# A CRITICAL ANALYSIS OF THE DEDUCTIBILITY FOR INCOME TAX PURPOSES OF DUAL-PURPOSE EXPENDITURE

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# ABSTRACT

This thesis critically analysed the apportionment of dual-purpose expenditure. In doing so, two categories of dual-expenditure were examined: expenditure that has been incurred for both trade and non-trade purposes, and expenditure that has been incurred to produce both taxable and exempt income. In conducting this analysis, this thesis set out to answer three questions: has the apportionment of dual-purpose expenditure been officially sanctioned in South Africa, when does the need for apportionment arise, and on what basis should a taxpayer apportion expenditure that has been incurred for a dual purpose?

A doctrinal methodology was applied to the documentary data which consisted of relevant tax legislation; South African, Australian and English case law; and commentary of experts in the field of tax law.

From the analysis performed, it was revealed that the apportionment of dual-purpose expenditure has been officially sanctioned in South Africa. In addition, it was concluded that the applicable legal principles for determining the need for apportionment and for performing the apportionment calculation are clear and well-established. The difficulty which taxpayers, the courts and the South African Revenue Service face, however, is applying these principles in practice. This research therefore concluded that there is a need for further guidance in this complex area of tax law. In addition, this research proposed some recommendations which could provide more certainty and clarity.

Key Words:

Apportionment, dual-purpose expenditure, exempt income, in the production of income, purposes of trade, single indivisible expense, South African Income Tax, taxable income.

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# CHAPTER 1: INTRODUCTION

## 1.1 CONTEXT OF THE RESEARCH

Expenses are generally deductible if they satisfy the requirements of the preamble to section 11, sections 11(a), 23(f) and 23(g) of the Income Tax Act No. 58 of 1962 ("the Act"). The preamble to section 11 and section 11(a) set out what may be deducted for income tax purposes, whereas sections 23(f) and 23(g) stipulate those expenses which cannot be deducted for income tax purposes. The preamble to section 11 and section 11(a) read as follows in the 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 income, provided such expenditure and losses are not of a capital nature.

The preamble to section 23, and sections 23(f) and 23(g) of the Act provide that:

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

For the purposes of this thesis, two aspects of what is commonly referred to as the "general deduction formula" are relevant: expenses must be incurred in the production of income and for the purposes of trade in order to qualify for deduction. Expenditure that has been incurred for the purpose of producing exempt income, or for a non-trade purpose, will not be deductible in terms of section 11(a), read with sections 23(f) and 23(g) of the Act.

Many items of expenditure are, however, laid out with mixed motives. A taxpayer might incur an expense partly for the purpose of producing taxable income and partly for the purpose of producing exempt income. Where a single, indivisible expense appears to have been incurred for a dual purpose, the question arises as to whether apportionment is appropriate, and if so, on what basis the apportionment should be made (de Koker & Williams: 2015).

With regard to the problem of apportionment, the first question that needs to be addressed is whether the Act or case law sanctions the apportionment of expenditure that has been incurred for both trade and non-trade purposes. In the past, the previous version of section 23(g) specifically disallowed any expense which was not wholly or exclusively laid out or expended for the purposes of trade. In *ITC 734*, 18 SATC 202, the taxpayer was a farmer who travelled overseas with his wife for the dual purpose of buying a bull to be used in his farming operations in South Africa and of taking a holiday. In applying the principle that the expense must have been incurred wholly and exclusively for purposes of trade, Newton Thompson J held (at 203-204) that the travelling expenses were not deductible as they had been incurred for a dual purpose:

> It seems harsh that, on the facts of this case, the taxpayer should not be able to deduct expenditure incurred in purchasing a bull because he also took a holiday. I have considered whether, on the evidence, I could find that this expenditure of £337 was exclusively laid out in connection with the purchase of the bull. In view of the taxpayer's own candid and honest evidence I feel that I cannot do that ... Very reluctantly, I confess, I find that the taxpayer has not discharged that onus in this case and his appeal fails.

In practice, however, the South African Revenue Service ("the SARS") did not apply the provisions of section 23(g) too strictly and allowed taxpayers in certain instances to apportion expenses which had been incurred for both trade and non-trade purposes. During 1991, however, the decision was made in *Solaglass Finance Company (Pty) Ltd v CIR*, 1991 (2) SA 257 (A), 53 SATC 1, that the provisions of section 23(g) were to be strictly applied and that no deduction could be granted where an expense had been incurred for a dual purpose (Stack, Cronje & Hamel: 2002).

It is submitted that the inconsistencies between the practice of the SARS and a strict application of the legislation ultimately lead to section 23(g) being amended in 1992. The question that remains is whether the current version of section 23(g) provides specific authority for the apportionment of dual-purpose expenditure.

It is also possible that expenditure can be incurred for the purpose of producing both taxable and exempt income. Although the Act does not expressly provide for the apportionment of expenditure that has been incurred to produce both taxable and exempt income, the courts have in certain instances applied apportionment (Williams: 2009). This practice was applied in *CIR v Rand Selections Corporation Ltd*, 1956 (3) SA 124 (A), 20 SATC 390, where

Centlivres CJ stated (at 400) the following:

> It was contended on behalf of the company that, as the Act itself does not direct an apportionment of the expenditure or tell us how to ascertain what portion of the expenditure may be deducted from the 'income', the whole of the expenditure is deductible from the 'income'. I do not agree with this contention ... The Commissioner has conceded, and I think rightly so, that a portion of the expenditure attributable to the 'income' can be deducted under section 11(2)(a) but, in my opinion, it was not legally competent for him to allow as a deduction from the 'income' an amount which is arbitrary.

In other cases, for example *CIR v Standard Bank of SA Limited*, 1985 (4) SA 485 (A), 47 SATC 179, the aspect of a dominant purpose appears to have been considered by the courts (Stack *et al*: 2002).

Having raised the question of whether the Act or case law sanctions apportionment, the second question that needs to be answered is: when is apportionment appropriate? De Koker and Williams (2015) are of the view that the apportionment of expenditure is only appropriate where a single, indivisible expense has been incurred for more than one purpose.

In *Solaglass Finance Company (Pty) Ltd v CIR* the court had to decide whether the losses in question satisfied the tests of deductibility as provided for in section 11(a), read with section 23(g). In deciding whether the losses were deductible, the key question that needed to be answered was whether the losses were incurred for a dual purpose (Williams: 2009). The majority judgment, which was delivered by Botha JA (at 26), held that the losses had been incurred for a dual purpose and therefore did not meet the requirements of section 23(g):

> In my opinion the evidence speaks for itself and in so speaking it proclaims that the appellant's trading activities were geared to the achievement of a dual purpose: furthering the interest of the Group's subsidiaries and thus of the Group itself; and making a profit for the appellant.

By contrast, the minority judgment held that the losses had only been incurred for a single purpose and therefore did not fall foul of the provisions of section 23(g). Commenting on the decision reached in *Solaglass Finance Company (Pty) Ltd v CIR*, de Koker and Williams (2015:7.11) state the following:

> It could be argued that the Appellate Division in *Solaglass* accepted too readily that the subsidiary in that case, which was acting as a banker to the group, had geared its activities to the achievement of a dual purpose, namely, furthering the interest of the group and making a profit for itself.

A similar concern is expressed by Davis, Emslie T.S., van Dorsten, Dachs and Emslie C.A. (2014:93-94) with regard to the decision reached in *C:SARS v Mobile Telephone Networks Holdings (Pty) Ltd*, 76 SATC 205:

> But were the audit fees in this case laid out for a dual or mixed purpose, which the SCA seems to have regarded as axiomatic? In circumstances where the audit fees have to be incurred by companies due to a statutory obligation to have their financial records audited, can it truly be said that they are laid out for a dual or mixed purpose as far as the production of income is concerned, in circumstances where a taxpayer happens to earn both 'income' as defined and exempt income such as dividends? Would it not be more accurate to say that audit fees are incurred for no purpose other than to comply with a statutory obligation?

Where, however, the specific facts and circumstances indicate that a single, indivisible expense has been incurred for a dual purpose, there will be a need for apportionment (de Koker & Williams: 2015). As the Act is largely silent on attribution and apportionment principles (Connell: 2004), it is submitted that taxpayers need to look to judicial precedent for guidance. Over the years, in cases dealing with apportionment, the courts have held that the objective is to reach a solution which is both fair and reasonable. This is clear in Corbett JA's statement (at 259-260) in *CIR v Nemojim (Pty) Ltd*, 1983 (4) SA 935 (A), 45 SATC 241:

> It is a practical solution to what otherwise could be an intractable problem and in a situation where the only other answers, *viz* disallowance of the whole amount of expenditure or allowance of the whole thereof, would produce inequity or anomaly one way or the other. In making such an apportionment the court considers what would be fair and reasonable in all the circumstances of the case ...

A similar approach has also been adopted in certain Australian cases dealing with apportionment. In the well-known case of *Ronpibon Tin NL v FCT*, (1949) 78 CLR 47, the written judgment stated (at 59) the following:

> It is perhaps desirable to remark that there are at least two kinds of items of expenditure that require apportionment. One kind consists in undivided items of expenditure in respect of things or services of which distinct and severable parts are devoted to gaining or producing assessable income and distinct and severable parts to some other cause. In such cases it may be possible to divide the expenditure in accordance with the applications which have been made of the things or services. The other kind of apportionable items consists in those involving a single outlay or charge which serves both objects indifferently. Of this directors' fees may be an example. With the latter kind there must be some fair and reasonable assessment of the extent of the relation of the

> outlay to assessable income. It is an indiscriminate sum apportionable, but hardly capable of arithmetical or ratable division because it is common to both objects.

Significant difficulty, however, underlies the apportionment process and there is little practical guidance as to how one arrives at an amount which is both fair and reasonable (Augustinos: 2013). Davis *et al* (2014:93) reaffirm this view by stating the following:

> The finding that a strictly arithmetical apportionment is not always appropriate would seem to have interesting implications for the departmental practice of the Commissioner, who is now clearly required to determine what is fair and reasonable on a case-by-case basis. The obvious question is: how is this to be done? On the facts of this case, which was decided by three courts, each court arrived at a different apportionment. How then are the Commissioner and the corporate taxpayers (who these days are haunted by the spectre of understatement penalties) to arrive at an apportionment that is fair and reasonable on the facts of each case? We wonder.

The research to be undertaken for the purposes of this thesis is motivated by the difficulties that taxpayers, the courts and the SARS have experienced over the years when faced with the deductibility of dual-purpose expenditure.

## 1.2 RESEARCH OBJECTIVES

The primary goal of the research is to critically analyse the deductibility of dual-purpose expenditure. In doing so, the research sets out to answer three questions:

- Does the Act and case law in South Africa sanction the apportionment of dual-purpose expenditure?
- When is the apportionment of expenditure appropriate?
- On what basis should a taxpayer apportion expenditure that has been incurred for a dual purpose?

The aim of the research, in answering the above questions, is to extract current principles and practices adopted by the courts and the SARS when dealing with dual-purpose expenditure; to highlight difficulties encountered when faced with the deductibility of dual-purpose expenditure; and to suggest some recommendations which may assist taxpayers, the courts and the SARS.

## 1.3 RESEARCH METHODOLOGY AND DESIGN

A legal interpretative research approach will be applied to the research question. More specifically, the research methodology to be utilised can be described as doctrinal research. This research methodology will involve "the systematic process of identifying, analysing, organising and synthesisng statutes, judicial decisions and commentary" (McKerchar, 2008:18-19). By adopting a doctrinal research methodology, natural logic will be applied to documentary evidence in a critical analysis of the law pertaining to the deductibility of dual-purpose expenditure (Stack: 2012).

In carrying out the above research the following documentary data will be critically analysed:

- relevant tax legislation;
- relevant case law from South Africa, Australia and the United Kingdom where the tax treatment of dual-purpose expenditure has been considered and commented on; and
- commentary of experts in the field of tax law.

The validity and reliability of the research will be promoted by:

- carrying out an exhaustive literature survey;
- relying on credible documentary data which will be sourced from tax legislation, judicial precedents and the writings of experts in the field of tax law;
- performing a rigorous analysis of the documentary data, based on the rules of statutory interpretation; and
- developing sound arguments supported by credible evidence.

To ensure the integrity and validity of the research, opposing viewpoints will be considered.

As the research will only involve a critical analysis of documentary data, all of which is freely available in the public domain, no ethical considerations arise with regard to the use of these documents.

## 1.4 OVERVIEW OF THE RESEARCH

Where an expense has been incurred for more than one purpose the first question that arises is whether apportionment has been officially sanctioned in South Africa. In answering this question, chapter two addresses two broad categories of expenditure. The first category of expenditure is those expenses which have been incurred for both trade and non-trade purposes, whilst the second category of expenditure is those expenses which have been incurred in the production of both taxable and exempt income.

Having established in chapter two whether the apportionment of dual-purpose expenditure is permitted in South Africa, chapter three examines the need for apportionment. Chapter three first sets out when the apportionment of an expense is appropriate. This is followed by an analysis of judicial precedent to extract the principles which have been established by our courts for determining the purpose of an expense. In performing this analysis, cases where expenditure was incurred for both trade and non-trade purposes are examined, as well as cases where expenditure was incurred in the production of both taxable and exempt income.

Chapter four commences with an examination of the apportionment principles and methodologies applied in various cases. This is followed by a detailed critical analysis of the apportionment methods used in *ITC 1842*, 72 SATC 118, *Mobile Telephone Networks Holdings (Pty) Ltd v C:SARS*, 73 SATC 315, and *C:SARS v Mobile Telephone Networks Holdings (Pty) Ltd* ("the *MTN* cases" or "the recent *MTN* cases"). Finally, chapter four makes some recommendations which may provide more certainty and clarity in this complex area.

Chapter five summarises the key findings of this research. In doing so it revisits the research objectives and sets out the conclusions reached. In addition, chapter five sets out areas which are beyond the scope of this thesis as well as areas which would benefit from further research.

# CHAPTER 2: THE SANCTIONING OF APPORTIONMENT

## 2.1 INTRODUCTION

The apportionment of expenditure has been the subject of many cases in South Africa as a result of the difficulty experienced by taxpayers and the SARS in applying the principles established by the courts. This is highlighted by PricewaterhouseCoopers Inc. (2014:5) who state:

> These well-established principles have proved difficult to apply in circumstances where a globular amount of expenditure incurred by the taxpayer partly qualifies, in terms of these principles, for deduction, and partly does not.

This chapter will begin with a brief discussion of the definition of trade. This will be followed by an analysis of whether the Act and case law in South Africa authorises the apportionment of expenditure that has been incurred for both trade and non-trade purposes. Finally, this chapter will discuss the definition of income which will be followed by an analysis of whether the Act and case law in South Africa sanctions the apportionment of expenditure that has been incurred to produce both taxable income and exempt income.

The goal of this chapter is to establish whether the Act and case law in South Africa sanctions the apportionment of dual-purpose expenditure. In setting out to achieve this goal, this chapter will set the foundation for chapter three which will discuss the need for apportionment.

## 2.2 TRADE AND NON-TRADE PURPOSES

### 2.2.1 DEFINITION OF TRADE

In order to deduct an expense in terms of the "general deduction formula", a taxpayer needs to be carrying on a trade, and the expense in question must have been incurred for the purposes of trade (Williams: 2009). This is clearly stated in the preamble to section 11 which reads as follows: "for the purpose of determining the taxable income derived by any person from <u>carrying on any trade</u>, there shall be allowed as deductions from the income of such person so derived …" (emphasis added).

In addition, section 23(g) provides that a deduction will not be available in respect 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 purposes of trade” (emphasis added).

It is therefore submitted that the concepts of trade and trading are important when determining the deductibility of expenditure. This is reaffirmed by Williams (2009:253) who states the following:

> Where the taxpayer claims expenditure as a deduction in terms of section 11(a) or any of the sub-sections of section 11, the question whether that taxpayer was engaged in trading is of immediate importance …

Trade is defined in section 1 of the Act as:

> … 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 as defined in the Patents Act or any design as defined in the Designs Act or any trade mark as defined in the Trade Marks Act or any copyright as defined in the Copyright Act or any other property which is of a similar nature.

