

**THE DEDUCTIBILITY OF DAMAGES AND ASSOCIATED LEGAL
EXPENSES FOR THE PURPOSES OF DETERMINING
TAXABLE INCOME IN SOUTH AFRICA**

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by

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DECLARATION

I, Ezekiel Madovi, declare that the work presented in this thesis is original. It has never been presented to any other University or Institution. Where other people's works have been used, references have been provided. It is in this regard that I declare this work as originally mine. It is hereby presented in partial fulfilment of the requirements for the award of the Master of Commerce (Taxation).

Signed.....

Date.....

ABSTRACT

The deduction of damages and the associated legal costs must satisfy the requirements of the preamble to section 11 and section 11(a) of the Income Tax Act 58 of 1962, read with section 23(g) (referred to as the general deduction formula). This research examined under what circumstances a payer of damages and the associated legal costs would be able to claim a deduction from taxable income. This research also considered whether or not the issue of fault is a relevant consideration in determining whether a deduction should be allowed. In some cases the courts appear to have disallowed a deduction if the expenditure or loss was incurred as a result of a negligent or unlawful act. In other instances the courts have allowed the deduction of damages despite the expenditure or loss having been incurred as a result of a negligent or unlawful act.

The research concludes that negligence is not a relevant consideration in the deduction of damages and the associated legal costs. In order to secure a claim for damages the taxpayer must prove that the expenditure was incurred in the production of income and it was expended for the purposes of trade. Associated legal costs are only deductible if the damages satisfy the requirements of section 11(c).

Key words: damages, the production of income, legal costs, negligence, taxation.

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CHAPTER 1: INTRODUCTION

1.1 Context of the research

This thesis seeks to analyse under what circumstances a taxpayer can deduct damages and the associated legal costs in arriving at his or her taxable income. Taxable income is defined in section 1 of the Income Tax Act, 58 of 1962 (referred to as the “Act”), as:¹

...the aggregate of:

- (a) the amount remaining after deducting from the income of any person all the amounts allowed ... to be deducted from or set off against such income ...

“Income”, in its turn, comprises amounts included in “gross income” as defined in section 1 of the Act, after deducting the exemptions provided for in the Act. “Gross income” is defined as follows:

... in the case of any resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such resident and in the case of any person other than a resident, the total amount in cash or otherwise received by or accrued to or in favour of such person from a source within the Republic, during such year or period of assessment, excluding receipts or accruals of a capital nature ...

Most of the allowable deductions can be claimed in terms of section 11 of the Act. The preamble to section 11 and section 11(a), which provides for what may be deducted, and section 23(g), which provides for what may not be deducted, constitute what is referred to as the “general deduction formula”. The preamble to section 11 and 11(a) provide that:²

for the purposes 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 persons so derived

- (a) expenditure and losses actually incurred in the production of the income, provided such expenditure and losses are not of a capital nature.

¹ Income Tax Act, 58 of 1962.

² *Ibid.*

On the other hand section 23(g) prohibits the deduction of "any moneys claimed as a deduction from income derived from trade, to the extent to which such monies were not laid out or expended for the purposes of trade."³

A person's taxable income is based on the definitions of "gross income", "income" and allowable deductions, including the "general deduction formula". Many of the phrases and words used in the definition of "gross income" and the "general deduction formula" are not defined in the Act. In terms of section 11(a), in order to rank as a deduction, expenditure or losses (including damages and legal costs) must have been incurred "in the production of the income". In the case of *Port Elizabeth Electric Tramway Co Ltd v CIR*,⁴ (referred to as the *Port Elizabeth Tramway* case) the court interpreted the phrase to mean that the expenditure must have been incurred by the taxpayer for the purposes of producing income, and it must have been closely linked to the income producing trade.

There is a degree of uncertainty in this area of law with regard to the deduction of damages. In certain cases the deduction of damages was allowed and in other cases not. In some instances the courts have considered the issue of fault in determining whether or not an expenditure or loss should be deducted. Some judgments appear to suggest that if an expenditure or loss is incurred as a result of a negligent or unlawful act it is not deductible. However, in other judgments the courts have granted the deduction despite the fact that the expense was incurred as a result of a negligent or unlawful act.

The *Port Elizabeth Electric Tramway* case did not fully clarify the position of the law with regard to the deductibility of damages and associated legal costs.⁵ The facts of the case were that the taxpayer conducted a transport business. One of the drivers was injured in an accident and later died and the dependants of the driver sued for damages and compensation. The taxpayer paid compensation and legal costs. The issue which came before the court was whether the compensation and legal costs paid by the taxpayer were deductible in terms of the Act. The court held that the employment of drivers carries with it a potential liability to pay compensation if such drivers are injured in the course of their employment. The court allowed a deduction for the compensation paid to the dependants of the taxpayer.

³ *Ibid.*

⁴ 1936 CPD 241, 8 SATC 13.

⁵ *Ibid.*

In the *Port Elizabeth Tramway* case, Watermeyer JA stated that the issue of negligence or unlawfulness of the business operation did not arise in that particular case. However, in its *obiter* remark the court stated that “if the act done is unlawful or negligent and the attendant expense is occasioned by the unlawfulness or, possibly, the negligence of the act, then probably it would not be deductible.”⁶ Regrettably the *Port Elizabeth Tramway* case did not clarify the position of the law with regard to expenditure incurred as a result of a negligent act.

