IN THE SUPREME COURT OF APPEAL
OF SOUTH AFRICA

REPORTABLE

Case No: 26/2001

In the matter between:

COMMISSIONER FOR THE SOUTH AFRICAN REVENUE SERVICE — ***APPELLANT***

and

SCRIBANTE CONSTRUCTION (PTY) LTD — ***RESPONDENT***

Coram: ***HOWIE, SCHUTZ JJA et HEHER AJA***
Heard: ***3 MAY 2002***
Delivered: ***14 MAY 2002***

Summary: Income tax – s s 11(a) and 23(g) of Act 58 of 1962 – dividends declared by company credited to shareholders' loan accounts – interest paid on such loans – whether taxable

---

J U D G M E N T

HEHER AJA/…

***HEHER AJA*:**

[1] The respondent is a civil engineering construction company the activities of which are mainly road building and earthmoving. It has been a family concern for more than fifty years. Its shareholders are three family trusts. They have developed a number of practices designed to suit both their own interests and those of the company. One such is to leave dividends "banked" in the company (which then credits their loan accounts with an agreed rate of interest) until more advantageous investment opportunities arise.

[2] During 1990 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. No money was moved or changed hands. The arrangements were effected solely by book entries. In fact, the cash funds of the company which

were available for the purpose of the distribution remained in the interest-bearing call accounts held by the company.

[3] In its 1991, 1992 and 1993 returns for income tax the company 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 allowed by s 11(a) of the Income Tax Act, 58 of 1962. The appellant disallowed the deductions. In amplification, he informed the taxpayer that

> '[t]he 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. In the case of *Scribante Construction (Pty) Ltd* it is clear that the interest was incurred as a result of the dividend declaration and consequently is not-productive.'

[4] The company appealed successfully to the Income Tax Special Court. A further appeal by the Commissioner to the Full Court of the Eastern Cape Division was decided in the taxpayer's favour by a majority. The matter now comes before this Court with special leave granted.

[5] The only evidence before the Special Court was that of the company's auditor, Mr Jacobs. It was not seriously contested. Aside from the background which I have sketched, the salient facts which emerged are set out in the next paragraph.

[6] When the company declared the dividend, the money held in the call accounts was surplus to its immediate operational requirements to the extent of R3 373 242, which is why it was prepared to pay interest on that amount but not beyond it. During the years 1991, 1992 and 1993 the net current accounts of the company (excluding cash on hand) were respectively R1 346 996, R2 984 216 and R1 587 971. If the shareholders had been paid out instead of lending the money to the company or had withdrawn all the interest-bearing loans, the company would have been in a solvent condition with sufficient available cash to meet its day to day requirements. An important aspect of the company's business involved the furnishing of

contract guarantees (surety bonds) for construction work which it was to undertake. The ability of the company to reflect a substantial cash reserve in its financial statements was of material assistance in readily obtaining the issue of guarantees from financial institutions, thereby sharpening its competitive edge when tendering for contracts and increasing its income potential. The interest earned by the company on the call accounts fluctuated. In 1991 the average rate was 16% per annum, in 1992 15.3% and in 1993 11.3%. Although the total interest on the loaned funds in the call accounts over the three years amounted to R1 648 216, the amount credited to the shareholders loan accounts was only R1 516 108, the company retaining the difference. (The interest rate which the company had agreed to pay the shareholders was apparently less than it in fact earned in each of the first two years but greater in the third.) The shareholders disclosed the interest credited to their loan accounts and were duly assessed on it. Jacobs

testified that the manner of treatment of the dividends by the company was a common practice in private companies.

[7] The issues argued before us were 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 s 11(a) of the Act and whether the interest was laid out or expended by the company for the purposes of trade within the meaning of s 23(g).

[8] The legal principles are well-established.

'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 (see *Commissioner for Inland Revenue* v *Nemojim (Pty) Ltd* 1983 (4) SA 935(A) at 947 G – H and the authorities there cited).'

Commissioner for Inland Revenue v *Standard Bank of South Africa* 1985 (4) SA 485 (A) 498 F – G.

As Hefer JA pointed out in *Ticktin Timbers CC* v *Commissioner for Inland Revenue* 1999 (4) SA 939 (SCA) 942 I

‘There can be no objection in principle to the deduction of interest on loans in suitable cases. Loan capital is the lifeblood of many businesses but the mere frequency of its occurrence does not bring about that this type of expenditure requires different treatment.’