In *Burgess v CIR*, 55 SATC 185, EM Grosskopf JA stated (at 196) the following with regard to the meaning of trade:

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

This definition of trade is supported by Haupt (2015) who submits that the meaning of trade should be given a wide interpretation and should include any profitable activity.

Having established what constitutes a trade, the question that follows is whether the Act sanctions the apportionment of expenditure that has been incurred for both trade and non-trade purposes.

### 2.2.2 WHOLLY AND EXCLUSIVELY INCURRED

In the past section 23(g) prohibited the deduction of any expenditure which had not been incurred wholly or exclusively for the purposes of trade. In this regard the previous version of section 23(g) read as follows:

> No deductions shall in any case be made in respect of the following matters, namely –
>
> (g) any moneys claimed as a deduction from income derived from trade, which are not wholly and exclusively laid out or expended for the purposes of trade (emphasis added).

One of the first cases in South Africa to apply the wholly and exclusively requirement was *ITC 698*, 17 SATC 97. In *ITC 698* the appellant sought to deduct the travelling expenses he had incurred in connection with a trip overseas. The purpose of the trip was to further his existing diamond brokerage business and to conduct exploratory work with regard to a new export trade business. Price J held (at 98) that as the travelling expenses had been incurred for a dual purpose, the entire amount was not deductible:

> No case has been quoted to the Court in which the Court has held that it is entitled to sub-divide all expenditure not wholly and exclusively incurred in the earning of income concerned but which is incurred partly with that intention and partly with some other intention ... The simple provision is, therefore, made that the expenditure must be wholly and exclusively incurred in the production of the income which is under consideration.

The apportionment of dual-purpose expenditure was also considered in *ITC 800*, 20 SATC 226. In this case the appellant was a company whose main object was to exploit certain base mineral claims. In addition to this, the company was also entitled to carry on the business of investing and financing. Expenditure was incurred in the exploitation of the company's mineral claims, however, this was discontinued and no additional expenditure was incurred after January 1952. From this date on, the company invested its moneys for a period of five months that is, from February 1952, to June 1952. During this period the company earned interest income in the amount of £637 11s and incurred expenditure of £1,148 14s. The Commissioner disallowed the deduction of the £1,148 14s on the grounds that the expenditure was not incurred in the production of income, was of a capital nature and was not wholly and exclusively laid out for purposes of trade. For the purpose of this thesis the Commissioner's third contention will only be considered, that being whether the expenditure was wholly and exclusively laid out for purposes of trade.

For the financial year ended June 1952, the appellant incurred total expenditure in the amount of £2,497 15s 10d. Of this total expenditure, an amount of £1,148 14s was expended during the period February 1952 to June 1952. The Commissioner contended that the expenditure incurred in connection with the investment of the money could not be separated from the other expenditure and as a result, did not meet the requirement of being wholly and

exclusively laid out for purposes of trade. The court did not agree with the above reasoning, as evidenced by Price J's statement (at 229):

> Section 12(g) does not forbid the dissection of a lump sum of expenditure proportionately into sums each allocated to different items of income if this can be done. Indeed the Court has itself made such allocations in various cases. The statement of the law made in the case would be accurate if this exception were included. Section 12(g) provides that 'any moneys claimed as a deduction from income derived from trade which are not wholly or exclusively laid out or expended for the purposes of trade' may not be deducted from income. The section says nothing whatever about the dissection of a lump sum of expenditure.

Price J made it clear that, where it was possible to divide a lump sum of expenditure into its separately identifiable components, there was nothing in the Act which prohibited the taxpayer from doing so. This view is also supported by de Koker and Williams (2015:7.11A) who state the following:

> The subject of the apportionment of expenditure must commence with a need for apportionment; discrete amounts expended for different, separately identifiable purposes do not require to be apportioned, and their eligibility for deduction can be judged on their individual merits.

Where, however, a single, indivisible expense has been incurred for both trade and non-trade purposes, the courts have consistently held that the previous version of section 23(g) did not permit the apportionment of such expenditure. This principle was affirmed in two well-known cases; *ITC 734* and *CIR v Pick 'n Pay Wholesalers (Pty) Ltd*, 1987 (3) SA 453 (A), 49 SATC 132. In *ITC 734* Newton Thompson J stated (at 203) "that where expenditure is incurred for a dual purpose and one of those purposes would not qualify the expenditure for deduction from income for tax purposes, then no portion of the amount expended may be so deducted." In *CIR v Pick 'n Pay Wholesalers (Pty) Ltd,* Nicholas AJA referred to the case of *Bentleys, Stokes and Lowless v Beeson (Inspector of Taxes)*, [1952] 2 All ER 82, when he stated (at 148) the following:

> But the question in all such cases is: Was the entertaining, the charitable subscription, the guarantee, undertaken solely for the purposes of business, that is, solely with the object of promoting the business or its profit-earning capacity? It is, as we have said, a question of fact. And it is quite clear that the purpose must be the sole purpose. The paragraph says so in clear terms. If the activity be undertaken with the object both of promoting business and also with some other purpose, for example, with the object of indulging an independent wish of entertaining a friend or stranger or of supporting a charitable or benevolent object, then the paragraph is not satisfied though in the mind of the actor the business motive may predominate.

### 2.2.3 AUTHORITY FOR APPORTIONMENT

It is submitted that the case of *Solaglass Finance Company (Pty) Ltd v CIR* was the catalyst for the amendment of the wording to section 23(g). In this case the taxpayer was a wholly owned subsidiary of Plate Glass Shatterprufe Industries Limited. The taxpayer's main object was to lend money to any person or company within the group and to borrow money as it deemed fit. During the 1978 and 1979 years of assessment the taxpayer sought to deduct amounts which it had written off in respect of irrecoverable loans.

The question to be answered by the court was whether the abovementioned losses were incurred wholly and exclusively for purposes of trade. A majority of the court (three out of the five judges) held that the taxpayer's business was conducted for a dual purpose, namely to promote the group's interests and also to make a profit. In this regard Botha JA stated (at 26) the following:

> In my opinion the evidence speaks for itself and in so speaking it proclaims that the appellant's trading activities were geared to the achievement of a dual purpose: furthering the interest of the Group's subsidiaries and thus of the Group itself; and making a profit for the appellant.

The majority therefore held that as the losses had been incurred for a dual purpose they did not meet the requirements of section 23(g) and were therefore disallowed as a deduction.

Shortly after the case of *Solaglass Finance Company (Pty) Ltd v CIR,* the Explanatory Memorandum on the Income Tax Bill, 1992 was released which stated (Department of Finance, 1992:17) the following:

> Section 23(g) of the principal Act prohibits the deduction of any amount of expenditure which was not wholly and exclusively laid out for the purposes of trade. Nevertheless, it has been the long-standing practice of Inland Revenue, which has in the past been accepted by the courts, to allow an apportionment of expenditure which is incurred partly for purposes of trade and partly for purposes other than trade.
>
> The Appellate Division of the Supreme Court has, however, recently held that the provisions of section 23(g) must be strictly applied, and no deduction may be granted where expenditure is incurred for a dual purpose. The amendment introduced by this subclause is intended to restore the previous practice of allowing an apportionment of such expenditure.

The Explanatory Memorandum on the Income Tax Bill, 1992 therefore made it clear that the proposed amendment was to align the legislation to the practice of the SARS (Department of

Finance: 1992). Having been amended, the current version of section 23(g) reads as follows:

> No deductions shall in any case be made in respect of the following matters, namely –
>
> (g) any moneys, claimed as a deduction from income derived from trade, to the extent to which such moneys were not laid out or expended for the purposes of trade (emphasis added).

The current version of section 23(g) does not require an expense to be laid out wholly and exclusively for purposes of trade, prohibiting the deduction of moneys only to the extent to which they were not laid out or expended for the purposes of trade (de Koker & Williams: 2015). A question posed by de Koker and Williams (2015:7.11A) is whether the prohibition in section 23(g) constitutes a specific authority for apportionment:

> Certainly, it is awkward to read a prohibition as constituting an authorization. The prohibition envisages apportionment, it does not outlaw it, as it previously did, but perhaps it does not quite specifically authorize it. In any event, it is only one type of apportionment that it envisages, that of a single amount laid out both for 'trade' and 'non-trade' purposes. Wider authority for apportionment emerges, rather, from the specific terms of the particular provision under which a deduction is sought, general principles of law and rulings of the courts. Nevertheless, it may safely be said that, on the whole and taken as a general principle, the concept of apportionment is a robust one, enjoying the support both of the courts and of SARS. And the legislature's relaxation of the terms of s 23(g) must surely serve as a striking endorsement of the concept.

It is therefore submitted that the current wording of section 23(g) does permit the apportionment of dual-purpose expenditure. This is reaffirmed by Stack *et al* (2002:84) who state the following: "apportionment has therefore officially been sanctioned by the Act for the first time."

### 2.3 INCOME AND EXEMPT INCOME

#### 2.3.1 DEFINITION OF INCOME

In addition to being incurred for the purposes of trade, an expense also needs to be incurred in the production of income in order for it to be deductible in terms of the "general deduction formula". This is clearly stated in section 11(a) of the Act which reads as follows: "expenditure and losses actually incurred in the production of income ..." (emphasis added).

The preamble to section 23 and section 23(f) reaffirms this principle by stating that:

> No deductions shall in any case be made in respect of the following matters, namely –

(f) any expenses incurred in respect of any amounts received or accrued which do not constitute income as defined in section *one* (emphasis added).

It is therefore clear that an expense incurred to produce an amount which does not constitute income cannot be claimed as a deduction in terms of sections 11(a) and 23(f).

In applying the provisions of sections 11(a) and 23(f) it is submitted that it is important to consider the meaning of income. Income is defined in section 1 of the Act as follows: "**"income"** means the amount remaining of the gross income of any person for any year or period of assessment after deducting therefrom any amounts exempt from normal tax under Part I of Chapter II."

In order to calculate income, a taxpayer needs to remove from gross income any amounts which are exempt in terms of sections 10, 10A, 10B or 10C of the Act. In addition, when applying the provisions of sections 11(a) and 23(f), it is also clear that a taxpayer cannot deduct any amounts which were incurred to produce exempt income (Stack *et al*: 2002).

The question that remains, is whether a taxpayer can apportion a single, indivisible expense that has been incurred to produce both taxable and exempt income.

### 2.3.2 AUTHORITY FOR APPORTIONMENT

In *ITC 607*, 14 SATC 366, the taxpayer was a company which derived its income by way of rents. During the year of assessment ended 30 June 1943, the company erected a new building which became available for rent on 19 December 1942. In erecting the new building, the company borrowed £8,000 on 1 July 1942 and £4,000 on 1 September 1942. Both these amounts bore interest at a rate of 4.5% per annum. In addition to incurring interest on the aforementioned borrowings, the company also incurred municipal rates on the new property.

In submitting its return for the 1943 year of assessment, the company sought to deduct the interest expense and the municipal rates. The Commissioner, however, disallowed the expenses which had been incurred prior to 19 December 1942 on the grounds that they had not been incurred in the production of income.

Ingram CJ made it clear that even though the Act contained no specific provisions for the apportionment of expenditure this did not preclude the Commissioner from making an apportionment by stating (at 369):

> The underlying principle laid down by these decisions is that the expenditure, the deduction of which is claimed, must be linked to the income that is earned; and where it is possible to apportion the expenditure to the income so earned such apportionment must be made; and that expenditure which cannot be so linked and apportioned must be disallowed … It is true that the Act itself contains no provision for such apportionments, but it may be regarded as to be implied from the terms of sec 11(2)(a), which permits only the deduction of such expenditure as is actually incurred in the production of the income.

Ingram CJ therefore agreed with the Commissioner's apportionment, allowing a deduction of the rates and interest expense which were incurred during the period in which the property was available for letting.

The Appellate Division case of *CIR v Rand Selections Corporation Ltd* also dealt with the apportionment of expenditure. In this case the taxpayer was a company which derived its income from share-dealing transactions and dividend income. Having knowledge that another company (hereinafter referred to as the "Lace Company"), in which it held 6,458 shares, would shortly be going into liquidation, the taxpayer acquired a further 452,592 shares at a cost of £362,073. The taxpayer therefore held a total of 459,050 shares in the Lace Company acquired at a cost of £367,859. The Lace Company was subsequently placed under voluntary liquidation and the following amounts were paid to the taxpayer:

- £212,311 which represented a return of capital to the taxpayer; and
- £124,123 which represented a liquidation dividend paid out of profits.

As the taxpayer was a share dealer it was common cause that the amount of £212,311 would be included in the taxpayer's income, whereas the liquidation dividend of £124,123 was specifically exempted in terms of section 10(1)(k). The taxpayer sought to deduct the full cost of the shares against the income of £212,311, however, the Commissioner only allowed a deduction of the exact amount of the return of the floating capital, namely £212,311. It was thus left to the court to decide whether the taxpayer could deduct the full amount of £367,859 or only a portion thereof.

Having examined the specific facts, Centlivres CJ first submitted that the expenditure of £367,859 had been incurred for the dual purpose of earning both income and exempt income. The learned judge also stated that the portion of the expenditure which was attributable to the exempt dividend income would not be allowed as a deduction as it had not been incurred in the production of income. The problem before the court was how to

apportion the expenditure between its deductible and non-deductible components.

The taxpayer argued that as the Act did not specifically direct apportionment, the whole amount of £367,859 should be deductible. Centlivres CJ, however, disagreed with this position stating (at 400) that:

> The silence of the Act on the point might even be used as a basis for the contention that no portion of the expenditure is deductible, seeing that that expenditure produced both 'income' and 'dividends' and that section 12(f) in effect says that no expenditure incurred in producing 'dividends' can be deducted.

Rejecting an arbitrary allocation of expenditure, Centlivres CJ suggested the following formula for apportioning the expenditure (X being the total expenditure incurred, Y the amount of income and Z the amount of exempt income):

Deductible expenditure = X multiplied by Y / (Y+Z)

In applying the above formula to the specific numbers in the case, the taxpayer was thus entitled to deduct an amount of £212,142 from its income.

The decisions reached in *ITC 607* and *CIR v Rand Selections Corporation Ltd* were reaffirmed in the more recent case of *CIR v Nemojim (Pty) Ltd*. *CIR v Nemojim (Pty) Ltd* involved a taxpayer which was a dealer in shares. During the 1977 and 1978 years of assessment the taxpayer carried out a number of dividend-stripping operations. This involved purchasing all the shares of dormant companies with large cash reserves, distributing these cash reserves as a dividend and then re-selling the shares. In most cases the taxpayer made a profit, that is, the sum of the proceeds from the dividends and the resale of the shares exceeded the cost of the shares. Although the company made a profit from these dividend-stripping operations it created an assessed loss from an income tax perspective. This was due to the fact that the taxpayer deducted the full cost of the acquisition of the shares of the dividend-stripped companies whilst the portion of the proceeds which constituted dividend income was exempt from income tax in terms of section 10(1)(k). The Commissioner, however, did not permit the creation of an assessed loss and only allowed a deduction of the cost of the shares to the extent that it did not exceed the proceeds from the resale of the shares.

The question that the court needed to answer was whether Nemojim could deduct the full purchase price of the shares, or whether a part thereof was not deductible in terms of section 23(f). This chapter will not analyse Nemojim's purpose in acquiring the shares, but rather will accept Corbett JA's view which reads (at 256) as follows:

> Adopting that approach in the present case, I am of the view that the expenditure incurred by Nemojim in the acquisition of the shares in question had, in all but three instances, a dual purpose, *viz* the receipt of moneys on resale (which would constitute income in Nemojim's hands) and the receipt of a dividend after the declaration thereof (which would constitute exempt income in Nemojim's hands); and that the expenditure actually effected this dual purpose.

Having accepted that the shares were acquired for a dual purpose, the court then proceeded to consider whether the apportionment of the expenditure between the two purposes was appropriate. In doing so, Corbett JA first noted that even though the Act made no provision for apportionment, it was a practical solution which the courts had previously adopted where an expense had been incurred for two purposes. The learned judge also stated that the result of the apportionment calculation should be fair and reasonable to all parties concerned.