In the case of *Joffe v CIR*⁷ (referred to as the *Joffe* case), the court held that the payment of damages was not deductible. In brief, the facts of the case were as follows: the taxpayer, an engineering firm, paid damages to the dependants of a workman who had been killed by the collapse of the cantilever hood erected by the taxpayer. The accident was caused by the company’s negligence in failing to take proper precautions to prevent the structure from collapsing. The issue which came before the court was whether the damages paid by the taxpayer to the workman’s dependants were deductible under section 11(a) of the Act. The court held that the negligence which caused the damages was not an inevitable concomitant of the taxpayer’s business. Therefore the expenditure was not deductible.

In the *Joffe* case, Watermeyer JA seems to point out that the damages were not deductible because negligence was not an inevitable result of the taxpayer’s business operations. It can be seen from the two judgments, *Port Elizabeth Tramway* and *Joffe*, that if an expense was incurred as a result of negligence it may not be deductible. In *Port Elizabeth Tramway* case it was stated *obiter* that if the act which caused the expenditure was unlawful or negligent the damages might not have been deductible. On the other hand in the *Joffe* case Watermeyer JA stated that there was no evidence that the negligence which caused the damages was an inevitable concomitant of the taxpayer’s trading operations.

The question of onus of proof also arises when a taxpayer claims a deduction from income for the payment of damages and associated legal costs. Section 102(1)(d) of the Tax Administration Act, 28 of 2011, imposes the burden of proof on the taxpayer to prove that an amount qualifies as a deduction.⁸ In a claim for a deduction, the taxpayer must prove that the risk of having to pay damages is a necessary concomitant of the taxpayer’s trading operations. In the *Joffe* case the claim was disallowed because the taxpayer failed to prove

⁶ 1936 CPD 241 at 246.

⁷ 1946 AD 157.

⁸ Tax Administration Act, 28 of 2011.

that accidents of that nature which led to the payment of damages were an inherent risk of the taxpayer's business.

The payment of damages is usually accompanied by the payment of legal costs. In the *Port Elizabeth Electric Tramway* case, the deduction of the legal expenses was not granted. Section 11(c) of the Act, which was inserted into the Act after this decision, provides for the deduction of legal expenses if the expenditure was incurred "in respect of any claim, dispute or action at law arising in the course of or by reason of the ordinary operations undertaken in the carrying on of trade".⁹ Section 11(c)(ii) provides that legal expenses are not deductible where they were incurred in respect of a claim for damages which, when paid, would not qualify as a deduction in terms of section 11(a).¹⁰ The deductibility of damages and the associated legal costs are therefore clearly related.

In *ITC 1837*,¹¹ the court held that legal costs are deductible in terms of section 11(c) of the Act, even where they are incurred as a result of negligence or unlawfulness on the part of the taxpayer. In this case, the defamation action was found to be closely linked to the taxpayer's trading operations. A causal connection between the legal expenditure and the taxpayer's trading operations was established and therefore the expenditure was deductible from the taxpayer's income. The court considered whether the risk of incurring liability was inseparable from the taxpayer's business and found that the possibility of incurring liability for defamation was inseparable from the discharge of the taxpayer's functions as the Premier of a Province. The court's decision was based on the case of *Commissioner for the South African Revenue Service v Thor Chemicals SA (Pty) Ltd*,¹² (referred to as the *Thor Chemicals* case). In the *Thor Chemicals* case the taxpayer incurred legal costs in a matter regarding the mercury poisoning of its employees. The taxpayer company manufactured mercury in its plant and certain employees suffered from mercury poisoning. The Department of Manpower conducted an investigation in terms of the Machinery and Occupational Safety Act, 6 of 1983. The taxpayer had legal representation at the hearing and it incurred legal costs. The issue which came before the court was whether the legal expenses incurred by the taxpayer were deductible in terms of section 11(c) of the Income Tax Act. The court held that the poisoning of the employees arose in the course of or by reason of the ordinary operations

⁹ Income Tax Act 58 of 1962.

¹⁰ *Ibid.*

¹¹ 71 SATC 177.

¹² 62 SATC 208.

undertaken by the taxpayer in carrying on its trade. The legal costs were held to be deductible in terms of section 11(c) in both *ITC 1837* and the *Thor Chemical* cases.

In the *Port Elizabeth Tramway* case the court allowed a deduction for the compensation paid to the dependants of the driver of a tram who was injured in an accident, but did not allow a deduction for the legal costs incurred in resisting the claim for compensation. It can be argued that if compensation was deductible, the legal costs should also have been allowed. However, Watermeyer JA held that the legal costs were not closely connected to the income earning operations. Mason J, in the case of *Lockie Bros Ltd v CIR*¹³ (referred to as the *Lockie Bros* case), stated that an expense would be deductible if it was incurred in the course of or by reason of the ordinary operations undertaken by the taxpayer in carrying on of his trade. According to Kruger and Scholtz if this test had been used in both the *Port Elizabeth Tramway* and the *Joffe* cases, the taxpayers would have been allowed a deduction of the legal costs from their income.¹⁴ The test which was laid down in the *Lockie Bros* case is now included in section 11(c) of the Act, which provides for the deductibility of legal expenses.

