific eligible use. The tracing test is also applied in Australia and can be seen as a fundamental tool in determining the deductibility of interest. A link must be established between the borrowed money and its use. The indirect use should lead to an increase or sustainability of economic value because of the borrowed funds.

Principles to establish whether the interest will be deductible:

- Is the interest expense incurred for the purpose of gaining or producing income from the business or property?
(refer to section 4.2.1)

- Are the proceeds of the loan revenue or capital of nature?
(refer to section 4.2.3)
- Can borrowed funds be traced to an income-producing use?
(refer to section 4.2.4)
- What is the direct and indirect use of the borrowed funds?
(refer to section 4.2.5)
- Is there a link between the borrowed money and its current use?
(refer to section 4.3.1)
- Was income earned from a business or property?
(refer to section 4.3.1)
- Did the company have a reasonable expectation of profit?
(refer to section 4.3.1)

The main principle is that interest will be deductible on borrowed funds to acquire shares if the taxpayer proves that the purpose was to earn income from this transaction. The following table will summarise the main differences and similarities between the Canadian and South African legislation concerning the deductibility of interest. This comparison shows that Canada has specific legislation dealing with interest deductibility, whereas Australia and South Africa apply general principles in the legislation to determine interest deductibility.

Table 4 - Comparison between the legislation relating to interest deductibility of South Africa and Canada

Country		South Africa	Canada
Interest definition	Definition in Act	Yes Section 24J(1) (Section 2.2.1)	No
	Court cases / References	<i>CIR vs Genn & Co (Pty) Ltd</i> 1955 (3) SA 293 (A) (20 SATC 113) (Section 1.2)	IT-533 (Section 1.2)
General Provision dealing with deductibility of expenses	Applicable	Yes	Yes
	Legislation	Section 11(a) of the South African Act (Section 2.2.1)	Section 18(1) of the Canadian Act (Section 4.2.1)
	Court cases	<ul style="list-style-type: none"> • <i>ITC 1275</i> 1978 40 SATC 197(C) (Section 2.2.1) • <i>ITC 1476</i>, 1989 52 SATC 141(T) (Section 2.2.1) • <i>Port Elizabeth Electric Tramway Co Ltd vs CIR</i> 1936 CPD 241 (Section 2.2.1) 	<i>Ludco Enterprises Ltd. et al vs The Queen</i> 2002 2 CTC 95, 2001 DTC 5505 (SCC) (Section 4.2.1)
Specific Provision dealing with deductibility of expenses	Applicable	Yes	Yes
	Legislation	Section 24J(2) of the South African Act (Section 2.2.1)	Section 20(1)(c) of the Canadian Act (Section 4.2.1)

Country		South Africa	Canada
Taxation Rulings	Relevant Rulings	<ul style="list-style-type: none"> • Binding Private Ruling 058 (Section 2.2.6.1) • Binding Private Ruling 063 (Section 2.2.6.2) 	<ul style="list-style-type: none"> • IT-80 (Section 4.2.1) • IT-533 (Section 4.2.5)
Nature of interest expense	Principle	Not applicable as interest deductibility is determined by section 24J(2) (Section 2.2.1)	<ul style="list-style-type: none"> • If proceeds of a loan are inventory to the borrower, then interest expense will be deductible. • Where borrowed money is not inventory to the borrower, it will be a capital expense (Section 4.2.3)
	Court cases	Not applicable	<i>Gifford vs The Queen</i> , 2004 DTC (Section 4.2.3)
“In the production of”	Applicable	Yes	Yes
	Court cases	<ul style="list-style-type: none"> • <i>Port Elizabeth Electric Tramway Co Ltd vs CIR</i> 1936 CPD 241 (Section 2.2.4.1) • <i>Commissioner of Taxes vs Rendle</i> 1965 (1) SA (SRAD) (Section 2.2.4.2) 	<i>Ludco Enterprises Ltd. et al. vs The Queen</i> 2002 2 CTC 95, 2001 DTC 5505 (SCC) (Section 4.3.1)
Tracing test	Applicable	Yes	Yes

Country		South Africa	Canada
Tracing test	Description	<ul style="list-style-type: none"> • What is the purpose and intention of obtaining a loan? • Is there a clear link between the interest expense and the income earned from the acquisition of the shares? (Section 2.2.2 and Section 2.2.5) 	<ul style="list-style-type: none"> • Does the use refer to the direct and indirect use? • Does the use refer to the first use or the current use? (Section 4.2.4)
	Court cases	<ul style="list-style-type: none"> • <i>CIR vs Shapiro</i> 1928 NPD 436, 4 SATC 29 (Section 2.2.5.1) • <i>New State Areas Ltd vs CIR</i> 1946 AD 610 (14 SATC 155) (Section 2.2.3) • <i>ITC 1089</i>, 28 SATC 208 (Section 2.2.5.2) • <i>CSARS vs Scribante Construction (Pty) Ltd</i> 2002 (4) SA 835 (SCA) (Section 2.2.5.2) 	<ul style="list-style-type: none"> • <i>Trans-Prairie Pipelines Ltd vs M.N.R.</i> 1970 CTC 537 • <i>The Queen vs Bronfman Trust</i> 1987 1 CTC 117; 1987 DTC 5059 (SCC) (Section 4.2.5.1)