The court therefore ordered that the purchase price of the shares be apportioned between the two purposes. The taxpayer was therefore entitled to deduct the portion of the expenditure which was attributable to its share dealing operations. Corbett JA was satisfied that this was fair and reasonable to all parties concerned, as evidenced by the following statement (at 267): "there is nevertheless a measure of satisfaction to be gained from a result which seems equitable, both from the point of view of the taxpayer and from the point of view of the *fiscus*."

### 2.3.3 AUTHORITY FOR DOMINANT PURPOSE

In addition to apportioning expenses, there have also been cases where the aspect of a dominant purpose appears to have been considered by the courts (Stack *et al*: 2002).

In *Producer v COT*, 1948 (4) SA 230 (SR), 15 SATC 405, a partnership which was formed in Southern Rhodesia decided to expand its business operations by establishing a company in the Union of South Africa. The South African company was funded by the partnership which had borrowed money, obtained overdrafts and utilised certain accumulated profits. The appellant company in this case was registered in 1940 and took over the whole of the business of the partnership including the assets and liabilities. In June 1943 the South

African company was indebted to the appellant company in the amount of £116,954. In the same year it was decided to increase the share capital of the South African company to £100,000 by the issue of 95,000 £1 shares. Half of these shares were allotted to the appellant company, the cost of which was set off against the existing debt of £116,954. Thereafter the appellant company continued to deduct the interest in respect of borrowed money and bank overdrafts which were originally raised to provide funding to the South African company. For the year of assessment ending 31 March 1947, the Commissioner disallowed a portion of the interest payable by the appellant company on the grounds that the interest was incurred in connection with the subscription for shares in the South African company and therefore not incurred in the production of income.

In deciding this case, Hudson CJ first made it clear that if a specific sum of money is borrowed for the purpose of earning amounts which do not constitute income, the interest on such borrowed money is not deductible. In examining the purpose of the borrowing, Hudson CJ submitted that the debt had been incurred in the normal course of the taxpayer's business and not for the specific purpose of subscribing for shares. The court therefore concluded that as there was no direct connection between the borrowing of moneys and the purchase of shares, the interest expenditure was deductible in full. In delivering his concluding remarks, Hudson CJ made (at 411-412) the following strong statement:

> I may add that the fact that the Commissioner, who presumably had full access to the books and accounts of appellant, is unable to point to any specific sum as having been borrowed for the purpose of purchasing the shares and has been compelled to resort to a formula for estimating the amount of interest paid in each year in respect of that purchase, is strongly indicative of the fallacy of his contention.

The deductibility of interest was re-visited in *CIR v Allied Building Society*, 1963 (4) SA 1 (A), 25 SATC 343. In this case the taxpayer was in the business of a permanent building society. The object of the taxpayer's business was to raise funds and invest them in such manner that its income exceeded its expenditure. The taxpayer raised these funds from the public by the issuing of shares and the acceptance of savings and fixed deposits. In addition, the taxpayer received certain interest-bearing loans from the Government. Subject to certain restrictions, the taxpayer accepted all monies offered to it from the public. Importantly, the holding or non-holding of un-productive properties never played a role in determining whether the taxpayer accepted monies from the public. Finally, the taxpayer derived its income by way of interest on loans made by it, dividends, rents and sundry receipts.

During the tax year ended 30 June 1959 the taxpayer held certain fixed properties which did not produce income. These fixed properties consisted of three vacant stands and three large buildings which were under construction. As these properties did not produce income, the Commissioner disallowed a portion of the taxpayer's interest expenditure calculated with reference to the value of the non-productive properties in relation to the value of the total assets of the taxpayer. The taxpayer appealed against the Commissioner's decision on the grounds that the entire interest expenditure had been incurred in the production of income.

Ogilvie Thompson JA first made it clear that the taxpayer received all monies into a single fund which it used generally for making all payments. It was also clearly stated that the taxpayer's funds were held for the purposes of business, and that it was not possible to link any cash receipt with any particular outgoing. The learned judge then proceeded to state that the vital inquiry, when determining the deductibility of interest, was the purpose of the borrowing. Having examined the specific facts, Ogilvie Thompson JA submitted that the taxpayer's purpose in borrowing money was to obtain the means of earning income. This is supported by his statement which reads (at 358) as follows: "the society's basic business is borrowing money cheaply and lending it more dearly."

The court also disagreed with the contention that the taxpayer had borrowed certain monies for the purposes of acquiring non-revenue-producing properties. In dismissing this view, Ogilvie Thompson JA made it clear that the taxpayer's business was not the acquisition of immovable property but rather the earning of income by investment. In addition, the learned judge submitted that the acquisition of non-revenue-producing properties was incidental to the taxpayer's business of borrowing money in order to earn income by investment.

The court therefore concluded that the taxpayer had borrowed all monies for the purpose of earning income and the interest expenditure was deductible in full. This is evidenced by Ogilvie Thompson JA's closing statement (at 360) which reads as follows:

> … the society's expenditure by way of interest on moneys borrowed by it is not aimed at augmenting its fixed capital in general or its non-revenue-producing properties in particular, but is dictated by the very nature of its income-earning operations of cheaply borrowing all money offered and then more dearly lending out as much thereof …

The principles established in *CIR v Allied Building Society* were reaffirmed in *CIR v Standard Bank of SA Limited*. In this case the taxpayer was a commercial bank which operated in South Africa. In its tax returns for the 1979, 1980 and 1981 years of assessment

the taxpayer claimed as a deduction the interest it had paid on monies borrowed from depositors. The taxpayer used a small portion of the borrowed monies to purchase redeemable preference shares from which it earned exempt dividend income. The Commissioner argued that the portion of the interest expenditure which was attributable to the borrowings which had been used to purchase the redeemable preference shares was not deductible as it did not produce income.

In considering this case Corbett JA applied the principles which had been laid down in *CIR v Allied Building Society*. In doing so the learned judge reaffirmed that the vital enquiry was the bank's purpose in borrowing the moneys upon which it paid interest. Corbett JA further stated that there needed to be a sufficiently close connection between the interest expenditure and the acquisition of the preference shares to conclude that the interest expenditure had been incurred in the production of exempt dividend income.

In examining the purpose of the borrowing the court found that there was not a close enough causal connection between the interest expenditure incurred and the earning of the exempt dividend income. This finding was based on the following key factors:

- The taxpayer accepted all deposits as a matter of business policy.
- There was no connection between the acceptance of deposits and the making of investments in redeemable preference shares.
- The taxpayer was generally reluctant to participate in preference share transactions.
- Preference share transactions constituted a small and insignificant part of the taxpayer's total lending business and were regarded as being incidental to the main business of the taxpayer.

The court held that the taxpayer's purpose in borrowing the deposit monies was to obtain floating capital which it lent out at interest, thereby earning income. Even though Corbett JA acknowledged that a portion of the deposit monies were utilised to invest in redeemable preference shares, the learned judge submitted, that in his view, the preference share transactions were incidental to the main business of the bank.

It was therefore held that there was not a close enough connection between the raising of the deposits and the investment in the redeemable preference shares. Dachs (2011:153) reiterates this view by commenting on the case as follows:

> However, the Court agreed with the decision of the Court *a quo*, namely that a sufficiently close connection between the raising of the deposits and the investment in preference shares did not exist to justify a conclusion that the purpose of the borrowing was to earn exempt dividends, and the interest was therefore held to be deductible.

In concluding Corbett JA found that the full interest expenditure was deductible by stating (at 198) the following:

> My conclusion is that the court *a quo* correctly held that this case was governed by the principles laid down in the *Allied Building Society* case. And, in my view, there is no valid basis for treating portion of the interest paid by the Bank to depositors as not falling within the general deduction formula of s 11(a) or as being excluded from deductibility by s 23(f).

The cases of *Producer v COT, CIR v Allied Building Society* and *CIR v Standard Bank of SA Limited* are in contrast with the case of *ITC 1020*, 25 SATC 414. In *ITC 1020* the taxpayer was a company which carried on the business of letting property. The taxpayer had originally acquired a loan of £9,500 on which the interest paid had been allowed as a deduction by the Commissioner. During the year of assessment in question the taxpayer acquired a further loan of £25,000 which it used to repay the existing loan of £9,500 and to pay dividends of £15,500. The new loan incurred interest at a rate of 5.5% per annum and was repayable in instalments of £1,000 per annum. In assessing the taxpayer, the Commissioner disallowed 19/50ths of the interest payable on the reduced amount of the loan after the first instalment of £1,000. Objecting to the assessment, the taxpayer argued that the £1,000 annual instalment was made in connection with the portion of the loan which was used to pay dividends of £15,500, and as such the full interest on the remaining £9,500 should be allowed as a deduction.

The taxpayer's argument was based on the premise that there were in fact two separate loans, one of £9,500 and one of £15,500, and that it paid the annual instalment of £1,000 in respect of the £15,500. Kuper J rejected this contention by stating (at 414-415) the following:

> The contract of loan was for one amount of £25,000, the interest in respect of part of which was deductible and the interest in respect of the balance was not deductible. As far as the lender of the money was concerned, there was no difference to him in regard to the character of the loan. He had made one loan. It did not matter to him that part of it was being used by the appellant company to repay existing loans.

Kuper J further stated that the single globular loan had been obtained for two distinct purposes, with the one purpose qualifying for deduction. The court thus concluded that it was correct to apportion the annual instalment of £1,000 between the £9,500 used to repay existing loans and the £15,500 used to pay the dividends. In addition, it was agreed that the interest paid on the portion of the loans used to pay the dividends was not deductible as it had not been incurred in the production of income.

The cases of *Producer v COT, CIR v Allied Building Society* and *CIR v Standard Bank of SA Limited* can be distinguished from the case of *ITC 1020*. In the former three cases the courts found that apportionment was not appropriate, however, in the latter case the court did apportion the interest between its deductible and non-deductible components. It is submitted that the vital difference is that in the former three cases the courts found that the taxpayer had a sole purpose when borrowing the funds in question, whereas in the latter case, the court found that the taxpayer had borrowed the funds for two distinct purposes.

In determining the purpose of the borrowings in *CIR v Allied Building Society* and *CIR v Standard Bank of SA Limited* the courts considered many factors, including what the funds were used for. This approach is supported by Meyerowitz (2008:13-7) who states the following:

> The ultimate use or destination of the borrowed money is not necessarily the decisive factor. It is relevant only in determining the purpose of the borrowing which, in most cases, is the most important factor in the dominant enquiry as to the true nature of the transaction.

In *CIR v Allied Building Society* it was found that the interest expenditure incurred which had not produced income related to activities which were incidental to the main business activities of the taxpayer. In delivering his judgment Ogilvie Thompson JA stated (at 359) the following: "the acquisition by the society of such non-revenue-producing properties as it holds is purely incidental to the business of borrowing money in order to earn income by investment."

In *CIR v Standard Bank of SA Limited,* Corbett JA found (at 197-198) that the interest expenditure in question also related to business activities of an incidental nature:

> Fourthly, preference share transactions generally constitute a small and insignificant part of the Bank's total lending business and were described by Dr Strauss (again without being challenged thereon) as 'being purely incidental to the main business of the Bank'.

In both these cases the courts held that the incidental uses were not persuasive enough to find that the taxpayers in question had borrowed the funds for a dual purpose. This is supported by Corbett JA who stated (at 198) the following:

> It is thus clear that the court *a quo* was considering whether there was a close enough connection to link the purpose of the raising of the deposits with the taking up of preference shares; and concluded that there was not. With this conclusion I agree.

It is therefore submitted that in *Producer v COT, CIR v Allied Building Society* and *CIR v Standard Bank of SA Limited* the courts did not decide the cases on the grounds of a dominant purpose, but rather found that the taxpayers in question had incurred the expenditure for a sole purpose. This is supported by Ogilvie Thompson JA who said (at 357-358) the following in *CIR v Allied Building Society*

> In the present case, therefore, the vital inquiry, in my opinion, relates to the purpose for which the money is borrowed by the society.
>
> The society's purpose in borrowing money, upon which it pays the interest in issue, is manifestly to obtain the means of earning income. The society's basic business is borrowing money cheaply and lending it more dearly. The money it borrows constitutes its floating capital which it lends out at interest, thereby earning income: the interest the society pays on the money so borrowed is *prima facie* clearly an expenditure incurred in the production of income.

## 2.4 CONCLUSION

It is clear from the provisions of sections 11(a), 23(f) and 23(g) of the Act that an expense needs to be incurred in the production of income and for the purposes of trade in order for it to be deductible. In many instances, however, an expense can be incurred for a dual purpose.

Where an expense has been incurred for both trade and non-trade purposes it is important to first consider the meaning of trade. Having analysed the definition of trade and judicial precedent, it is submitted that the meaning of trade should be given its widest possible interpretation and should include any profitable activity.

Where an expense had been incurred for both trade and non-trade purposes, section 23(g) of the Act previously disallowed the entire expenditure on the grounds that it was not wholly and exclusively laid out or expended for purposes of trade. The practice of the SARS, however, was to apportion the expenditure in question and allow a deduction for the portion which had been incurred for the purposes of trade. It is submitted that the inconsistency

between a strict application of the Act and the practice of the SARS ultimately lead to section 23(g) being amended to its current form. In its current form, section 23(g) disallows any expenditure to the extent that it has not been incurred for the purposes of trade. Although not explicitly stated, it is submitted that the current wording of section 23(g) does provide authority for the apportionment of dual-purpose expenditure. This is supported by Meyerowitz (2008:11-17) who states the following:

> Section 23(g) prohibits the deduction of expenditure to the extent that it is not laid out for the purposes of trade. This amendment is explicit authority for apportionment in respect of expenditure incurred for trading and other purposes.

An expense can also be incurred for the dual purpose of earning income and exempt income. In terms of section 11(a), read with section 23(f), an expense must be incurred in the production of income in order for it to qualify as being deductible. An expense incurred to earn exempt income will not qualify for deduction in terms of the "general deduction formula". Where, however, an expense has been incurred to earn both taxable and exempt income, the question is whether the Act and case law in South Africa sanctions the apportionment of such expenditure. In the leading cases of *CIR v Rand Selections Corporation Ltd* and *CIR v Nemojim (Pty) Ltd* the courts authorised apportionment and ordered that it should be made on a fair and reasonable basis. In *CIR v Allied Building Society* and *CIR v Standard Bank of SA Limited,* however, it appears that the courts may have looked to the dominant purpose of the expenditure and as such did not authorise an apportionment calculation. It is submitted, however, that in *CIR v Allied Building Society* and *CIR v Standard Bank of SA Limited,* the courts concluded that the taxpayers in question had incurred the interest expenditure for the sole purpose of earning income. The fact that the taxpayers had used the borrowings for an incidental business activity did not alter the fact that the purpose of the borrowings had been to obtain floating capital from which they would earn income.

It is therefore submitted that where a single, indivisible expense has been incurred for two or more distinct purposes, the courts have sanctioned, and the need arises for apportionment. Being of critical importance, chapter three will analyse the need for apportionment in more detail.

# CHAPTER 3: THE NEED FOR APPORTIONMENT

## 3.1 INTRODUCTION

Having established in chapter two that the Act and judicial precedent sanctions the apportionment of dual-purpose expenditure, the question that follows is: when is it appropriate to perform an apportionment exercise? It is submitted by de Koker and Williams (2015:7.11A) that the need for apportionment only arises where a single, indivisible expense has been laid out for more than one purpose:

> The subject of the apportionment of expenditure must commence with a need for apportionment; discrete amounts expended for different, separately identifiable purposes do not require to be apportioned, and their eligibility for deduction can be judged on their individual merits. Apportionment is essentially a question of fact, dependent on the circumstances of each case. It is only when a single, indivisible expenditure has been laid out for more than a single purpose that the questions arise whether apportionment is permissible, what form it should take and what its consequences are.

This chapter will begin with a critical analysis of the Act, case law and academic writings to determine when an amount is regarded as having been laid out or expended for the purposes of trade. This will be followed by a discussion of when an expense is regarded as having been incurred in the production of income. In performing the above analyses, this chapter will discuss the principles established by the courts for determining whether an expense has been laid out for more than one purpose.

The goal of this chapter is, firstly, to discuss the principles applying in determining whether amounts are expended for the purposes of trade and in the production of income and, secondly, to answer the question: when is the apportionment of expenditure appropriate? In addressing this question, this chapter serves as the precursor to chapter four which discusses the apportionment calculation.