Although the test for deductibility in section 11(c) of the Act is less stringent than section 11(a) (“in the course of or by reason of the ordinary operations . . .” as opposed to “in the production of income”), the fact that the deductibility of the legal costs relating to a claim for damages is dependent on the deduction in terms of section 11(a) subjects the associated legal expenses to a more stringent test.

As a result of the decisions in the *Port Elizabeth Tramway*, *Joffe*, *ITC 183* and *Thor Chemicals* cases, there is clearly uncertainty relating to the deductibility of expenditure or a loss relating to a claim for damages and, more so, where the expenditure or loss was incurred as a result of a negligent or unlawful act. This uncertainty extends to the deductibility of the payment of the associated legal expenses.

1.2 Goals of the research

The goal of this thesis is to investigate under what circumstances a payer of damages and the associated legal costs can claim a deduction from income. In particular, the research seeks to evaluate whether or not negligence is a criterion for assessing the deductibility of these expenses. In achieving this goal, this thesis will seek to interpret the phrase “in the production

¹³ 1922 TPD 42, 32 SATC 150.

¹⁴ Kruger, D and Scholtz, W.(2003). *Broomberg on Tax Strategy 4 ed* at 223.

of income”. A comparison will be made of the subsections (a) and (c) of section 11 of the Act in this research. The research will also investigate the issue of onus; what the taxpayer needs to prove in order to be granted a deduction of damages and the associated legal costs.

1.3 Methods, procedures and techniques

This research seeks to provide an understanding of the treatment of damages and the associated legal costs. Consequently, an interpretative research approach will be adopted for the present research as it seeks to understand and describe.¹⁵ The research methodology to be applied can be described as *doctrinal* research methodology.¹⁶ This method provides a systematic exposition of the rules governing a particular legal category (in the present matter the legal rules relating to deductibility of damages and the associated legal expenses), analyses the relationships between the rules, explains areas of difficulty and is based purely on documentary data.¹⁷ The documentary data to be used for the research consists of tax legislation, case law, textbooks and journal articles.

The research is conducted in the form of an extended argument, supported by documentary evidence. The validity and reliability of the research and conclusions will be ensured by:

- adhering to the rules of the statutory interpretation, as established in terms of statute and common law;
- placing greater evidential weight on legislation, case law which creates precedent or which is of persuasive value (primary data) and the writings of acknowledged experts in the field;
- discussing opposing viewpoints and concluding, based on preponderance of credible evidence; and
- the rigour of the arguments.

As all the data are in the public domain, no ethical considerations arise in relation to their use. Interviews will not be conducted; opinions will be considered in their written form.

¹⁵ Babbie, E., & Mouton, J. (2009) *The practice of social research: South African edition*.

¹⁶ McKerchar, M. (2014) *Philosophical Paradigms, Inquiry Strategies and Knowledge Claims: Applying the Principles of Research Design and Conduct to Taxation. E-Journal of Tax Research* at 1.

¹⁷ McKerchar, M. (2014) *Philosophical Paradigms, Inquiry Strategies and Knowledge Claims: Applying the Principles of Research Design and Conduct to Taxation. E-Journal of Tax Research* at 1.

1.4 Preliminary chapter outline

The research is divided into five chapters. The first chapter introduces the research. It addresses the uncertainty regarding the deductibility of damages and the associated legal costs. The chapter sets out the goals of the research and the research methodology applied in undertaking the research. Chapter two discusses the phrase “in the production of income”. This chapter discusses the tests which have been developed by the courts in the interpretation of the phrase “in the production of income”. Chapter three compares the requirements of subsections (a) and (c) of section 11 of the Act. This chapter also considers how the deductibility of damages and the associated legal costs is related. Chapter four discusses the deductibility of damages and the associated legal costs. The chapter also considers whether negligence is a relevant consideration in assessing the deductibility of damages and related costs. Chapter five provides a summary of the thesis. The chapter concludes the research. The onus of proof is discussed and the chapter provides a summary of what a taxpayer needs to prove in order to secure a deduction for damages and the associated legal costs.

CHAPTER TWO

INTERPRETING THE PHRASE “IN THE PRODUCTION OF INCOME”

2.1 Introduction

In order to qualify as a deduction from income, expenditure and losses (including damages and legal costs) must have been incurred “in the production of income”.¹⁸ For the purposes of the present research it is assumed that the expenditure on damages and associated legal costs has actually been incurred during the year of assessment.¹⁹ Therefore, this chapter will focus on how the courts have interpreted the “phrase in the production of income”. The phrase “in the production of income” as provided for in section 11(a) of the Act has been a subject of debate amongst scholars and has not been uniformly interpreted by the courts. The chapter proceeds in four sections. The first section introduces the chapter. The following section will address the major decisions that have been handed down by our courts in the interpretation of the phrase “in the production of income”.