The objectives listed in section 1.5.2.2 to section 1.5.2.5 relating to Canadian principles and practise was achieved in this chapter. Canadian legislation was discussed to identify alternative ways of structuring transactions according to legislation requirements to ensure that interest will be deductible when borrowing funds to purchase shares while restructuring the business.

The Canadian legislation is similar to South African legislation due to a specific provision in the Canadian and South African Act relating to interest deductibility. Canada issued income tax interpretation bulletins (refer to section 4.2.1 and section 4.2.5) where South Africa issued binding private rulings relating to interest deductibility (refer to section 2.2.6).

Similar to Australia, Canada can learn from the South African legislation with regards to the BEE requirements which assists previously disadvantaged taxpayers to also participate in business restructuring in a tax efficient way. Another negative characteristic of the Canadian legislation is that there is no interest definition in the Canadian Act. The *Miller* case (refer to section 1.2) is used as a guideline to indicate what defines interest.

An alternative which South Africa could consider from the Canadian practice is the application of the direct and indirect use test to determine whether the interest expense directly or indirectly contributed to the dividend income received. The direct and indirect use test was applied in the *Trans-Prairie Pipelines Ltd vs M.N.R.* 1970 CTC 537, 1970 DTC 6351 (Ex Ct), as well as *The Queen vs Bronfman Trust* 1987 1 CTC 117; 1987 DTC 5059 (SCC) court cases.

CHAPTER 5 - SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

Chapters 2, 3 and 4 achieved all the objectives listed in section 1.5.2.2 to section 1.5.2.5, namely to list and evaluate interest deductibility in South Africa, Canada and Australia. The research indicated alternative ways to structure transactions to legislation requirements to ensure that interest cost in respect of funds borrowed to purchase shares will be deductible on restructuring in South Africa, Canada and Australia. The objective of this chapter is to summarise the research findings and make recommendations on the possible changes to South African legislation.

5.2 Research findings

The identification of alternative legislation on deductibility of interest when restructuring a business in South Africa was the focus of this study. Principles applied in each of the alternative countries relating to interest deductibility were identified and court cases were discussed that provided further guidance to taxpayers and tax practitioners. Obtaining a view of the different countries showed the differences as well as similarities.

The similarities and differences between South Africa and Australia were identified in section 3.4 and a comparison between South Africa and Canada was formulated in section 4.5. There is no interest definition in the Canadian Act or Australian Act. Section 24J(1) of the South African Act prescribes clearly what “interest” includes. The findings of this study revealed that Australia applies a general provision in the legislation acts when determining the interest deductibility on borrowed funds when acquiring shares. South Africa and Canada have a specific provision in the legislation acts relating to interest deductibility. Canada was forced to issue draft legislation on interest because of the court decision in *The Queen vs Bronfman Trust* 1987 1 CTC 117; 1987 DTC 5059 (SCC) (refer to section 4.2.5.2). After the introduction of section 24J in the South African Act, taxpayers are clearer on the treatment of interest deductibility when acquiring shares with borrowed funds. The requirements for interest deductibility includes that the interest expense should be incurred as part of carrying on a trade and

in the production of income. If these two requirements can be proved by the taxpayer, SARS will allow the interest expense as a deduction from taxable income.

One similarity between Australia and Canada is the main test used by the courts which is the “tracing” test. The test is used to determine whether or not borrowed funds are used for the purpose of gaining or producing income from business or property (refer to section 3.2.4 and section 4.2.4).

South Africa is the only country that provides BEE advantages for a company when restructuring the business. In the event of listed shares, a third of interest expenditure on borrowed funds relating to the acquisition of shares can be added to the base cost of the shares (refer to section 1.2 and section 2.2.8). This provision is applicable to specifically defined previously disadvantaged shareholders, but makes it more affordable for BEE candidates to also participate.

Alternative treatment for South Africa taken from the Australian principles is to have a framework where tests are used to determine if the expense was incurred in the production of income, as well as to determine if trade was carried on. This will incorporate the guidelines of section 24J.

When comparing South Africa to Canada, South African legislation and practice are less complicated than Canada. Canada treats dividend income differently, resulting in many more tests to be followed to determine if the end result is deductible interest. The objective listed in section 1.5.2.9 was achieved, as the test in this chapter provides the alternative criteria applicable when structuring transactions to obtain interest deductibility in South Africa compared to Canada and Australia.