## 3.2 FOR THE PURPOSES OF TRADE

Section 23(g) of the Act clearly states that a taxpayer needs to incur an expense for the purposes of trade in order for it to be deductible in terms of the “general deduction formula”. The questions that follow are: how does one determine the purpose for which an expense was incurred, and how does one determine whether an expense has been incurred for a dual purpose?

### 3.2.1 *MALLALIEU v DRUMMOND (INSPECTOR OF TAXES)*

The well-known English case of *Mallalieu v Drummond (Inspector of Taxes)*, [1983] 2 All ER 1095, concerned a lady barrister who attempted to claim a deduction for clothing which she wore under her gown during court appearances. Similar to the old version of section 23(g), the relevant United Kingdom tax legislation also required that an expense be wholly and exclusively laid out or expended for the purposes of trade in order for it to be deductible for income tax purposes. The issue before the court was whether the expenditure on the clothing was incurred solely for the purposes of the taxpayer's profession (Williams: 2009).

In deciding the case Lord Brightman first held (at 1099) that the meaning of the term "for the purposes of the trade" meant to "serve the purposes of the trade" or "for the purpose of enabling a person to carry on and earn profits in the trade." Lord Brightman also made it clear (at 1099) that the words "the purposes" did not refer to the purposes of the taxpayer but rather to the purposes of the business.

The learned Lord then submitted that when determining whether an amount has been expended for the purposes of the taxpayer's business one needs to look into the taxpayer's mind at the moment the expenditure is made. He also made it clear that the principle of a dominant purpose had no role to play with regard to the application of section 130 (a) and the existence of an additional non-trade purpose, no matter how insignificant, would result in the disallowance of the entire amount.

Lord Brightman's final point in setting out the principles to be applied to section 130 (a), was that the object of a taxpayer in incurring an expense must be distinguished from the effect of the expenditure. In explaining the difference between object and effect Lord Brightman gave an example of a medical consultant who travels to the South of France to attend to a patient who is also his friend. Having travelled to the South of France, the medical consultant incurs travelling costs which he seeks to deduct. The question which needs to be answered is whether the medical consultant travelled to the South of France purely for professional reasons or whether there was an additional private advantage. If the medical consultant's only object was to attend to his patient, the stay in the South of France would be an unavoidable effect. In this situation the taxpayer's object in making the trip would be purely professional and the travelling costs would be deductible. If, however, the medical consultant's object was to attend to his patient and have a holiday, then the travelling costs

would be deemed to have been incurred for a dual purpose and the travelling costs would not be deductible.

Having outlined the principles above, Lord Brightman made it clear (at 1100) that the key issue to be addressed was the distinction between object and effect: “the appeal before your Lordships is basically concerned with the distinction between object and effect.” The court therefore needed to consider the facts of the case to determine whether the lady barrister had purchased the clothing in question for a dual purpose, or whether she had purchased the clothing solely for the purposes of her profession, albeit with an incidental private advantage. The court found that the clothing in question consisted of ordinary articles of apparel which many ladies wore from choice and as a result Lord Brightman said (at 1103) the following:

> In my opinion the commissioners were not only entitled to reach the conclusion that the taxpayer’s object was both to serve the purposes of her profession and also to serve her personal purposes, but I myself would have found it impossible to reach any other conclusion.

In concluding, Lord Brightman reaffirmed his stance that the clothing in question had been acquired for a dual purpose by referring to *Hillyer v Leeke (Inspector of Taxes),* [1976] STC 490, where Goulding J stated (at 492-493) the following:

> The truth is that the employee has to wear something, and the nature of his job dictates what that something will be. It cannot be said that the expense of his clothing is wholly or exclusively incurred in the performance of the duties of the employment ... In the case of clothing, the individual is wearing clothing for his own purposes of cover and comfort concurrently with wearing it in order to have the appearance which the job requires ... and the expenditure in question, although on suits that were only worn while at work, had two purposes inextricably intermingled and not severable by any apportionment that the court could undertake.

### 3.2.2 *CIR v PICK ‘N PAY WHOLESALERS (PTY) LTD*

*CIR v Pick ‘n Pay Wholesalers (Pty) Ltd* concerned the deductibility of amounts donated by Pick ‘n Pay Wholesalers (Pty) Ltd to the Urban Foundation. The key question before the court was whether the donation had been expended wholly and exclusively for the purposes of trade.

Pick ‘n Pay Wholesalers (Pty) Ltd was of the view that the amounts paid to the Urban Foundation were a form of indirect advertising and therefore wholly and exclusively laid out for the purposes of trade. This was highlighted by Nicholas AJA who referred (at 145) to a

statement made by Mr Hurst (secretary and financial director of Pick 'n Pay Wholesalers (Pty) Ltd) in his evidence in chief:

> Well, the mainspring behind the idea was Mr Ackerman and we discussed the matter at Board level and its possibilities and we decided to go ahead and make this contribution as a business exercise.

The Commissioner, however, contended that the donations had been made for a dual purpose. It was thus left to the court to decide whether the donations had been incurred wholly and exclusively for the purposes of trade. In considering the deductibility of the donations Nicholas AJA first discussed the meaning of "wholly and exclusively laid out or expended for the purposes of trade". In doing so he referred to the United Kingdom case of *Bentleys, Stokes and Lowless v Beeson (Inspector of Taxes)*. In this case Romer LJ made it clear that in determining whether an expense was laid out exclusively for business purposes one needs to examine the motive or object in the mind of the taxpayer. Romer LJ also submitted that determining the motive or object of a taxpayer is a question of fact. The difficulty which the court faced in *Bentleys, Stokes and Lowless v Beeson (Inspector of Taxes)* was that the nature of the expense in question was entertainment, and entertainment by its very nature involves the characteristics of hospitality and benefaction. In addressing this challenge, Romer LJ made it clear that the question to be asked when determining the deductibility of an amount was whether the expense had been incurred solely for the purposes of business and solely with the object of promoting the business. He also made it clear that the attainment of an additional non-business result did not necessarily disqualify the expense from deduction. A similar view was expressed (at 1100) by Lord Brightman in *Mallalieu v Drummond (Inspector of Taxes)*: "the existence of that private advantage does not necessarily preclude the exclusivity of the business purposes."

Nicholas AJA (in the *Pick 'n Pay Wholesalers* case) then stated (at 149) the following with regard to determining the purpose of an expense: "the question is one of fact, and the fact is the state of mind of those responsible for making the donation at the time it was made."

Having examined the evidence, Nicholas AJA submitted that Mr Ackerman's (chairman and managing director of Pick 'n Pay Wholesalers (Pty) Ltd) involvement in the donation was in a dual capacity. He also rejected (at 151) the notion that when dealing with the donation as the chairman and managing director of Pick 'n Pay, Mr Ackerman's purpose was solely business: "I cannot accept that. A man does not change his mind when he changes his hat." The

learned judge therefore stated (at 151) that he found it difficult to conclude that the donations had not been incurred for a dual purpose:

> The alternative – to regard it, so far as Pick 'n Pay was concerned, merely as a cynical ploy to trade on the charitable sentiments of the community, in order to promote the naked business advantage of Pick 'n Pay – is unworthy and unacceptable. The alternative is wholly inconsistent with the *persona* of a company concerned for people and aware of its social responsibility to the community, which Pick 'n Pay has sought over the years, no doubt sincerely, to build up.
>
> In all the circumstances I am of the opinion that Pick 'n Pay did not show, on the probabilities, that in making the donation it did not have a philanthropic purpose as well as a business purpose.

### 3.2.3 *SOLAGLASS FINANCE COMPANY (PTY) LTD v CIR*

As already discussed in chapter two, *Solaglass Finance Company (Pty) Ltd v CIR* was also concerned with whether an expense had been incurred wholly and exclusively for the purposes of trade.

#### 3.2.3.1 MINORITY JUDGMENT

The minority judgment submitted that the key issue before the court was the meaning of the term "wholly and exclusively for the purposes of trade". In this regard Friedman AJA relied on principles which had been established in previous cases. The first case he referred to was that of *Bentleys, Stokes and Lowless v Beeson (Inspector of Taxes),* and the principles he relied upon were:

- It must be determined if the expense in question was incurred solely for the purposes of business, or solely with the object of promoting the business or its profit earning capacity.
- To determine the purpose of an expense one needs to look at the motive or object of the taxpayer.
- To determine the motive or object of a taxpayer is a question of fact.
- The fact that an expense achieves an additional result does not necessarily indicate that the expense was incurred for more than one purpose.

Friedman AJA then went on to discuss *Mallalieu v Drummond (Inspector of Taxes)* from which he highlighted the following principles:

- To determine whether an expense has been incurred for the purposes of trade, one must look at the taxpayer's object in making the expense by looking into the taxpayer's mind at the moment when the expense was made.
- Where an expense has been incurred for more than one purpose, it is immaterial whether the business purpose predominates over the other purposes.
- The object of the taxpayer in making the expense must be distinguished from the effect of the expense.

Having applied the above principles to the specific facts, Friedman AJA submitted that the purpose of the taxpayer's business was to make a profit out of the loans it made and the bills it discounted. The learned judge also submitted that the unavoidable result of providing a benefit to the group did not constitute an additional purpose which was different to the appellant's trade as a money-lender. The court therefore concluded that the losses in question were not disqualified from deduction in terms of section 23(g) of the Act.

### 3.2.3.2 MAJORITY JUDGMENT

The majority judgment, however, concluded that the losses had been incurred for a dual purpose. In arriving at this conclusion Botha JA also made it clear that the term "exclusively laid out or expended for the purposes of trade" was important. In determining the meaning of the term "exclusively laid out or expended for the purposes of trade" Botha JA referred briefly to the principles which had already been discussed by Friedman AJA. Unlike Friedman AJA, however, Botha JA did not find these principles very useful. The learned judge submitted that the distinction between motive and purpose, object and effect, and subjective intention and objective purpose was of little use. He further stated that there were no hard and fast rules, and that it was not possible to devise a single universal test for determining the purpose of an expense. He submitted that the answer lay in examining the specific facts of each individual case.

Having examined the facts, Botha JA considered each of the appellant's arguments. The appellant's first argument was that the company in question was first bought into operation for the purpose of promoting the interests of the group, and thereafter continued to trade solely for the purpose of generating a profit. Botha JA dismissed this contention by stating (at 26):

> I see no merit in the suggested dichotomy between the creation of the trading concern and its actual activities. What was aimed at by the former was achieved by the latter. The object of promoting the Group interests, which gave birth to the appellant as a trading entity, did not disappear with the actual carrying on of the business, but was in fact implemented thereby.

The appellant's second argument was that the promotion of the group's interests was merely a motive and not a purpose. In considering this argument, Botha JA acknowledged that the distinction between motive and purpose had been useful in *COT v BSA Co Investments Ltd*, 1966 (1) SA 530 (SRAD), 28 SATC 1, but was not relevant to the case in question. This is evidenced by the following statement (at 26-27):

> In that kind of case the benefit conferred on another person is but indirectly and remotely connected with the trading activities of the taxpayer. Here the position is quite different. On the evidence, the promotion of the Group interests is an integral part of the very activities carried on by the appellant. It borrows money from subsidiaries in the Group whenever they have a surplus available, irrespective of the needs of the appellant at that time. It lends money to subsidiaries at a reduced rate of interest whenever the interests of the subsidiaries concerned require that to be done, irrespective of the attendant disadvantage to the appellant. In short, the trading activities of the appellant are governed by policy considerations dictated by the interests of the Group. To talk of 'motive' as opposed to 'purpose' in relation to the appellant's furthering of Group interests is to ignore the evidence.

The appellant's final argument was that the promotion of the group's interests was not a purpose but merely a result of its trading activities. Botha JA also dismissed this on the basis that the appellant's business was structured to achieve both the promotion of the group's interests as well as the promotion of its own interests. In making this point clear, Botha JA stated (at 27) the following:

> The evidence shows plainly, in my opinion, that the appellant's business is wholly structured and conducted with a view to achieving both the promotion of the Group interests and the making of a profit. If the former is a 'result', so is the latter; and if the latter is a 'purpose', so is the former.

Having considered the evidence, Botha JA went on to conclude that the promotion of the group's interests was a purpose. In addition, the learned judge made it clear (at 27) that: "the concept of a 'dominant purpose' has no role to play here." The losses in question were therefore disallowed on the basis that they had not been incurred wholly and exclusively for the purposes of the taxpayer's business.

It has been submitted, however, that if one were to strictly apply the principles established in *Solaglass Finance Company (Pty) Ltd v CIR* to all inter-company expenses, the likelihood of the Commissioner finding that an expense has been incurred for a dual purpose will be high. This was highlighted (at 258) by Walton J in *Garforth (Inspector of Taxes) v Tankard Carpets Ltd*, [1980] STC 251:

> In my judgment, commissioners should be extremely slow in coming to any conclusion that the act was done solely for the benefit of the trade of one of the companies concerned, and should in general do so only where there are wholly separate findings of primary fact not depending on the say-so of the directors concerned. I cannot resist the impression that in 99 cases out of 100 the correct primary fact to find will be that which was in fact found in this case; namely that in such a situation as the present the interests of all the companies were considered together. This is in accord with all the probabilities; in the present and, indeed, most foreseeable cases.

The problem with the principles established by the majority in *Solaglass Finance Company (Pty) Ltd v CIR* can be best illustrated by way of example. Consider a large retail group which operates grocery stores throughout South Africa. Each store is housed in a separate subsidiary with a head office company performing group functions. In addition to the head office company and the numerous subsidiaries, the group owns a property company whose purpose is to acquire and let retail premises to the numerous stores. The property company owns the retail premises, earns rental income from the stores and incurs various expenses such as electricity, insurance and municipal rates. The property company charges market-related rentals and operates to make a profit in its own right. In addition to making a profit, the property company is required to serve the interests of the group. This involves acquiring and selling properties, as well as renewing and cancelling lease agreements as and when the need arises. If one were to strictly apply the principles established in *Solaglass Finance Company (Pty) Ltd v CIR* to the property company, there is a real possibility that the property company would be deemed to be carrying out two purposes: promoting the interests of the group and renting out retail premises for profit. Under the old section 23(g) the property company would have been at risk of having its expenses disallowed in full, whilst under the new section 23(g) an apportionment exercise would need to be performed. This concern has also been expressed by Meyerowitz D., Meyerowitz P., Davis and Emslie (1991:27) who state the following:

> It may well be that in the *Solaglass* case the Commissioner contested the deductions only because he considered that the loss did not arise from a money-lending transaction, but the approach of the majority in that case could encourage him to challenge other kinds of deductions claimed in which inter-company transactions are involved; for example, the rental paid by one group company to another for the use of premises, the interest on money borrowed by a group company to acquire plant to be let to another group company, the loss sustained by a manufacturing company in supplying the sales company in the group and so on.

De Koker and Williams (2015) submit that the majority in *Solaglass Finance Company (Pty) Ltd v CIR* accepted too readily that the taxpayer had been carrying out its activities for a dual purpose. In addition, they submit that the decision reached in *FCT v BHP Billiton Finance Ltd*, 2010 ATC 20-169, is possibly the correct one, whereby a subsidiary should be viewed as a business in its own right and not regarded as a mere conduit to the parent company. This case is analysed in more detail below.

#### 3.2.3.3 *FCT v BHP BILLITON FINANCE LTD*

In *FCT v BHP Billiton Finance Ltd* the taxpayer was a subsidiary company established for the purpose of acting as banker to the larger group. It obtained external borrowings which it on-lent to various group companies at a higher rate of interest, thus earning significant taxable income. The question before the court was whether BHP Billiton Finance Ltd could deduct losses it had suffered on two irrecoverable loans to group companies (de Koker & Williams: 2015).

The Australian tax authorities argued that the losses were not deductible on the basis that the subsidiary was not in the business of money-lending. In support of this they noted that the taxpayer did not perform an analysis of the risks and the returns associated with each lending activity, but rather implemented decisions which had been taken by its parent company.