The following sections and subsections will provide a further analysis of how the courts have developed the tests to determine whether or not expenditure was incurred in the production of income.

2.2 Case law relating to “in the production of income”

The landmark decision in the interpretation of the phrase “in the production of income” is *Port Elizabeth Electric Tramway Co Ltd v CIR* (referred to as the *Port Elizabeth Tramway* case).²⁰ The facts of the case were that the taxpayer conducted a transport business.²¹ One of the drivers was injured in an accident and later died and the dependants of the driver sued for damages and compensation.²² The taxpayer company paid compensation and legal costs.²³ The taxpayer company sought to deduct the compensation that it paid to the deceased’s family and the legal costs.²⁴ The Commissioner refused to allow the deduction on the basis of the fact that the compensation was not incurred in the production of income. The issue which

¹⁸ Section 11(a) of the Income Tax Act 58 of 1962 provides that in order of expenditure and losses to be deductible they must have been actually incurred in the production of income, provided such expenditure and losses are not of a capital in nature.

¹⁹ Section 11(a) of the Income Tax Act 58 of 1962.

²⁰ 1936 CPD 241.

²¹ *Port Elizabeth Electric Tramway Co Ltd v CIR* 1936 CPD 241.

²² *Ibid.*

²³ *Ibid.*

²⁴ *Ibid.*

came before the court was whether the compensation and legal costs paid by the taxpayer were deductible in terms of the Act.²⁵ In its interpretation of the term “in the production of income”, the court stated that expenses do not produce income, but the work and labour or the use of capital to finance a business produce income.²⁶ The court further stated that “...income is produced by a series of operations and transactions entered into for the purpose of manufacturing or acquiring a saleable product and thereafter selling it or by rendering services for which payment is received.”²⁷ Expenditure or losses may be incurred during the course of these operations.²⁸

Watermeyer AJP developed a two-fold test that can be used in determining whether an expenditure or loss was incurred in the production of income. In the first enquiry, Watermeyer AJP stated that “[t]he 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.”²⁹ Secondly, the expenditure sought to be deducted must be closely linked to the business operations of the taxpayer.³⁰ Watermeyer AJP was of the opinion that if the expenses are attached to the business operations *bona fide* incurred for the purpose of earning income and if they are necessary to the taxpayer’s business operations they are deductible.³¹

The court found that the act which entailed the expenditure was the employment of the drivers.³² It stated that the employment of drivers is integral to the operation of a tramway company.³³ The court held that the employment of drivers carries with it a potential liability to pay compensation if such drivers are injured in the course of their employment.³⁴ Moreover, the court stated that the risk of incurring liability is inseparable from the employment of drivers and the carrying on of the business.³⁵ Hence, the compensation paid to the driver’s widow was closely linked to the taxpayer’s business operations.³⁶ The court allowed a deduction for the compensation paid to the dependants of the taxpayer.³⁷ In the

²⁵ *Ibid.*

²⁶ *Port Elizabeth Electric Tramway Co Ltd v CIR* 1936 CPD at 243.

²⁷ *Port Elizabeth Electric Tramway Co Ltd v CIR* 1936 CPD at 243.

²⁸ *Ibid.*

²⁹ *Port Elizabeth Electric Tramway Co Ltd v CIR* 1936 CPD 241.

³⁰ *Ibid.*

³¹ *Ibid.*

³² *Ibid.*

³³ *Ibid.*

³⁴ *Port Elizabeth Electric Tramway Co Ltd v CIR* 1936 CPD 241.

³⁵ *Ibid.*

³⁶ *Ibid.*

³⁷ *Ibid.*

Port Elizabeth Tramway case³⁸ the court held that the compensation paid was incurred in the production of income, whilst the legal costs incurred in resisting the claim were not. The deduction of legal costs has subsequently been remedied by the enactment of section 11(c) of the Income Tax Act.³⁹

The *Port Elizabeth Tramway* case laid the foundation for the interpretation of the phrase “in the production of income”. The learned judge, Watermeyer AJP, stated that the first thing is to identify the act which entailed the expenditure. Williams argues that if a person identified the act as the negligent driving of the tramway car, the expenditure would not have been deductible.⁴⁰ In his *obiter* remark Watermeyer AJP expressed the opinion that if the act which caused the expenditure was unlawful or negligent the expenditure would probably not have been deductible. After identification of the act, the first enquiry is to investigate the purpose of the act entailing expenditure. Williams argues that when Watermeyer AJP referred to “the purpose of the act entailing expenditure” he meant the purpose of the act and not the purpose of the expenditure.⁴¹ This argument is premised on the judgment of the learned judge Watermeyer AJP who stated that expenses do not produce income. Income is produced from a series of acts performed by the taxpayer. Hence, as stated in *Port Elizabeth Tramway* case, all the expenses attached to the taxpayer’s business operation must be deductible provided they are closely linked to the income earning operations. The second enquiry is an objective assessment of the connection between the expenditure incurred and the taxpayer’s business operations. As stated by Watermeyer AJP, there must be a close connection between the expenditure incurred and the taxpayer’s income earning operations. There must be a direct relationship between the expense and the business operations. In order for the expenditure to be deductible, it must have been incurred genuinely for the purposes of earning income.