Restructuring the business by way of acquiring shares from borrowed funds has various taxable benefits for the company. The advantages of share purchases in the three countries are listed below:

Table 5 - Advantages of share acquisitions in South Africa, Australia and Canada

South Africa	Australia	Canada
Lower capital outlay.	Lower capital outlay.	The share sale is more attractive to the vendor; the price may be lower.
More attractive to vendor, the price may be lower.	Potential to step-up the tax value of assets in a 100 percent acquisition.	The purchaser may benefit from tax losses of the target company.
May benefit from tax losses of target company.	Less complex contractually and likely to be more attractive to seller.	The purchaser gains the benefit of existing supply and technology contracts.
Existing contracts will be unaffected and therefore may gain the benefit of existing supply or technology contracts.	May benefit from tax loss of the target company (unless the target company was a member of a tax-consolidated group).	The purchaser does not have to pay transfer taxes on shares acquired.
	Lower or nil stamp duties payable.	
(Rudnicki, 2012:14)	(Linke, 2012:13)	(Blanchet, 2012:13)

The disadvantages of share purchases in the three countries are listed below:

Table 6 - Disadvantages of share acquisitions in South Africa, Australia and Canada

South Africa	Australia	Canada
Assumption of all liabilities that are in the target company, including tax liabilities.	Liable for any claims or previous liabilities of the entity, including joint and several liability for tax debts of seller’s consolidated group where no valid tax sharing agreement exists.	Purchaser acquires unrealised tax liability for depreciation recovery on the difference between original cost and tax book value of assets.
Stamp duty on the higher of the market value or consideration paid for the shares is payable by purchaser.	Target company losses remain with the seller where the target company is leaving the seller’s tax-consolidated group.	Purchaser is liable for all contingent and actual liabilities of the target company.
No tax deduction of the funding cost.	GST (goods and services tax) leakage may arise on transaction costs if full input tax credits are not available.	There is no deduction for the excess of purchase price over tax value of assets.
(Rudnicki, 2012:14)	(Linke, 2012:13)	(Blanchet, 2012:13)

Any business restructuring adopted in South Africa, Australia and Canada can benefit from using the following test that is formulated from this study. When using the test as a guide to determine interest deductibility on borrowed funds to acquire shares, it will provide the taxpayer with sufficient detail to restructure business transactions in a more tax efficient way to ensure that interest will be deductible

Table 7 – Alternatives for interest deductibility on borrowed funds when acquiring shares



5.3 Recommendations for further research

The aim of this research was to identify alternative treatments to South African legislation relating to interest deductibility on borrowed funds when acquiring shares while restructuring a business. Recommendations on possible changes to South African legislation on the deductibility of interest are derived from Australian case law principles. The use test (refer to section 3.2.5.1), as well as the subjective purpose test (refer to section 3.2.5.6) are possible tests to include as part of identifying whether the interest will be deductible. From the principles and legislation applied by Canada, it can be suggested to include as an alternative for South Africa the direct and indirect use test (refer to section 4.2.5).

International trade transactions are currently increasing. Further research will have to take cognisance of the fact that countries worldwide are continually adjusting to change, and tax legislation is continually being updated to lure foreign investment. In times of crises such as with the Euro zone at present, countries will revisit legislation and recommend amendments to maintain survival in the market.

It is clear from the above discussion that further research is required that can broaden the view of interest deductibility in other countries. The research can also be extended to include more companies' perspectives regarding the interest deductibility on borrowed funds when acquiring shares as part of restructuring.

It is recommended that a similar study be conducted in other countries to determine how the countries apply the tax legislation relating to the interest deductibility when borrowing funds to acquire shares. Taxpayers consider all tax benefits prior to entering into the transaction. A study can be completed to determine the number of transactions successfully entered into per country, which will indicate which country attracts the most investors for transactions where funds are borrowed to acquire shares.

The lack of interest methodology in the legislation acts of Australia and Canada can result in a proposal that the acts incorporate a definition to ensure that taxpayers are clear on what interest entails. The Australian and Canadian governments can refer to section 24J(2) of the South African Act to incorporate this proposal.

In conclusion, the BEE advantages that are included in the South African practice can be implemented by other countries. Implementing and promoting BEE in business restructurings could provide tax benefits and ensure business growth.

It is also recommended that a study be conducted to analyse the new section 24O introduced in the South African Act in October 2012 and how this section affect the deductibility of interest when acquiring shares when restructuring a business. This section relates to debt financed acquisitions of controlling share interests. “A special deduction will be added for interest incurred if that interest is associated with debt used to acquire controlling share interests in operating companies, and the acquisition is comparable to those indirectly allowed for indirect share acquisitions. (National Treasury, 2012)”

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