In considering the Commissioner's argument, Edmonds J first made it clear that performing an analysis of the risks involved each and every time a loan is granted, is not a requirement for a business to be classified as a money-lender. The learned judge also reiterated that it was not the responsibility of the Australian tax legislation to dictate to business-owners on how to run their businesses. In explaining this, he referred to *Tweddle v FCT*, (1942) 180 CLR 1, where Williams J stated (at 7) the following:

> It is not suggested that it is the function of income tax Acts or of those who administer them to dictate to taxpayers in what business they shall engage or how to run their business profitably or economically. The Act must operate upon the result of a taxpayer's activities as it finds them.

Edmonds J (at 10783) then went on to make it clear that the fact that the subsidiary company had been created for the purpose of providing financing to the group did "not make Finance's business an appendage to the business of the Group as a whole; any more than it makes Finance a mere conduit of BHPB's business." Stressing this point, Edmonds J referred to *Commissioner of Taxation v Tasman Group Services Pty Ltd*, 2009 ATC 20-138, where Ryan J stated (at 10227) the following:

> It is a trite proposition that, where a subsidiary, even if wholly owned by a parent company, carries on a business, the business is that of the subsidiary not the parent. Irrespective of how closely it may monitor the business activities of the subsidiary, the parent does not itself carry on those activities but is engaged in the separate business of a parent or holding company which is, normally, the receipt of income in the form of dividends from the subsidiary.

Having examined the facts, Edmonds J found that the subsidiary company's money-lending activities were not ancillary or subservient to some other business carried on by itself. In addition, Edmonds J held (at 10784) that "its activities of borrowing and lending were its only activities; and it had no equity, direct or indirect, in the companies in the Group to which it lent." The court therefore concluded that the subsidiary company was in the business of money-lending and as such could deduct the losses it had suffered on the two irrecoverable loans.

In analysing the cases of *Solaglass Finance Company (Pty) Ltd v CIR* and *FCT v BHP Billiton Finance Ltd*, de Koker and Williams (2015) submit that the decision arrived at in *FCT v BHP Billiton Finance Ltd* is possibly the correct one. In addition, de Koker and Williams (2015) submit that the decision reached in *FCT v BHP Billiton Finance Ltd* could be of use in a South African context:

> The significance of the Billiton judgment in a South African context is that, in a tax jurisdiction closely akin to our own, a strong judgment in the modern era has recognised that one company in a group could qualify as carrying on business as a banker or money-lender to the others in the group without being regarded, for tax purposes, as a mere 'conduit' or 'appendage'.

### 3.2.4 *WARNER LAMBERT SA (PTY) LTD v C:SARS*

*Warner Lambert SA (Pty) Ltd v C:SARS*, 65 SATC 346, also involved the deductibility of expenditure in the context of section 23(g). In this case the taxpayer was a South African subsidiary of an American parent. The taxpayer was also a signatory to the Sullivan Code and its senior management involved in social responsibility projects. The principles contained in the Sullivan Code were ultimately legislated into the Comprehensive Anti-Apartheid Act which the taxpayer was obliged to adhere to. In order to comply with the requirements of the Comprehensive Anti-Apartheid Act, the taxpayer incurred two broad categories of costs: wage improvements and similar expenses, and social responsibility expenditure.

It was common cause that the wage improvement costs were incurred in the production of income, however, the Commissioner was of the view that the social responsibility expenditure was not deductible. The taxpayer disagreed with the Commissioners view, and objected on the basis that the incurral of the social responsibility expenditure was to prevent the loss of its status as a subsidiary of the American parent, which was vital to its trading success.

The issue before the court was whether the social responsibility expenditure was deductible in terms of section 11(a) read with section 23(g). In examining the deductibility of the social responsibility expenditure the court needed to address the following three questions:

- Was the expenditure incurred in the production of income?
- Was the expenditure of a capital nature?
- Was the expenditure incurred for the purposes of trade?

This thesis will only consider the third question: was the expenditure incurred for the purposes of trade?

Conradie JA first made it clear that it was not possible to apply a single test when looking at the provisions of section 23(g), but rather the specific facts of each individual case should be examined. The learned judge then referred to *CIR v Pick 'n Pay Employee Share Purchase Trust*, 54 SATC 271, where Smalberger JA stated (at 281) the following:

> In a tax case one is not concerned with what possibilities, apart from his actual purpose, the taxpayer foresaw and with which he reconciled himself. One is solely concerned with his object, his aim, his actual purpose.

The appellant argued that its purpose in incurring the social responsibility expenditure was the same as its purpose in incurring the other deductible Sullivan Code expenditure. In addition, the appellant was of the view that the tax treatment of all types of Sullivan Code expenditure should be the same. In referring to the appellant's argument Conradie JA stated (352) the following:

> If, therefore, the purpose of the admittedly deductible expenditure and that of the contested expenditure was the same, their tax treatment should also be the same. Both were expended in the production of income or neither was.

Having considered the specific facts, Conradie JA concluded that it was vital for the taxpayer to maintain its subsidiary status. In addition, the learned judge stated that the taxpayer would lose various trade advantages should it not maintain its subsidiary status. The court therefore concluded that the social responsibility expenditure had been incurred for the purposes of trade.

In addition to having to be incurred for the purposes of trade, an expense also needs to be incurred in the production of income in order to qualify for deduction in terms of section 11(a) read with section 23(f) of the Act. The next section of this chapter will analyse the meaning of the term "incurred in the production if income".

### 3.3 INCURRED IN THE PRODUCTION OF INCOME

The term "incurred in the production of income" is not defined in the Act. The courts have therefore been called upon many times to consider its meaning. This section of the chapter will analyse case law and academic writings in order to set out the principles established for determining whether an expense has been incurred for the dual purpose of earning both taxable and exempt income.

#### 3.3.1 *PORT ELIZABETH ELECTRIC TRAMWAY COMPANY LTD v CIR*

No discussion of the term "incurred in the production of income" would be complete without reference to *Port Elizabeth Electric Tramway Company Ltd v CIR*, 1936 CPD 241, 8 SATC 13. This case involved a taxpayer who operated a tramway company. One of its drivers lost control of a tram whilst descending down a steep hill and crashed into a building. The driver ultimately died as a result of the injuries he sustained in the accident. Prior to his death, the driver claimed compensation under the Workmen's Compensation Act. The taxpayer

defended the claim against it, but ultimately was ordered to pay an amount to the driver's widow. In defending the claim, the taxpayer also incurred legal costs. The issue before the court was whether the compensation and the legal costs incurred in resisting the claim for compensation were incurred in the production of income.

In deciding this case Watermeyer AJP held (at 16) that there were two broad questions which needed to be answered: "(a) whether the act, to which the expenditure is attached, is performed in the production of income, and (b) whether the expenditure is linked to it closely enough?" In deciding whether the act is performed in the production of income, Watermeyer AJP stated (at 16) that "the purpose of the act entailing expenditure must be looked to. If it is performed for the purpose of earning income, then the expenditure attendant upon it is deductible." Commenting on Watermeyer AJP's reference to purpose Williams (2009:447) states the following:

> When Watermeyer AJP uses the word 'purpose' in the phrase 'the purpose of the act entailing expenditure', did he mean *the (objective) purpose which the act served* or did he mean *the (subjective) purpose of the taxpayer in performing the act that gave rise to the expenditure?* In *Mallalieu v Drummond* Lord Brightman said that the words in the United Kingdom legislation, '"expended for the purposes of the trade" … do not refer to "the purposes" of the taxpayer as some of the cases appear to suggest. They refer to "the purposes" of the business which is a different concept …'
>
> It seems that when Watermeyer, in *Port Elizabeth Electric Tramway*, referred to 'the purpose of the act entailing expenditure' he meant the *subjective* purpose of the taxpayer in performing that act …

Watermeyer AJP then went on to consider the second broad question, that being, whether the expenditure is linked closely enough to the act. In addressing this question Watermeyer AJP stated that all expenses attached to the performance of a business operation *bona fide* performed for the purpose of earning income are deductible if:

- the expense is necessary for the performance of the business operation;
- the expense is attached to the business operation by chance; or
- the expense is genuinely incurred for the purpose of carrying on the business operation more efficiently (Haupt: 2015).

Having considered the specific facts Watermeyer AJP submitted that it was necessary for a tramway company to employ drivers. The learned judge also stated that the tramway

company carried a potential liability to pay compensation should one of its drivers be injured in the course of their employment. The court therefore held that the compensation was deductible as it was a necessary concomitant and inseparable from the taxpayer's income-earning activities.

With regard to the deductibility of the legal costs the appellant provided no additional evidence besides stating that they should be treated in the same way as the compensation payment. Watermeyer AJP acknowledged that in certain circumstances legal costs were deductible, however, he also stated that the legal costs needed to be closely connected with the earning of the income in order to qualify for deduction. Having analysed the specific facts, Watermeyer AJP came to the conclusion that legal fees expended in resisting a demand for compensation were not an operation entered into for the purpose of earning income. The court therefore held that the legal costs did not satisfy the tests for deductibility.

### 3.3.2 *CIR v NEMOJIM (PTY) LTD*

Ordinarily the cost of the shares of a sharedealer are fully deductible in terms of section 22 of the Act. This is due to the fact that shares constitute trading stock in the hands of a sharedealer (Stack *et al*: 2002). In *CIR v Nemojim (Pty) Ltd* it was common cause that the taxpayer carried on the business of a sharedealer and that the shares in which it dealt constituted its trading stock. During the 1977 and 1978 years of assessment the taxpayer carried out a number of dividend-stripping operations. This involved purchasing all the shares of dormant companies with large cash reserves, distributing these cash reserves as a dividend and then re-selling the shares. In most cases the taxpayer made a profit, that is, the sum of the proceeds from the dividend and the resale of the shares exceeded the cost of the shares. Although the company made a profit from these dividend-stripping operations it created an assessed loss from an income tax perspective. This was due to the fact that the taxpayer deducted the full cost of the acquisition of the shares of the dividend-stripped companies, whilst the portion of the proceeds which constituted dividend income was exempt from income tax in terms of section 10(1)(k). The Commissioner, however, did not permit the creation of an assessed loss and only allowed a deduction of the cost of the shares to the extent that it did not exceed the proceeds from the resale of the shares (Meyerowitz, D. & Meyerowitz, P: 1983). The question before the court was whether the taxpayer was entitled to claim the full purchase price of the shares as a deduction or whether a part thereof was not deductible by reason of section 23(f).

In deciding whether an expense has been incurred in the production of income Corbett JA stated (at 256) that "important, sometimes overriding factors, are the purpose of the expenditure and what the expenditure actually effects." In support of this principle, Corbett JA then went on to refer to various cases where a similar view had been expressed. He first referred to *Port Elizabeth Electric Tramway Company Ltd v CIR* where Watermeyer AJP said (at 16):

> As pointed out above, businesses are conducted by different persons in different ways. The purpose of the act entailing expenditure must be looked to. If it is performed for the purpose of earning income, then the expenditure attendant upon it is deductible.

The second case he referred to was *New State Areas Ltd v CIR*, 1946 AD 610, 14 SATC 155, where Watermeyer CJ said (at 170): "its true nature is a matter of fact and the purpose of the expenditure is an important factor…"

The third case he referred to was *Sub-Nigel Ltd v CIR*, 1948 (4) SA 580 (A), 15 SATC 381, where Centlivres JA said (at 394):

> It seems to me clear on the authorities that the Court is not concerned whether a particular item of expenditure produced any part of the income: what it is concerned with is whether that item of expenditure was incurred for the purpose of earning income.

His fourth reference was to *CIR v Genn & Co (Pty) Ltd*, 1955 (3) SA 293 (A), 20 SATC 113, where Schreiner JA said (at 121):

> In deciding how the expenditure should properly be regarded the Court clearly has to assess the closeness of the connection between the expenditure and the income-earning operations, having regard both to the purpose of the expenditure and to what it actually effects.

His final reference was to *CIR v Allied Building Society* where Ogilvie Thompson JA said (at 357): "in the particular circumstances of the present case, the most important factor in that inquiry is, in my opinion, the purpose of the borrowing."

In referring to all these cases Corbett JA (in the *Nemojim* case) made it clear (at 256) that in determining the deductibility of expenditure one needs "to assess the closeness of the connection between the expenditure and the income-earning operations, having regard both to the purpose of the expenditure and to what it actually effects." This view is supported by de Koker and Williams (2015) who submit that an expense will qualify for deduction if it has been incurred for the purpose of earning income and there is a direct relationship between

the expense in question and the actual earning of the income.

In applying the above principles to *CIR v Nemojim (Pty) Ltd* Corbett JA was of the view that the expenditure incurred in acquiring the shares had a dual purpose. The taxpayer's one purpose was to earn dividends which were exempt from income tax, whilst the other purpose was to receive proceeds from the resale of the shares which were taxable. Corbett JA therefore submitted that as one of the purposes was to earn exempt dividend income the taxpayer had not incurred the purchase price of the shares wholly for the purposes of producing income.

The respondent company relied upon previous case law to argue that it had purchased the shares and not the potential dividends which were attributable to the shares in question. In support of this argument counsel for the respondent referred to the Scottish case of *CIR v Forrest*, 8 TC 704, where The Lord Justice Clerk, Lord Alness stated (at 708) the following:

> To say that the respondent purchased the dividend upon the shares is I think inaccurate. He bought the shares with their potentialities, whatever they were. There was then no dividend in existence. He paid a certain and arbitrary price for these shares, and that is the whole transaction.

Corbett JA rejected the above argument on the grounds that the facts and issues involved in *CIR v Forrest* were different to those in *CIR v Nemojim (Pty) Ltd*. In addition, Corbett JA made it clear that the issue was not whether the taxpayer had legally purchased the dividends, but whether the expenditure incurred in purchasing the shares was closely connected to the receipt of the dividend income. Having examined the specific facts, the learned judge submitted that the taxpayer had acquired the dormant companies with the purpose of distributing their distributable reserves. He also submitted that as the taxpayer had acquired all the shares in the dormant companies it had the power to carry out its intended purpose.

Counsel for the taxpayer also referred to a Rhodesian and two Australian cases, however, Corbett JA dealt with them briefly, dismissing them as not relevant. Finally, the taxpayer argued (at 264) that if the "court were to accede to the appellant's plea for apportionment, it would mean that a similar apportionment would have to be made in the case of every 'ordinary' share-dealing company." In addressing this contention Corbett JA made it clear that there were differences between a company which buys shares for the purposes of dividend stripping and a company which buys shares for the purposes of making a profit on

their resale.

Having considered all the evidence, Corbett JA submitted the following:

- The taxpayer had acquired the shares in the dormant companies for the purpose of distributing available reserves.
- The taxpayer had acquired all the shares in the dormant companies, and therefore had the power to carry out its intended purpose.
- The taxpayer had actually carried out its intended purpose of distributing available reserves.
- There was therefore a sufficiently close connection between the receipt of the dividend income and the cost of acquiring the shares.

The court therefore concluded that the taxpayer had incurred the cost of acquiring the shares for two purposes: the purpose of earning dividend income and the purpose of earning proceeds from the resale of the shares. Corbett JA therefore ordered that the cost of acquiring the shares be apportioned between the two purposes.

### 3.3.3 THE *MTN* CASES

The recent *MTN* cases have arguably shed some light on the issue of apportioning expenditure that has been incurred in the production of exempt and taxable income. The background to these cases is best described as follows: the taxpayer was a subsidiary of the MTN Group Ltd, and had five subsidiaries of its own. The business of the MTN Group was the provision of mobile telecommunication services, and it was common cause that the taxpayer was carrying on a trade. The taxpayer's income consisted of dividends and interest. The Commissioner disallowed almost all of the taxpayer's audit fees during the years of assessment 2001 to 2004 on the basis that the bulk of the taxpayer's income consisted of exempt dividends.

The key issue before the court was whether all, or a portion of the audit fees were deductible in terms of section 11(a) read with section 23(f) of the Act. This issue was heard by the South Gauteng Tax Court, the South Gauteng High Court and finally by the Supreme Court of Appeal. Each of these cases are discussed in detail below.