The principles laid down in *Port Elizabeth Tramway case* have been cited with approval in several cases. The case of *CIR v Genn & Co (Pty) Ltd*⁴² (referred to as the *Genn* case) cited some of the principles laid down in the *Port Elizabeth Tramway* case. The taxpayer company incurred expenditure in the form of interest and commission as a result of the loan that it took

³⁸ *Ibid.*

³⁹ Section 11(c) of the Income Tax Act 58 of 1962, provides for the deduction of legal expenses, if the expenditure was incurred “in respect of any claim, dispute or action at law arising in the course of or by reason of the ordinary operations undertaken in the carrying on of trade”.

⁴⁰ Williams, R.C (2005) *Income Tax in South Africa Cases & Materials 2ed* at 365.

⁴¹ Williams, R.C (2005) *Income Tax in South Africa Cases & Materials 2 ed* 366.

⁴² 1955 (3) SA 293 (A), 20 SATC 113.

up to purchase trading stock.⁴³ The taxpayer sought to deduct the expenses from its taxable income.⁴⁴ The Commissioner allowed a deduction for interest paid by the taxpayer, but disallowed the deduction of the commission fee, on the basis of the fact it was of a capital nature.⁴⁵ The issue which came before the court was whether the interest and commission paid to the company which arranged the loans were deductible as expenditure incurred in the production of income.⁴⁶

The significance of the *Genn* case lies in its reference to the link that must exist between the expenditure and the production of income.⁴⁷ The learned judge started by explaining the broad test which was developed by Watermeyer AJP in *Port Elizabeth Tramway* case. Schreiner JA stated that the words “they may be regarded” used by Watermeyer AJP should mean “proper, natural or reasonable”.⁴⁸ The court stated that in determining the closeness of the link that must exist between the expenditure and the production of income, there must be an enquiry as to whether it would be proper, natural or reasonable to regard the expenses as part of the cost of performing the business operation.⁴⁹ Schreiner JA stated that the court must also look at the purpose of the expenditure and what it actually effects.⁵⁰ If the expenditure incurred is closely linked to the production of income and if it is expended for the purposes of trade, it must be deductible. Schreiner JA held that there was no distinction in principle between the interest paid by the taxpayer on borrowed money and the commission paid to the company which arranged the loans.⁵¹ The court allowed the deduction of interest and commission, stating that the expenditure was incurred in the production of income and it was closely connected to the taxpayer’s business operations.⁵²

The Appellate Division of Southern Rhodesia (Zimbabwe), in *COT v Rendle*,⁵³ stated that the broad test which was developed in *Port Elizabeth Tramway* case is now being used as a standard test by the courts. The test is as follows:⁵⁴

⁴³ *Ibid.*

⁴⁴ *Ibid.*

⁴⁵ *Ibid.*

⁴⁶ *Ibid.*

⁴⁷ *Ibid.*

⁴⁸ *CIR v Genn & Co (Pty) Ltd* 1955 (3) SA 293 (A), 20 SATC 113 at 120.

⁴⁹ *Ibid.*

⁵⁰ *CIR v Genn & Co (Pty) Ltd* 1955 (3) SA 293 (A), 20 SATC 121.

⁵¹ *CIR v Genn & Co (Pty) Ltd* 1955 (3) SA 293 (A), 20 SATC 121.

⁵² *Ibid.*

⁵³ 1965 (1) SA 59.

⁵⁴ *Port Elizabeth Electric Tramway Co Ltd v CIR* 1936 CPD 241 at 246.

All expenses attached to the performance of a business operation *bon fide* incurred for the more efficient performance of such operation provided they are so closely connected with it that it would be proper, natural or reasonable to regard the expenses as part of the cost performing the income earning operation.

The court identified three types of expenditure as follows:⁵⁵

- (1) Expenses which are necessary for the performance of the business operation;
- (2) Expenses which are attached to the performance of the business operation by chance; or
- (3) Expenses which are *bona fide* incurred for the more efficient performance of such business operations.

All of these types of expenditure are deductible provided that they are closely connected with the performance of the business operation ...

In the case of *COT v Rendle*,⁵⁶ the taxpayer was a chartered accountant who carried on a business with a fellow accountant. The firm received money from its clients and rendered services on their behalf.⁵⁷ The issuing of receipts and actual banking of the money was carried out by the clerks employed by the firm.⁵⁸ One of the firm's clerks misappropriated the firm's money and the money belonging to two companies.⁵⁹ The firm sought legal advice after the incident and it was advised to settle with the two companies.⁶⁰ The taxpayer sought to deduct legal fees and the money which had been embezzled by one of the clerks from its taxable income.⁶¹ The Commissioner of Taxes refused to allow the deductions and stated that they were not incurred in the production of income.⁶² The court dealt with the secondary category of expenditure – that is, the expenditure attached to the performance of the business operations by chance.⁶³ In determining whether the expenditure is deductible the court stated that:⁶⁴

⁵⁵ *COT v Rendle* 1965 (1) SA (SR, AD) 62B – D.

⁵⁶ *COT v Rendle* 1965 (1) SA 59.