In *Commissioner for Inland Revenue* v *Giuseppe Brollo Properties (Pty) Ltd*

1994 (2) SA 147 (A) 152 I – 153 G Nicholas AJA said

‘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 use 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. See *Commissioner for Inland Revenue* v *Allied Building Society* 1963 (4) SA 1 (A) at 13 C – G.’

Counsel for the appellant submitted that, properly analysed, the loan to the company was merely the means of financing the dividend. He argued that there was never any intention of paying the dividend out to the shareholders. I do not agree. I have already referred to the uncontested practice of the shareholders in using the company as a banker. In that context the crediting of the loan accounts constituted an actual payment as if the dividends had been deposited into an account held by a shareholder at a banking institution.

Counsel pointed out that if the funds had been taken out of the company the acquisition of contract guarantees would have been more difficult. That is true, but it is only relevant if one assumes that the dividend declaration was not what it purported to be. On the contrary, Jacobs's evidence as to what motivated the company and it shareholders was never put in issue: the availability of profits in the form of surplus cash, the desire of the shareholders to know where they stood financially vis-à-vis the company and each other, and a perception that changes in the income tax laws were imminent which would have the effect of taxing undistributed profits in the hands of the company. Of these considerations the existence of the surplus is the decisive factor in the present context. It serves to distinguish the authorities relied on by counsel for the appellant in which, in all the cases, the taxpayer was unable to pay a dividend from its own funds: *Guiseppe Brollo Properties* at 150 I, 154 H; *Ticktin Timbers* at 943 D – E, 944 I – 945 C;

Commissioner for Inland Revenue v Elma Investments CC 58 SATC 295 (1996) at 297 *in fine*. 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. The argument that the company could not actually afford to divest itself of the dividends which it declared and therefore they were effectively retained by it was therefore misplaced. A company is not to be criticized for declaring and distributing dividends simply because it might otherwise put the funds to use profitably. The declaration of a dividend is a commercial decision regulated by the terms of the company's statutes and the rules which have been developed in practice: see the authorities referred to in *Commissioner for Inland Revenue* v *Dirmeik* 1996 (2) SA 736 (C) at 740 C – I. I find nothing in the evidence to suggest that the declaration and distribution concerned in this case were motivated by anything but bona fide commercial considerations.

[9] The same can be said of the crediting of the loan accounts. The shareholders were under no apparent compulsion, commercial or otherwise, in agreeing to lend the money to the company. Each remained free to withdraw his loan at the discretion of the directors. The reliance by the appellant on the *Guiseppe Brollo Properties* case *supra* at 153 F – G and *Commissioner for Inland Revenue* v *Elma Investments CC* at 297 was ill-founded: once the declaration of the dividend is not part of a broader scheme but is an independent commercial decision taken in the context of a company which has the resources available for distribution as a dividend, it becomes inapposite to compare the financial strength of the company before the declaration with the position after it borrowed the money in order to determine whether an additional expense or added burden has resulted. In fact the company was not poorer. As a result of the arrangement it benefited

by the loan as it could not have done if the shareholders had used the money or invested it elsewhere as they were fully entitled to do.

[10] There is no doubt that the interest paid by the company enabled it to secure (even if only temporarily) the shareholders funds which could otherwise have been moved elsewhere. Equally it is certain that the availability to the company of the funds substantially increased its competitiveness and, temporarily, its income in the form of the interest which it retained. Those two considerations simply stated provide the sufficiently close link between the expenditure and the income earning operations having regard to the purpose of the expenditure and what it actually effects, *Commissioner for Inland Revenue* v *Genn & Co (Pty) Ltd* 1955 (3) SA 293 (A) at 299 G. The fact that the company could have operated quite adequately without the funds is not the only pertinent factor. It was enough that they served for the more efficient performance of its

operations: *Port Elizabeth Electric Tramway Co* v *Commissioner for Inland Revenue* 1936 CPD 241 at 246. The interest paid to the shareholders on their loan accounts was plainly an actual expense which enabled the company to produce income both in the form of its allocation of the interest earned and through the commercial advantages which possession of the loan funds generated. Section 11(a) was thereby satisfied.

[11] Seen from the perspective of the company, 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. In addition, borrowing money and re-lending it at a higher rate of interest, thereby making a profit, constitutes the carrying on of a trade: *Burgess v Commissioner for Inland Revenue* 1993 (4) SA 161 (A). That is analogous to the way in which the company managed the loan funds, at least during 1991

and 1992. It follows that the deductions which the company claimed were not struck by s 23 (g).

[12] The appeal is dismissed with costs.

J A HEHER
ACTING JUDGE OF APPEAL

CONCUR:

HOWIE JA
SCHUTZ JA