### 3.3.3.1 SOUTH GAUTENG TAX COURT

In *ITC 1842* Gildenhuys J explained (at 123) that the court needed to consider "whether the audit fees were incurred in the production of 'income' (as defined), or in respect of dividends, or for both purposes." In doing so he first referred to *Port Elizabeth Electric Tramway Company Ltd v CIR* where Watermeyer AJP set out the following principles for determining whether an expense has been incurred in the production of income: all expenses attached to the performance of a business operation *bona fide* performed for the purpose of earning income are deductible if:

- the expense is necessary for the performance of the business operation;
- the expense is attached to the business operation by chance; or
- the expense is genuinely incurred for the purpose of carrying on the business operation more efficiently (Haupt: 2015).

Gildenhuys J also made it clear that the expenditure in question did not need to be directly causally connected to the earning of income. In support of this view Gildenhuys J referred to *CIR v Drakensberg Garden Hotel (Pty) Ltd*, 1960 (2) SA 475 (A), 23 SATC 251, where Schreiner JA said (at 257) the following:

> To be deductible the expenditure must have been actually incurred in the production of income. It must not be of capital nature and it must have been wholly or exclusively laid out for the purpose of trade. It need not, however, have been causally related to the income which is the subject of the assessment in question.

A similar view was also expressed by Centlivres J in *Sub-Nigel Ltd v CIR* as explained by Meyerowitz (2008:11-19) below:

> In *Sub-Nigel Ltd v CIR* it was held that expenditure incurred in the production of income does not mean that there can be no deduction unless income has been produced, but means that the expenditure must have been incurred for the purpose of earning income whether in the current or any future year of assessment; if it is so incurred it is deductible even if no income is earned.

The respondent, in *ITC 1842*, argued that in order for an expense to be deductible it needs to be incurred for the purpose of producing income and the effect of the expense must have been to produce income. In light of this, the respondent submitted that the audit fees had not been incurred in the production of income. Dismissing this view, Gildenhuys J submitted that the correct criteria for determining whether an expense

has been incurred in the production of income was whether the expense was connected to the taxpayer's income earning operations, not whether the expense produced income or was directly linked to income.

The learned judge then referred to *Joffe & Co (Pty) Ltd v CIR*, 1946 AD 157, 13 SATC 354, where Watermeyer CJ submitted that the following expenditure would be deductible:

- expenditure necessarily attached to the performance of the operations of the income-earning trade; and
- expenditure *bona fide* incurred for the purpose of carrying on the trading operations, provided such payments are wholly and exclusively made for that purpose and are not expenditure of a capital nature.

Applying the principles from *Joffe & Co (Pty) Ltd v CIR,* Gildenhuys J held that the auditing of financial records was clearly a function which was necessarily attached to the performance of the appellant's income-earning trade. In addition, Gildenhuys J explained that the fact that the audit fees themselves did not directly produce income did not render them non-deductible. The court therefore concluded that the audit fees had been incurred for the dual purpose of producing income and exempt income and ordered for an apportionment exercise to be performed.

#### 3.3.3.2 SOUTH GAUTENG HIGH COURT

Not being satisfied with the outcome of the South Gauteng Tax Court case, the taxpayer appealed to the South Gauteng High Court. In addition, the Commissioner cross-appealed in respect of the deductibility of the audit fees.

The background facts to *Mobile Telephone Networks Holdings (Pty) Ltd v C:SARS* were agreed in a pre-trial meeting and it was common cause between the parties that the taxpayer had earned taxable interest income and exempt dividend income. Victor J first made it clear (at 320) that "the applicable legal principles are clear but its application to the facts introduces the complexities." The learned judge then repeated the principles which had already been set out in the earlier South Gauteng Tax Court case by stating (at 320) the following:

> In order for the expenditure to be deducted it must be incurred in the *bona fide* performance of the operation, must have been incurred in the production of income and need not be causally related to the income, and regard must be had to the purpose of the expenditure and to what it actually affects.

In seeking to disallow the audit fees in full, the respondent contended that the expenditure was *ex post facto* in nature and that it did not advance the trade of the company and the production of its revenue. In support of this, the respondent submitted that the primary role of the auditor was protecting the interests of investors and creditors and not the generation of income. Victor J, however, submitted that the work performed by the auditors extended beyond the mere verification of interest and dividend income. He also made it clear, that in his view, the additional tasks performed by the auditors related to the income earning activities of the taxpayer. In applying the established principles to the specific facts Victor J held (at 321) that "the expenditure was incurred to directly facilitate the carrying on of its trade not only in a legally compliant manner but to generate income."

Having failed in its main submission the respondent also cross-appealed on the basis that the deduction of 50 per cent of the audit fee was excessive. In explaining the basis for the cross appeal Victor J stated (at 322) the following:

> It is the respondent's case that audit fees do not attach to those operations as there is no statutory obligation to have audited financial statements. Where there is trading through a company then the trader must accept that there are additional expenses for audit fees and the legal obligation is unrelated to the earning of income.

The respondent therefore argued that the audit fees did not attach to the income-earning operations of the taxpayer as they were a statutory expense unrelated to the earning of income. The court, however, pointed out that the Commissioner was not seeking to disallow the audit fees in full. This approach proved to be the downfall of the respondent's second submission as explained by Davis, Emslie T.S., van Dorsten, Dachs and Emslie C.A. (2011:158):

> This ambivalence in approach by the respondent resulted in fortifying its alternative argument where it did assume in favour of the taxpayer that expenses were incurred in the production of revenue. Once that is so then the respondent must accept that the audit expenses are not related to an election made to trade through a company (which requires audited accounts as opposed to an individual which does not). Such an approach would provide enormous obstacles to the world of trade and commerce.

The court therefore concluded that the audit fees had been incurred for the purpose of earning both taxable and exempt income and ordered that an apportionment exercise be performed. Commenting on the South Gauteng High Court decision Davis *et al* (2011:155) state the following:

> The judgment in this matter cannot, with respect, be regarded as an important milestone in our tax jurisprudence, but we nevertheless consider that the Court correctly recognised that audit fees are deductible as being an expenditure necessarily incurred as the concomitant of trading in corporate form, and that an apportionment where the income of a taxpayer consists of interest ('income' as defined) and dividends (exempt income) should be based on the extent to which the fees relate to audit work performed in relation to the interest income. The Commissioner's arguments that audit fees do not actually produce income, and that they are an *ex post facto* expenditure which benefit shareholders and others, rather than the company itself, were in our view correctly rejected.

### 3.3.3.3 SUPREME COURT OF APPEAL

The Commissioner, not being satisfied with the decision reached by the South Gauteng High Court, duly appealed to the Supreme Court of Appeal. The background facts had not changed from the South Gauteng Tax Court and South Gauteng High Court hearings and the Commissioner did not dispute that the respondent could only carry on it business in the corporate form. In addition, the Commissioner did not dispute that the respondent had to have its financial records audited.

Ponnan JA (in the Supreme Court of Appeal case) first made it clear that when determining whether an expense is incurred in the production of income, important factors include the purpose of the expense and what it actually effects. The learned judge also stated (at 211) that "the court has to assess the closeness of the connection between the expenditure and the income earning operations." Ponnan JA also referred to the principle established in *Joffe & Co (Pty) Ltd v CIR*, being, all expenditure necessarily attached to the income-earning operations of the taxpayer should be deductible. In applying the above principles to the specific facts, Ponnan JA submitted that the South Gauteng Tax Court's decision, that the auditing of financial records is a function which is necessarily attached to the performance of the taxpayer's income-earning operations, was correct.

Commenting on the conclusion reached by the court, Cliffe Dekker Hofmeyr (2014:8) state the following:

> … the SCA firstly accepted that the incurral of the audit fees was necessarily attached to the performance of the taxpayer's income-earning operations, and could not be wholly disregarded on that basis.
>
> Secondly, the SCA implicitly accepted that the audit fees were incurred for a dual purpose, and that an appropriate apportionment had to be made.

The decision to apportion the audit fees has, however, been questioned by Davis *et al* (2014:93) as evidenced by the following statement:

> We also wonder, with respect, whether this was in fact a case for apportionment at all … But were the audit fees in this case laid out for a dual or mixed purpose, which the SCA seems to have regarded as axiomatic?

The learned authors (2014:94) also propose that the audit fees were probably not incurred for the purpose of earning either interest income or dividend income but rather to comply with a statutory obligation:

> … the taxpayer had to incur the audit fees whatever the nature of its gross income, and in such circumstances it can be doubted whether the audit fees were incurred for the purpose of producing any particular category or categories of gross income at all. All one can realistically say is that the audit fees were the necessary concomitant of the taxpayer's trading operations …
>
> In the light of the SCA's acceptance of the Tax Court's finding that the auditing of the taxpayer's financial records was clearly a function that was necessarily attached to the performance of its income-earning operations, perhaps the conclusion should have been that the audit fees were fully deductible.

## 3.4 CONCLUSION

The need for apportionment only arises where a single, indivisible expense has been incurred for more than one purpose. The task, however, of determining whether an expense has been incurred for a dual purpose is often fraught with difficulties. This was made clear by Victor J *in Mobile Telephone Networks Holdings (Pty) Ltd v C:SARS* when he stated (at 320) the following: "the applicable legal principles are clear but its application to the facts introduces the complexities."

This chapter first examined the trade requirement of section 11 and section 23(g). In doing so, various English, South African and Australian tax cases were analysed in order to understand the principles that have been established by the courts when determining

whether an expense has been incurred for the purposes of trade. The key principle emanating from these cases is that a taxpayer's purpose must always be looked at when deciding whether an expense has been incurred for trade purposes. In determining a taxpayer's purpose, the courts have held that the object or motive of the taxpayer must be examined, and in determining a taxpayer's object one needs to look into the taxpayer's mind at the moment the expense is incurred. The courts have also held that an additional private result or the presence of a dominant purpose are irrelevant when determining whether an expense has been incurred for the purposes of trade. Finally, *FCT v BHP Billiton Finance Ltd* made it clear that where a subsidiary company carries on a trade it should be viewed in its own right and not regarded as a mere conduit or appendage of the parent company.

The need for apportionment also arises where an indivisible expense has been incurred to produce both taxable and exempt income. This chapter analysed *Port Elizabeth Electric Tramway Company Ltd v CIR*, *CIR v Nemojim (Pty) Ltd* and the recent *MTN* cases. In *Port Elizabeth Electric Tramway Company Ltd v CIR* the court held that the purpose of the act entailing expenditure must be looked to. In *CIR v Nemojim (Pty) Ltd* Corbett JA made it clear (at 256) that in determining the deductibility of expenses one needs "to assess the closeness of the connection between the expenditure and the income-earning operations, having regard to the purpose of the expenditure and to what it actually effects." The courts in the *MTN* cases made it clear that the purpose of the expense and what it actually effects is an important factor as well as the closeness of the connection between the expenditure and the income earning operations. In addition, the *MTN* cases support the principle that all expenditure necessarily attached to the income-earning operations of the taxpayer should be deductible. The courts also ruled that an expense need not actually produce income or be directly linked to income, but rather the test is whether the expense is closely connected to the income-earning operations of the taxpayer. Finally, it has been submitted by Davis *et al* (2014) that a situation may arise where an expense is not incurred for the purpose of earning taxable income or exempt income, but rather for the purpose of complying with a statutory obligation.

It is submitted that although the above principles may provide guidance in determining whether an expense has been incurred for a dual purpose, there is ultimately no single universal test. The courts have consistently held that the specific facts of each individual case should always be examined. Where the specific facts indicate that an expense has been incurred for a dual purpose, an apportionment exercise will need to be performed. In the

cases discussed in this chapter, apportionment was only applied in the *Nemojim* and *MTN* cases. Chapter four will analyse the various methods and calculations which the courts have adopted in apportioning dual-purpose expenditure.

# CHAPTER 4: APPORTIONMENT METHODS

## 4.1 INTRODUCTION

Where a single, indivisible expense has been incurred for more than one purpose the question that follows is: how does one practically apportion the expense between the various purposes? This question is further complicated by the fact that South African tax legislation provides no guidance as to how a taxpayer should apportion an expense that has been incurred for a dual purpose. This was explained (at 400) by Centlivres CJ in *CIR v Rand Selections Corporation Ltd*:

> It was contended on behalf of the company that, as the Act itself does not direct an apportionment of the expenditure or tell us how to ascertain what portion of the expenditure may be deducted from the 'income', the whole of the expenditure is deductible from the 'income'. I do not agree with this contention. The silence of the Act on the point might even be used as a basis for the contention that no portion of the expenditure is deductible, seeing that that expenditure produced both 'income' and 'dividends' and that section 12(f) in effect says that no expenditure incurred in producing 'dividends' can be deducted. The Commissioner has conceded, and I think rightly so, that a portion of the expenditure attributable to the 'income' can be deducted under section 11(2)(a) but, in my opinion, it was not legally competent for him to allow as a deduction from the 'income' an amount which is arbitrary.

This chapter will examine various cases and the apportionment methods adopted. In doing so, each case, and the attendant apportionment method will be analysed for the purpose of extracting key principles. In addition, the recent *MTN* cases will be examined with a view to critically analysing the apportionment methods adopted by the three courts. Finally, three recommendations will be made with a view to providing more certainty with regard to the apportionment process.

The goal of this chapter is to determine how a taxpayer should apportion an expense that has been incurred for a dual purpose and to suggest some recommendations which may provide more clarity and certainty in this fraught area.

## 4.2 APPORTIONMENT METHODS

The Act, and in particular, sections 11(a), 23(f) and 23(g) do not provide any guidance as to how a taxpayer should apportion expenditure that has been incurred for more than one purpose. Although certain Practice Notes (South African Revenue Service: 1994) have been

released by the SARS to assist taxpayers with apportioning dual-purpose expenditure, they do not have the force of law, and in some instances have been challenged by the SARS itself. This is reaffirmed by Meyerowitz, Emslie and Davis (1998:173) who state that "the revenue official furthermore accepted that practice note 24 had no force in law, but went on to assert that a proper apportionment had to be made in terms of section 23(g) of the Act." This uncertainty has led to the courts being called upon many times to assist with apportionment cases. A selection of these cases is analysed below.

#### 4.2.1 *CIR v RAND SELECTIONS CORPORATION LTD*

As discussed in chapter two, *CIR v Rand Selections Corporation Ltd* involved a taxpayer that earned its income from share-dealing transactions and dividends. During the tax year under review the taxpayer received the following amounts from one of its investments which had been placed under liquidation:

- £212,311 which represented a return of capital to the taxpayer; and
- £124,123 which represented a liquidation dividend paid out of profits.

The cost of the liquidated investment in the hands of the taxpayer had been £367,859. As the taxpayer was a share dealer it was common cause that the amount of £212,311 would be included in the taxpayer's income, whereas the liquidation dividend of £124,123 was specifically exempted in terms of section 10(1)(k). The issue before the court was what portion of the cost could be deducted by the taxpayer in calculating its taxable income. Having considered the evidence, Centlivres CJ stated that the portion of expenditure attributable to taxable income should be allowed as a deduction. To achieve this result the learned judge ordered the following formula to be applied:

> X multiplied by Y / (Y + Z), where X was the total expenditure incurred, Y was the taxable income and Z represented the dividend income.

#### 4.2.2 *ITC 832*

*ITC 832*, 21 SATC 320, concerned a taxpayer that carried on the business of a finance company. The taxpayer's primary assets were shares in subsidiaries and an interest-bearing loan to one of the aforementioned subsidiaries. During the tax year under review the taxpayer earned interest income in the amount of £10,896 and incurred administrative expenditure totalling £1,509. Importantly the taxpayer did not earn any dividend income

from its subsidiaries. The taxpayer sought to deduct the entire £1,509 on the basis that it had been incurred to produce the taxable interest income of £10,896. The Commissioner, however, disallowed the full deduction and determined that an amount of £841 was more appropriate.

It was common cause amongst all parties that an expense was only deductible if it was incurred in the production of income. The taxpayer therefore argued that as it had only earned interest income during the year under review no portion of the administrative expenditure should be disallowed. Rejecting this argument, Faure Williamson J stated (at 321-322) the following:

> This seems to me a completely fallacious argument …
>
> … It would be almost impossible, in my view, for the company to show that any portion of its revenue was actually expended in the production of income by way of interest. But it has been recognized that where a taxpayer such as the company has revenue from more than one source, one such source justifying deductions because the revenue is taxable and another such source not justifying deductions because the revenue is not taxable, even if particular items of revenue cannot be identified with one or other source of revenue, an attempt can be made to apportion.