⁵⁷ *Ibid.*

⁵⁸ *Ibid.*

⁵⁹ *Ibid.*

⁶⁰ *Ibid.*

⁶¹ *Ibid.*

⁶² *Ibid.*

⁶³ *Ibid.*

⁶⁴ *COT v Rendle* 1965 (1) SA (SR, AD) 62E.

...the enquiry must be whether the “chance” of such expenditure being incurred is sufficiently closely connected with the business operation. The enquiry is not whether the actual expenditure itself (should it ever eventuate) is sufficiently closely connected.

The court looked at the connection between the expenditure and the income earning operations.⁶⁵ The court held that the expenditure that was incurred by the taxpayer in respect of the legal fees and the money that it reimbursed to its clients was sufficiently closely linked to the firm’s business operations.⁶⁶ Therefore, the expenditure was held to have been incurred in the production of income. The relevant sections of the Income Tax Act of Zimbabwe, 16 of 1954, and the South African Income Tax Act are almost identical. Section 13(2)(a) of the Income Tax Act of Zimbabwe⁶⁷ and section 11(a) of South African Income Tax Act, share similar requirements and for the purposes of this research it is noted that the production of income requirement is found in both legislations.

In the case of *ITC 1428*⁶⁸ the court applied the test which was used in the *Port Elizabeth Tramway case* in determining whether or not expenditure was incurred in the production of income. The facts of the case were as follows: the taxpayer was an accountant and a company secretary for a firm of professional consulting civil engineers.⁶⁹ Later the taxpayer assumed the responsibilities of an administrative director who had retired.⁷⁰ Consequently, the taxpayer was required to assume the rights and obligations associated with directorship of the company.⁷¹ However, it was not possible to appoint the taxpayer formally as a director of the company because of the restrictions imposed by the South African Association of Consulting Engineers; only professional engineers can be appointed in a firm of professional consulting engineers.⁷² The taxpayer was regarded as a director, he received the same benefits and his salary was based on those paid to other directors.⁷³ The company imposed an obligation on its directors to buy shares and to sign a service agreement in which the obligation to buy shares

⁶⁵ *Ibid.*

⁶⁶ *Ibid.*

⁶⁷ Section 13(2)(a) of the Act reads:

(2) The deductions allowed shall be –

(a) expenditure and losses (not being expenditure and losses of a capital nature) wholly and exclusively incurred by the taxpayer for the purposes of his trade or in the production of the income.

⁶⁸ (1985) 50 SATC 34(C).

⁶⁹ *Ibid.*

⁷⁰ *Ibid.*

⁷¹ *Ibid.*

⁷² *Ibid.*

⁷³ *Ibid.*

is set out.⁷⁴ The taxpayer obtained an overdraft to enable him to buy these shares.⁷⁵ He incurred interest as a result of the overdraft and he sought to deduct it from his taxable income.⁷⁶ The Commissioner refused to allow the deduction, stating that it was not incurred in the production of income.⁷⁷

The issue which came before the court was whether or not the expenditure was incurred in the production of income.⁷⁸ Firstly, the court looked at the purpose of the expenditure and stated that clearly the money was borrowed for the production of income.⁷⁹ Secondly, the court looked at whether there was a sufficient and direct link between the expenditure incurred and the actual earning of income.⁸⁰ The court held in the affirmative and stated that the position of directorship carries an obligation to purchase shares from the company.⁸¹ The taxpayer had to borrow money to purchase the shares, consequently he incurred interest. Moreover, the taxpayer could not have been a director if he did not buy those shares. The court found that interest paid was closely connected with the production of income and therefore it was deductible in terms of the Act.⁸²

This section of the chapter discussed the major cases which have been handed down by our courts in the interpretation of the phrase “in the production of income”. The next section will discuss the purpose of the act which entailed the expenditure. The taxpayer has to prove that the act which entailed the expenditure was performed for the purposes of producing income.

2.3 Purpose of the act entailing expenditure

The question of purpose is paramount in the deductibility of expenditure.⁸³ In *CIR v Standard Bank of SA Ltd*,⁸⁴ the court held that:

Generally, in deciding whether moneys outlaid by a taxpayer constitute expenditure incurred in the production of the income (in terms of the general deduction formula) important and sometimes overriding factors are the purpose of

⁷⁴ *Ibid.*

⁷⁵ *Ibid.*

⁷⁶ *Ibid.*

⁷⁷ *Ibid.*

⁷⁸ *Ibid.*

⁷⁹ *ITC 1428 (1985) 50 SATC 34(C) 38.*

⁸⁰ *Ibid.*

⁸¹ *Ibid.*

⁸² *ITC 1428 (1985) 50 SATC 34(C) 38.*

⁸³ Williams, R.C (2005) *Income Tax in South Africa Cases & Materials 2ed*, at 366.

⁸⁴ 47 SATC 179, 1985 (4) SA 485 (A).

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

The issue which came before the court was whether the bank could deduct interest on money deposited by its customers if it used the money to earn tax-free dividends on preference shares.⁸⁵ The court drew a distinction between money borrowed for a specific purpose and money which was borrowed for a general purpose.⁸⁶ The court stated that if money is borrowed specifically to invest in shares, the interest is not deductible.⁸⁷ However, if money is borrowed for a general purpose and it is put in the common pool of funds, this fund is a general fund which can be used for all purposes.⁸⁸ The court looked at the general purpose of the bank and stated that the general purpose of the bank is to borrow money at a lower interest rate and lend it at a higher interest.⁸⁹ Hence, the general purpose is to produce income. Therefore the interest expenditure was closely connected to the income-earning operations of the bank.⁹⁰ The court held that the interest expenditure was deductible.⁹¹

In *CIR v Allied Building Society*,⁹² Thompson J.A held that the court must look at the purpose of the expenditure. If the expenditure was incurred for the purposes of earning income, it is deductible. The issue which came before the court was whether the interest incurred by the Building Society was incurred in the production of income.⁹³ The court held that the business of a Building Society was to borrow money cheaply and lend it at a higher rate.⁹⁴ In borrowing money the society had to pay interest; such payments were necessarily made in order to earn income.⁹⁵ The obligation to pay interest is integral to the society's business and the society can only continue to conduct its business by paying interest. Therefore the interest was incurred in the production of the society's income and for the purposes of its trade.⁹⁶

⁸⁵ Haupt, P. (2015) *Notes on South African Income Tax* 4ed at 119.

⁸⁶ In *CIR v Standard Bank of SA Ltd* 47 SATC 179, 1985 (4) SA 485 (A).

⁸⁷ *Ibid.*

⁸⁸ *Ibid.*

⁸⁹ *Ibid.*

⁹⁰ *Ibid.*

⁹¹ *Ibid.*

⁹² 1963 (4) SA 1 (A) 25 SATC 343.

⁹³ *CIR v Allied Building Society* 1963 (4) SA 1 (A) 25 SATC 343.

⁹⁴ *Ibid.*

⁹⁵ *Ibid.*

⁹⁶ *Ibid.*

In addition, the court further stated that acquisition of society's properties was incidental to the society's business.⁹⁷ The acquisition of non-revenue producing properties was incidental to the society's business of borrowing money and earning income by investment.⁹⁸ Moreover, the court pointed out that "it was not material whether all the money borrowed for these purposes was in fact lent out at interest or was used for other purposes incidental to the society's business."⁹⁹ The court looked objectively at the purpose of the expenditure in its determination. The decision of the court was also based on the taxpayer's ability to discharge the onus. The society managed to prove that the interest incurred was incurred for the purpose of earning income. Hence, the interest was held to be deductible as expenditure incurred in the production of income.

The case of *CIR v Nemojim*¹⁰⁰ (referred to as the *Nemojim* case) dealt with a situation where an expense is incurred for a dual purpose. The taxpayer was a share dealing company.¹⁰¹ It made its profits from buying and selling shares in dormant companies holding cash reserves available for distribution by way of dividend.¹⁰² The taxpayer sold the shares at a loss because all the reserves at that time had been declared as dividends.¹⁰³ The issue which came before the court was whether the total loss that had been incurred by the taxpayer as result of dividend stripping, was deductible in terms of section 11(a) of the Act.¹⁰⁴

Having established that the expense had a dual purpose, the court stated that the expenditure must be apportioned.¹⁰⁵ The court allowed expenditure which was incurred in the production of income and disallowed a portion of expenditure which was incurred to produce exempt income.¹⁰⁶ The court looked at the purpose of the expense and what it actually effects in terms of section 23(f).¹⁰⁷ The court stated that the expenditure incurred by the taxpayer in acquiring the shares had a dual purpose.¹⁰⁸ The first purpose was for resale of the shares and

⁹⁷ *CIR v Allied Building Society* 1963 1963 (4) SA 1 (A) 25 SATC 343.

⁹⁸ *CIR v Allied Building Society* 1963 1963 (4) SA 1 (A) 25 SATC 343 at 226.

⁹⁹ *CIR v Allied Building Society* 1963 (4) SA 1 (A) 25 SATC 343.

¹⁰⁰ 45 SATC 241, 1983 (4) SA 935 (A).

¹⁰¹ *CIR v Nemojim* 45 SATC 241, 1983 (4) SA 935 (A).

¹⁰² *Ibid.*

¹⁰³ *Ibid.*

¹⁰⁴ *Ibid.*

¹⁰⁵ *Ibid.*

¹⁰⁶ *Ibid.*

¹⁰⁷ *Ibid.*

¹⁰⁸ *Ibid.*

the proceeds would constitute income in the hands of the taxpayer.¹⁰⁹ The second was for the receipt of a dividend that would constitute exempt income.¹¹⁰

The principle of apportionment was confirmed in the case of *Commissioner for the South African Revenue Service v Mobile Telephone Networks Holding (Pty) Ltd*¹¹¹ (referred to as the *Mobile Telephone Networks* case). The taxpayer company is the holding company of five directly held and a number of indirectly held subsidiaries and joint ventures.¹¹² The taxpayer company is also a subsidiary of the MTN Group Limited.¹¹³ The companies in the group are involved in the operation of mobile telecommunication networks and related services in Cameroon, Nigeria, Rwanda, South Africa, Swaziland and Uganda.¹¹⁴ The taxpayer company earned income in the form dividends from its subsidiaries.¹¹⁵ It also granted loans to those subsidiary companies.¹¹⁶ Hence the taxpayer received dividend income which is exempt income and interest income which is taxable.¹¹⁷ The taxpayer sought to deduct audit fees and professional fees that it had incurred.¹¹⁸