Faure Williamson J then referred to the cases of *ITC 607* and *CIR v Rand Selections Corporation Ltd* where the courts had successfully apportioned expenditure. In analysing the decision reached in *CIR v Rand Selections Corporation Ltd* the learned judge acknowledged that the formula adopted would not be appropriate in the present case. He further submitted that the court in *CIR v Rand Selections Corporation Ltd* did not lay down a fixed formula which had to be used, but rather a fair apportionment should be made based on the particular facts of each case.

The court then referred to *Sub-Nigel Ltd v CIR* where it was held that an expense would still be incurred in the production of income even if no income was actually received. Relying on this principle, Faure Williamson J stated (at 323) the following:

> It seems to me in the circumstances quite clear that some reduction has to be made in the expenditure which is deductible and the only difficulty in the matter in my view is to determine whether the basis adopted by the Commissioner of arriving at a figure of deductible expenditure was a fair and proper basis.

Having considered all the relevant facts the court concluded that a fair method of apportionment would be to disallow the expenditure on the basis of the following ratio:

Value of share investments / value of the sum of the share and loan investments.

### 4.2.3 *LOCAL INVESTMENT CO v COT*

*Local Investment Co v COT*, 1958 (3) SA 34 (SR), 22 SATC 4, involved a taxpayer that carried on business as an investment company. During the tax year under review the appellant company earned taxable income of £9,904 and exempt income of £2,037. In earning this income the taxpayer incurred expenses of £2,459. The bulk of these expenses were incurred to earn both taxable and exempt income, whereas £20 was incurred wholly and exclusively for the purposes of earning exempt income. In calculating its taxable income for the year under review the appellant company deducted the expenditure of £2,459 other than the amount of £20 which had been incurred for the purposes of earning exempt income. The Commissioner, however, sought to disallow a portion of the expenditure which had been incurred for the dual purpose of earning both taxable and exempt income.

Having made it clear that the Commissioner was entitled to apportion the expenditure, Beadle J stated (at 11) the following: "I turn now to consider the last question. How is the apportionment to be made?" In answering this question, the learned judge first made it clear that one could not lay down any specific rules as to how apportionment should be performed. In addition, he stated that apportionment was a question of fact and should always be fair and reasonable. Beadle J also acknowledged that an apportionment method used in one case may be inappropriate and unfair in another case.

Having set out the principles of apportionment, the court then considered the specific facts of the appellant company. The court first confirmed that the bulk of the expenditure was general in nature and had been incurred to earn both taxable and exempt income. The court then made it clear that the operations which earned the taxable income were no different to the operations which earned the exempt income, and that no specifically identifiable amounts could be attributed to the earning of the taxable income. The final piece of evidence which the court held to be relevant was that the ratio of capital invested to earn exempt income to total capital was approximately equal to the ratio of exempt income to total income. Having analysed the evidence Beadle J concluded that the Commissioner was entitled to apportion the general expenses by referring to the proportion which the non-taxable amounts bore to the gross income.

### 4.2.4 *CIR v NEMOJIM (PTY) LTD*

As already discussed in chapter three, *CIR v Nemojim (Pty) Ltd* involved a taxpayer that was in the business of buying and selling shares. In carrying out its business the appellant company entered into a series of dividend-stripping operations. This involved purchasing the shares of companies with large reserve balances, distributing the aforementioned reserves as dividends and then re-selling the shares. The appellant company included the proceeds from the sale of the shares in its gross income and deducted the full purchase price of the shares as an allowable expense. In addition, the dividends were not included in the taxpayer's taxable income due to the application of section 10(1)(k). The Commissioner, however, was of the view that the full purchase price of the shares was not deductible.

Finding in favour of the Commissioner the court concluded that the taxpayer had acquired the shares of the dividend-stripped companies for two purposes. The first purpose was to earn exempt dividend income and the second purpose was to earn taxable income by re-selling the shares. As one of the purposes was to earn exempt income, the court ordered for the cost of the shares to be apportioned.

In deciding on how to apportion the purchase price of the shares the court acknowledged that the Act made no provision for apportionment. In addition, the court made it clear that the apportionment should be fair and reasonable. Relying on *CIR v Rand Selections Corporation Ltd,* Corbett JA ordered that the following formula be applied to calculate the deductible portion of the cost of the shares: $A = (B + C) \times (D / (D + E))$

Where $A$ = deductible expenditure

$B$ = general expenditure relating to share-dealing

$C$ = total cost of acquisition of shares in companies subjected to dividend stripping in tax year

$D$ = total proceeds of the sale of such shares

$E$ = total dividends received in respect of such shares

In prescribing the above formula, Corbett JA was of the view (at 267) that it produced "a result which seems equitable, both from the point of view of the taxpayer and from the point of view of the *fiscus*."

### 4.2.5 *TUCK v CIR*

*Tuck v CIR*, 1988 (3) SA 819 (A), 50 SATC 98, involved a taxpayer who was a registered pharmacist employed by Wyeth Laboratories (Pty) Ltd, a wholly owned subsidiary of American Home Products Corporation. In 1967 American Home Products Corporation established a management incentive plan whereby key employees who had contributed to the success of the company were rewarded with cash, contingent cash and contingent stock. It was common cause that the taxpayer in question had contributed to the success of Wyeth Laboratories (Pty) Ltd and as such had been awarded shares in terms of the incentive plan. Having retired in September 1979, the taxpayer received an initial instalment of shares in 1981 worth R14,251. During 1982 the taxpayer received a further instalment of shares worth R20,997. The issue before the court was whether the receipt of the shares was capital or revenue in nature. Although this thesis does not analyse the apportionment of capital and revenue receipts, this case established an apportionment method which has since been relied upon by our courts when faced with dual-purpose expenditure.

Having analysed the details of the management incentive plan the court came to the conclusion that the taxpayer had received the shares in American Home Products Corporation for two reasons. The first reason was to reward the taxpayer for his excellent service during the years of his employment. The second reason was to compensate the taxpayer for complying with the restraint which was contained in the management incentive plan. In addition, the court held that the receipt which related to the service element was revenue in nature, whereas the receipt which related to the restraint element was capital in nature. Having acknowledged that the receipt of shares contained a capital element and an income element Corbett JA stated (114-115) that:

> … apportionment provides a sensible and practical solution to the problem which arises when a taxpayer receives a single receipt and the *quid pro quo* contains two or more separate elements, one or more of which would characterize it as capital.

In looking at the basis of apportionment, the learned judge acknowledged that an arithmetical calculation, as used in *CIR v Rand Selections Corporation Ltd* and *CIR v Nemojim (Pty) Ltd,* was not suitable. He also submitted that the element of service and the element of restraint were equally important factors which resulted in the taxpayer receiving the shares. The court therefore held that a 50/50 apportionment, as originally submitted by the appellant on his return, would be fair and reasonable to both the taxpayer and the *fiscus*.

### 4.2.6 THE *MTN* CASES

As already discussed in chapter three, the *MTN* cases dealt with a subsidiary of the MTN Group Ltd that earned both dividend and interest income. In earning this income the taxpayer incurred audit fees. The issue before the courts was whether, and how, these audit fees should be apportioned between the exempt dividend income and the taxable interest income. This issue was heard by the South Gauteng Tax Court, the South Gauteng High Court and finally the Supreme Court of Appeal.

The analysis undertaken in chapter three clearly sets out that the courts in all three cases came to the same conclusion that the audit fees had been incurred for a dual purpose. This chapter will analyse the methods and principles adopted by the three courts in apportioning the audit fees between the two purposes.

#### 4.2.6.1 SOUTH GAUTENG TAX COURT

Gildenhuys J first stated that even though the Act made no provision for apportionment, it was a practical solution which the courts had adopted. In addition, the learned judge made it clear that any apportionment exercise should achieve a result which is fair and reasonable to all parties concerned.

The court then went on to discuss the cases of *CIR v Rand Selections Corporation Ltd, CIR v Nemojim (Pty) Ltd, KBI v Van Blommestein,* 61 SATC 145, and *ITC 1589,* 57 SATC 153, where the courts had applied various arithmetic formulae to achieve a fair result. In considering an arithmetic approach to apportionment Gildenhuys J analysed the formulae which had been suggested by both the appellant and the respondent. The appellant provided evidence that the auditors had only spent 6% of their time in respect of the dividend income and that approximately 6% of the cash book entries related to dividends. The appellant therefore submitted that only 6% of the audit fees should be disallowed as a deduction. The court, however, was of the view that apportioning the audit fees on the basis of the time spent by the auditors would not result in a fair apportionment. This was due to the fact that the duties of the auditor extended beyond only verifying dividend and interest income. The respondent contended that as the dividend income constituted on average 95% of the appellant's total income, 95% of the audit fees should be disallowed. Again the court stated that this formula would not achieve a fair result as it did not take into account the extra time spent by the auditors in auditing the interest income.

Since neither the appellant's nor the respondent's formula achieved a fair result, the court looked to the principle which had been established in *Tuck v CIR*. In *Tuck v CIR* Corbett JA stated (at 115) that "it is not possible to infer that the one element is more important than the other and in all circumstances I consider that a 50/50 apportionment would be fair and reasonable." Adopting the same principle in the *MTN* case, Gildenhuys J concluded that a 50/50 apportionment would achieve a just and equitable result, as it not only recognised the extra time spent by the auditors on the interest income, but also the larger amounts of money involved in the appellant's dividend producing operations.

### 4.2.6.2 SOUTH GAUTENG HIGH COURT

The taxpayer was not satisfied with the decision reach in the South Gauteng Tax Court and as such appealed to the South Gauteng High Court. The crux of the taxpayer's appeal was that only 6% of the auditor's time was spent on the dividend section and therefore only 6% of the audit fee should be disallowed.

It was common cause that the taxpayer had incurred the audit fees for the purpose of earning both dividend and interest income. It was also undisputed that approximately 6% of the entries in the cash book and ledger related to dividends, and that only 5% or 6% of the auditor's time was spent on dividends.

In deciding this case, Victor J relied upon the principles established in *ITC 1589*. In *ITC 1589* the court held that the time spent on accountancy work which related to dividend income should be disallowed, whilst the spent time on accountancy work which related to taxable income was deductible. In arriving at a fairly rapid conclusion Victor J submitted (at 321) that "the amount of work done must remain the yardstick or benchmark and not the value of the dividend payments." The learned judge (in the South Gauteng High Court case) therefore held that the principle adopted in *ITC 1589* was the only fair basis for apportionment and ordered the Commissioner to allow a deduction of 94% of the audit fees.

### 4.2.6.3 SUPREME COURT OF APPEAL

The decision handed down in the South Gauteng High Court consequently lead to the SARS appealing to the Supreme Court of Appeal. In analysing the facts of the case, the Supreme Court of Appeal first confirmed that the audit fees had been incurred for a dual purpose. The second question that the Supreme Court of Appeal needed to address was how to apportion

the audit fees.

In addressing this question the court acknowledged that the Act made no provision for apportionment but that the courts had approved various formulae over time to achieve a fair result. Ponnan JA, however, then went on to explain that it was not always appropriate to use an arithmetic formula to apportion an expense between its deductible and non-deductible components. In this regard the learned judge referred to *Tuck v CIR* where the court had held that a 50/50 apportionment was fair to both the Commissioner and the taxpayer. As a final point Ponnan JA made it clear that apportionment was a question of fact and that it was not possible to lay down any general rules to direct how apportionment should be made.

Having analysed the evidence, Ponnan JA highlighted the following facts:

- An audit is directed at signing off an opinion.
- An auditor undertakes a wide range of tasks which do not relate to specific income items.
- The greater part of the loans made by the taxpayer were interest-free.
- The interest-earning operations of the taxpayer were relatively small in comparison to the dividend earning and interest-free operations.
- The value of the taxpayer's business was mainly attributable to the value of its subsidiaries.
- The time spent by the auditors on the interest and dividend sections of the audit were relatively small when compared to the overall audit time.
- The major part of the audit involved the consolidation of the subsidiaries' results into the taxpayer's results.
- The major part of the taxpayer's revenue came from dividend income.

In light of the above facts, Ponnan JA first held that an arithmetic basis, as used by the South Gauteng High Court, was not appropriate. In addition, the learned judge was of the view that the 50/50 apportionment, as ordered by the South Gauteng Tax Court, was overly generous. In concluding, the court held that having considered all the circumstances, a 10% deduction of the audit fees would be fair and reasonable to all parties concerned.

#### 4.2.6.4 CRITICAL ANALYSIS OF THE *MTN* CASES

De Koker and Williams (2015:7.11A) state that "in all cases dealing with apportionment, the objective is to reach a solution which is fair and reasonable in the circumstances of the particular case." This is reaffirmed by Moosa (2012:8) who states that "the *MTN Holdings* case did not create a universal test of invariable application. The formula to be applied must, in the circumstances of each case, satisfy the criteria of fairness and reasonableness."

The Oxford University Press (2015) defines the words fair and reasonable as follows:

- Fair: "Treating people equally without favouritism or discrimination" or "just or appropriate in the circumstances."
- Reasonable: "Having sound judgment; fair and sensible" or "based on good sense."

In cases dealing with apportionment the courts therefore need to arrive at a method which does not discriminate against the taxpayer or the Commissioner, is based on sound judgment and good sense, and is fair and sensible. The challenge which the courts face is practically implementing an apportionment method which satisfies the above requirements.

In attempting to achieve an apportionment which is fair and reasonable, the courts have either prescribed an arithmetic formula or an alternative approach (emphasis added). In *CIR v Rand Selections Corporation Ltd* and *CIR v Nemojim (Pty) Ltd* the courts adopted an arithmetic approach to apportionment, however, Davis, Emslie T.S., van Dorsten, Dachs and Emslie C.A. (2010:102 ) caution that "blind adherence to a formula … is not a reliable test, however convenient it might be to those who administer the provisions of fiscal legislation."

In the recent *MTN* cases, the South Gauteng Tax Court and the Supreme Court of Appeal suggested an alternative approach, whereas the South Gauteng High Court adopted an arithmetic formula. The outcomes of these cases are surprising, in that the Supreme Court of Appeal allowed a deduction of 10% of the audit fees whereas the South Gauteng High Court allowed a deduction of 94%. The obvious question that emerges from both these cases is how can two courts deem two very different answers to be both fair and reasonable. The fact that the South Gauteng High Court deemed 94% to be fair and reasonable whilst the Supreme Court of Appeal deemed 10% to be fair and reasonable clearly illustrates the difficulties faced by the courts when attempting to apportion dual-purpose expenditure. This is reiterated by Davis *et al* (2014:93) who comment on the *MTN* cases as follows:

> On the facts of this case which was decided by three courts, each court arrived at a different apportionment. How then are the Commissioner and corporate taxpayers (who these days are haunted by the spectre of understatement penalties) to arrive at an apportionment that is fair and reasonable on the facts of each case? We wonder.

It is submitted that the overriding principle of fairness and reasonability is appropriate for the purposes of apportioning dual-purpose expenditure. Indeed, this principle has not only been upheld by South African courts, but also courts in other countries such as Australia. The complexity, however, in applying this principle, is due to the fact that the Act and the SARS provide no guidance on how to achieve an apportionment which is fair and reasonable. In addition, the recent *MTN* cases have provided little assistance as explained by Cliffe Dekker Hofmeyr (2014:10) below:

> Further, the judgment is not clear as to whether a time-based or effort-based apportionment method may never be applied, or whether such a method was only inappropriate in this specific case.
>
> Accordingly, and with respect, it is submitted that the judgment does not constitute a very useful precedent for purposes of tax law.
>
> Because the SCA did not take a very rigid or objective approach in determining an apportionment percentage, it is expected that similar cases where apportionment is at issue will come before the SCA in future.

Having also analysed the recent *MTN* cases, Surtees (2014:5) states: "where does this leave taxpayers in relation to audit fees and similar expenses?" Apportionment, however, is not a problem which is unique to South Africa. Augustinos (2013:1) explains below the difficulties encountered in Australia:

> … that apportionment, as applied by the courts and the AAT, is a very loose and subjective process which offers little, if any, practical guidance to taxpayers on how to apportion dual-purpose expenses.

It is therefore submitted that greater clarity and guidance needs to be provided in order to assist taxpayers, the SARS and the courts with the apportionment of dual-purpose expenditure.

## 4.3 RECOMMENDATIONS

The purpose of this part of the chapter is to highlight three recommendations which may assist taxpayers, the SARS and the courts when faced with potential dual-purpose expenditure. The recommendations are not discussed in detail as a comprehensive study of them would be beyond the scope of this thesis.

### 4.3.1 RELEVANCE

Parsons (2001) submits that the deductibility of an expense is a two-stage process, involving the questions of relevance and apportionment. The question of relevance determines whether an expense should be characterised as dual-purpose or not. Parsons (2001) also submits that taxpayers, the courts and the tax authorities are often too quick to apportion expenses without first addressing the question of relevance. Commenting on the question of relevance, Augustinos (2013:4) states the following: "when faced with dual-purpose expenses the tribunal did not first assess the relevance of the expense as a whole but simply made a determination on apportionment."

Applying the question of relevance to the recent *MTN* cases it is submitted that the courts may have too readily accepted that the audit fees had been incurred for a dual purpose. This is supported by Davis *et al* (2014:93) who comment on the Supreme Court of Appeal case as follows: "but were the audit fees in this case laid out for a dual or mixed purpose, which the SCA seems to have regarded as axiomatic?"

It is therefore submitted that the courts, the SARS and taxpayers should adopt a two-stage process when dealing with potential dual-purpose expenses. The first stage would involve the question of relevance for the purpose of determining the true character of the expense. If the results from stage one indicate that the expense is indeed dual-purpose, then stage two apportionment should be performed. If the courts had adopted this approach with the recent *MTN* cases, and had devoted sufficient time and resources to the question of relevance, the results from stage one may have indicated that the audit fees were deductible in full and the difficulties encountered in apportioning the audit fees would have been entirely avoided. This view is supported by Davis *et al* (2014:94) who state: "perhaps the conclusion should have been that the audit fees were fully deductible."

### 4.3.2 GROUP TAXATION

Large corporations often consist of many individual companies which are collectively referred to as a group. Although a group consists of many separate companies, it is usually managed as a single economic unit. Whilst the group may be managed as a single unit from an economic and organisational basis, the Act currently makes no provision for a system of group taxation (Wilcocks & Middelmann: 2004). According to Connell (2004:118) "the law obliges the SARS to tax each group company as a separate juristic person, even where the group functions as a unitary commercial entity." This mismatch between the economic form of a group and the legal substance of the individual companies can lead to various tax anomalies (Connell: 2004).

One such anomaly is the deductibility of expenses incurred by a holding company to enable a subsidiary to earn taxable profits (Meyerowitz: 2008). In examining these anomalies, Mitchell (1995) gives the example of a group employing its executives at the holding company level. If the holding company only earned exempt dividend income from its subsidiary companies, the remuneration which it paid to its executives would not qualify for deduction in terms of section 23(f) of the Act.

A group tax system which ignores all intra-group transactions would assist in eliminating the tax anomalies that arise in a group context. This is best illustrated by an example of a holding company which earns dividend income from its subsidiary as well as other taxable income. In addition to the income that it earns, the holding company pays an administration fee to its subsidiary. Under the current tax system the holding company would be required to directly attribute and possibly apportion the administration fee between the exempt and taxable income. As discussed earlier in this chapter, this process is usually complex and uncertain. A system of group taxation, however, would remove any question of attribution or apportionment as the administration fee would be ignored at a group level.

It is therefore submitted that the implementation of a group tax system in South Africa would remove the question of apportionment within the context of intra-group transactions. This view is supported by Connell (2004:162) who states that: "group taxation and the extension of the trans national transfer pricing regime to sub national transactions should simplify compliance and clarify the rules in this fraught area." In

addition, a group tax system would promote consistent results and the canons of taxation, which include equity, neutrality and certainty (Wilcocks & Middelmann: 2004).

#### 4.3.3 SARS GUIDANCE

##### 4.3.3.1 INTERPRETATION NOTES

The SARS may issue Interpretation Notes from time to time setting out how it will interpret certain provisions of the Act. The purpose of these Interpretation Notes is to provide clarity and guidance where complexity exists (Haupt: 2015).

It is therefore submitted that the SARS could issue an Interpretation Note which sets out how the SARS will interpret the provisions of sections 11(a), 23(f) and 23(g) of the Act in the context of dual-purpose expenditure.

It should however be noted that Interpretation Notes do not have the force of law and merely set out the SARS' interpretation of the legislation. In addition, Interpretation Notes may be challenged by taxpayers, and are not binding on the SARS or a court of law.

##### 4.3.3.2 BINDING GENERAL RULING

Due to the fact that Interpretation Notes are not binding on the SARS, the Tax Administration Act No. 28 of 2011 ("the TAA") provides for a system of advanced tax rulings which provide certainty to taxpayers (Haupt: 2015). The TAA provides for three types of rulings:

- Binding private rulings.
- Binding class rulings.
- Binding general rulings.

Binding private rulings and binding class rulings are initiated by taxpayers, whereas binding general rulings can be initiated by the SARS on topics of general interest (Haupt: 2015). An example of a binding general ruling issued by the SARS is Binding General Ruling (VAT): No. 16 (Issue 2) (South African Revenue Service: 2015). This ruling sets out the formula taxpayers must use when calculating the input VAT they

can claim where they have made both taxable and non-taxable supplies. The ruling also includes a *de minimis* rule which states that if the taxable supplies are not less than 95% of the total supplies the taxpayer does not need to apportion the input VAT and can claim the full deduction. Finally, the ruling states that where the formula does not produce a fair and reasonable result the taxpayer must apply to the SARS for an alternative method.

It is submitted that a similar ruling for the apportionment of dual-purpose expenditure could provide certainty and clarity for taxpayers. Similar to Binding General Ruling (VAT): No. 16 (Issue 2) (South African Revenue Service: 2015), this ruling could provide for a formula to be used, as well as a *de minimis* threshold which could be based on the quantum of exempt income, non-trade income or the dual-purpose expense in question. The ruling could also contain a clause which states that if the formula does not produce a fair and reasonable result the taxpayer would need to apply to the SARS for an alternative method.

## 4.4 CONCLUSION

Where a single, indivisible expense has been incurred for more than one purpose, the question that follows is: how does one apportion the expense between the various purposes?

This chapter first examined certain cases and the attendant apportionment methods prescribed in each case. Having analysed these cases it is submitted that the overriding principle of apportionment is that it must produce a result which is fair and reasonable to both the taxpayer and the SARS. To achieve a fair and reasonable result, the courts have consistently held that a universal test cannot be prescribed and that the specific facts of each individual case need to be examined. In apportioning dual-purpose expenditure the courts have either adopted an arithmetic approach or an alternative approach. In *CIR v Rand Selections Corporation Ltd, ITC 832, Local Investment Co v COT* and *CIR v Nemojim (Pty) Ltd* the courts adopted an arithmetic approach, whereas in *Tuck v CIR* the court adopted an alternative approach.

In the recent *MTN* cases the courts upheld the principle of reasonability and fairness. The difficulty which the courts faced was practically apportioning the audit fees in a manner which adhered to this principle. In apportioning the audit fees the South

Gauteng Tax Court and the Supreme Court of Appeal used an alternative approach whilst the South Gauteng High Court used an arithmetic formula. Each of the courts arrived at a different answer ranging from a deduction of 10% of the audit fees to a deduction of 94% of the audit fees. On the basis of the results in the recent *MTN* cases it is evident that more certainty is required.

Addressing the question of relevance is one possible solution. This would entail the courts spending more time on characterising an expense to determine if it is genuinely dual-purpose or not. Davis *et al* (2014) submit that if the courts, in the recent *MTN* cases, had spent more time on the question of relevance they may have indeed found that the audit fees had not been incurred for a dual purpose and the question of apportionment would have been irrelevant.

Implementing a system of group taxation could assist where the question of apportionment arises as a result of intra-group transactions. A system of group taxation would involve the elimination of intra-group transactions which are often the cause of many apportionment queries. In addition, group taxation would reduce tax leakage within a group and promote certainty and equity when dealing with dual-purpose expenditure.

Finally, SARS guidance in the form of an Interpretation Note or a General Binding Ruling could provide practical guidance to taxpayers who are faced with the apportionment of dual-purpose expenditure.

# CHAPTER 5: CONCLUSION

## 5.1 INTRODUCTION

The primary goal of this research was to critically analyse the deductibility of dual-purpose expenditure. In doing so, this thesis set out to answer three questions:

- Does the Act and case law in South Africa sanction the apportionment of dual-purpose expenditure?
- When is the apportionment of expenditure appropriate?
- On what basis should a taxpayer apportion expenditure that has been incurred for a dual purpose?

The aim of the research, in answering the above questions, was to extract current principles and practices adopted by the courts and the SARS when dealing with dual-purpose expenditure; to highlight difficulties encountered when faced with the deductibility of dual-purpose expenditure; and to suggest some recommendations which may assist taxpayers, the courts and the SARS.

This chapter will summarise the conclusions reached in chapters two to four, as well as link these conclusions to the research goals. In linking the conclusions to the research goals, areas which were beyond the scope of this thesis are highlighted. In addition, any difficulties encountered in answering the research questions will be addressed. Finally, this chapter will discuss any topics and questions which will benefit from further research.

## 5.2 SUMMARY OF CONCLUSIONS

The object of chapter two was to determine whether the Act and case law in South Africa sanctions the apportionment of dual-purpose expenditure. In doing so, chapter two examined two categories of dual-purpose expenditure: expenditure that has been incurred for both trade and non-trade purposes and expenditure that has been incurred to produce both taxable and exempt income.

In examining expenditure that has been incurred for both trade and non-trade purposes chapter two first set out a brief analysis of the definition of trade. From this, it is submitted

that the meaning of trade should be given a wide interpretation and should include any profitable activity. Chapter two then analysed the previous and current versions of section 23(g), as well as appropriate case law, to determine whether the courts and the SARS permit the apportionment of expenditure that has been incurred for both trade and non-trade purposes. Having performed this analysis, it is submitted that the previous version of section 23(g) strictly prohibited the apportionment of expenditure which had been incurred for both trade and non-trade purposes. It is noted, however, that the practice of the SARS was to apportion dual-purpose expenditure even though the legislation at the time prohibited it. It is submitted that this inconsistency ultimately lead to the amendment of section 23(g). The current version of section 23(g) does not prohibit the deduction of expenditure that has not been wholly and exclusively laid out for the purposes of trade, however, the current wording does not explicitly state that apportionment is permissible. Having analysed academic writings, however, it is submitted that the current version of section 23(g) envisages, and provides authority, for the apportionment of dual-purpose expenditure.

Chapter two also analysed section 23(f) and appropriate case law to determine whether the courts and the SARS have sanctioned the apportionment of expenditure that has been incurred to produce both taxable and exempt income. From this analysis, it is submitted that in certain cases the courts and the SARS have sanctioned the apportionment of expenditure that has been incurred to produce both taxable and exempt income. In other cases, however, such as *CIR v Allied Building Society* and *CIR v Standard Bank of SA Limited,* it appears that the courts did not authorise the apportionment of dual-purpose expenditure, but rather looked to the dominant purpose of the expense in question. It is submitted, however, that in both these cases the courts concluded that the taxpayers in question had incurred the interest expenditure for the sole purpose of earning income. The fact that the taxpayers had used the borrowings for an incidental business activity did not alter the fact that the purpose of the borrowings had been to obtain floating capital from which they would earn income. It is therefore submitted that the dominant purpose test is not applicable to the deductibility of expenses which have been incurred to produce both taxable and exempt income, but rather apportionment is seen as the recognised approach.

The goal of chapter three was to determine when the apportionment of expenditure is appropriate. This chapter first analysed case law to extract the principles for determining whether an expense has been incurred for the purposes of trade. From this analysis it is submitted that the key principle emanating from these cases is that a taxpayer's purpose

must always be looked at. Where a taxpayer incurs a single, indivisible expense for both a trade and a non-trade purpose, the need for apportionment arises. In determining a taxpayer's purpose the courts have held that the object or motive of the taxpayer must be examined, and in determining a taxpayer's object one needs to look into the taxpayer's mind at the moment the expense is incurred. In addition, a private result or the presence of a dominant purpose, are irrelevant when determining whether an expense has been incurred for the purposes of trade. Where a company within a group performs a service for another company within the same group, there is a risk that the courts and the SARS may deem the company performing the service to be carrying out a dual-function. This was the majority decision in *Solaglass Finance Company (Pty) Ltd v CIR,* where the court held that the taxpayer existed for a dual-purpose. It is respectfully submitted, however, that the decision reached in *Solaglass Finance Company (Pty) Ltd v CIR* was incorrect and that the decision reached in *FCT v BHP Billiton Finance Ltd* was more appropriate. In *FCT v BHP Billiton Finance Ltd* the court made it clear that where a subsidiary company carries on a trade it should be viewed in its own right and not regarded as a mere conduit or appendage of the parent company.

Chapter three also examined the need for apportionment in the context of expenditure incurred to produce both taxable and exempt income. In examining this need, chapter three analysed *Port Elizabeth Electric Tramway Company Ltd v CIR*, *CIR v Nemojim (Pty) Ltd* and the recent *MTN* cases. It is submitted that the principles emanating from these cases for determining whether an expense has been incurred in the production of income are as follows:

- The purpose of the act entailing the expenditure must be looked to.
- The closeness of the connection between the expenditure and the income-earning operations must be assessed.
- The purpose of the expenditure and what it actually effects must be determined.
- Expenditure necessarily attached to the income-earning operations of the taxpayer should be deductible.
- An expense does not need to produce income or be directly linked to income to qualify for deduction.
- An expense necessarily incurred to comply with a statutory obligation may be deductible.

It is submitted that although the above principles provide guidance when determining whether an expense has been incurred for a dual purpose, there is ultimately no single universal test. The courts have consistently held that the specific facts of each case should be examined. Although the above legal principles are clear, applying them to the specific facts of each case can be complex. It is submitted that this area may benefit from further research.

The object of chapter four was to determine how to apportion dual-purpose expenditure. In setting out to achieve this object various cases were analysed. From this, it is submitted that the overriding principle of apportionment is that it should produce a result which is fair and reasonable to all parties concerned. In attempting to achieve a fair and reasonable result, the courts have either adopted an arithmetic approach or an alternative approach to apportionment. In adopting either approach, the courts have consistently held that it is not possible to devise a single universal test, but rather the specific facts of each case need to be examined. It is submitted that this approach creates uncertainty for taxpayers, the courts and the SARS.

This uncertainty was evident in the recent *MTN* cases which were also analysed in chapter four. These cases involved the apportionment of audit fees which had been incurred to produce both interest and dividend income. In apportioning the audit fees the South Gauteng Tax Court and the Supreme Court of Appeal used an alternative approach whilst the South Gauteng High Court used an arithmetic formula. Each of the courts arrived at a different answer, ranging from a deduction of 10% of the audit fees to a deduction of 94% of the audit fees. It is submitted that the results of the recent *MTN* cases indicates the need for further guidance in this complex area. Although a full analysis of the possible solutions was beyond the scope of this thesis, chapter four did make some recommendations.

The first recommendation was that our courts should spend more time on the question of relevance. It is respectfully submitted that in *Solaglass Finance Company (Pty) Ltd v CIR* and the recent *MTN* cases, our courts may have been too quick to conclude that the expense in question had been incurred for a dual purpose. If more time is spent on characterising an expense, the need for apportionment in certain situations may become irrelevant.

The second recommendation would be for National Treasury to implement a system of group taxation. A system of group taxation would involve the elimination of intra-group transactions which are often the cause of many apportionment queries. In addition, group

taxation would promote certainty and equity between companies transacting within a group context.

The final recommendation is for the SARS to issue guidance in the form of an Interpretation Note or a General Binding Ruling to assist taxpayers who are faced with the apportionment of dual-purpose expenditure.

The recent *MTN* cases have highlighted the uncertainty and difficulties that taxpayers, the courts and the SARS encounter when faced with dual-purpose expenditure. Although this research does offer some recommendations, a full analysis of the possible solutions and the attendant apportionment methodologies is beyond the scope of this thesis. It is submitted that further research would be invaluable in this fraught area of tax law.

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