The court held that in determining whether expenditure was incurred in the production of income it is paramount to investigate the purpose of the expenditure and what it actually effects.¹¹⁹ In addition the court stated that one has to assess the closeness of the connection between expenditure and the taxpayer's income operations.¹²⁰ The court held that auditing financial records is a necessary function of the taxpayer's business and it is closely connected to the taxpayer's income earning operations.¹²¹ However, the court held that expenditure was incurred for a dual purpose and hence apportionment was necessary in such circumstances.¹²² Furthermore, the court held that the apportionment must be fair and reasonable.¹²³

¹⁰⁹ *CIR v Nemojim* 45 SATC 241, 1983 (4) SA 935 (A).

¹¹⁰ *Ibid.*

¹¹¹ *Ibid.*

¹¹² *Commissioner for the South African Revenue Service v Mobile Telephone Networks Holding (Pty) Ltd* 2014 ZASCA; 2014 (5) SA 366 (SCA).

¹¹³ *Ibid.*

¹¹⁴ *Ibid.*

¹¹⁵ *Ibid.*

¹¹⁶ *Ibid.*

¹¹⁷ *Ibid.*

¹¹⁸ *Ibid.*

¹¹⁹ *Ibid.*

¹²⁰ *Ibid.*

¹²¹ *Ibid.*

¹²² *Ibid.*

¹²³ *Ibid.*

In a New Zealand case, *Ward and Co Ltd v Commissioner of Taxes*¹²⁴, the court held that if expenditure is incurred for the purposes of preventing the extinction of a business it is not incurred in the production of income. The company carried on a business as brewers¹²⁵. In New Zealand a special poll was conducted to determine whether or not the sale of liquor should be banned. The company spent money on advertising, canvassing and printing in order to persuade the public to vote against the government's proposal.¹²⁶ The taxpayer company sought to deduct the expenditure from its taxable income.¹²⁷ The issue which came before the court was whether expenditure was incurred in the production of income.¹²⁸ The court looked at the purpose of the expenditure and stated that the expenditure was incurred to prevent extinction of the business.¹²⁹ The court stated the expenditure was not necessary for the production of income and therefore it was not deductible.¹³⁰

In the case of *W Nevill & Co Ltd v F COT*¹³¹ the court held that in determining whether expenditure is linked to the production of income:

... it is necessary, for income tax purposes, to look at a business as a whole set of operations, directed towards producing income. No expenditure, strictly and narrowly considered, in itself actually gains or produces income. It is an outgoing not an incoming. Its character can be determined only in relation to the object which the person making the expenditure has in view. If the actual object is the conduct of the business on a profitable basis with due regard to economy which is essential in any well conducted business, then the expenditure is an expenditure incurred in gaining or producing the assessable income.

In *W Nevill & Co Ltd v F COT*, the court considered the issue of the timing of allowable deductions and whether or not a payment made in instalments to a manager to terminate his employment was deductible in one financial year, even though the instalments continued over two financial years.¹³² The taxpayer company decided to terminate the employment contract of one of its managers.¹³³ The company had to pay a sum of money in consideration of his

¹²⁴ 1923 AC 145,39 TLR 90.

¹²⁵ *Ward and Co Ltd v Commissioner of Taxes* 1923 AC 145,39 TLR 90.

¹²⁶ *Ibid.*

¹²⁷ *Ibid.*

¹²⁸ *Ibid.*

¹²⁹ *Ibid.*

¹³⁰ *Ibid.*

¹³¹ (1957) 56 CLR 290.

¹³² *W Nevill & Co Ltd v F COT* (1957) 56 CLR 290.

¹³³ *Ibid.*

employment contract.¹³⁴ Moreover, the company paid the money in instalments spanning two financial years.¹³⁵ The company sought to deduct the full amount in the first financial year.¹³⁶ The Commissioner refused to allow the deduction because it was not expended for the purposes of producing income.¹³⁷ The Commissioner also argued that the expenditure should be proportional, covering the two years, and it cannot be deducted in one financial year.¹³⁸ On the other hand the taxpayer company argued that the expenditure was incurred in the course of its business and it should be deductible.¹³⁹

The court considered whether or not the expenditure was incurred in the production of income.¹⁴⁰ The court was also tasked to determine whether or not the whole amount could be deductible in the first financial year. The case of *W Nevill* followed a subjective approach in the determining whether or not expenditure was incurred in the production of income.¹⁴¹ The court stated that the nature of the expenditure should be established from the taxpayer's perspective.¹⁴² If expenditure was incurred for the purpose of producing profits in any well-conducted business, then the expenditure can be regarded as having been incurred in the production of income. Latham CJ held that the expenditure was *bona fide* incurred for the purposes of producing income.¹⁴³ The taxpayer company expended the money on the grounds of commercial expediency; these expenses were incurred to improve the efficiency of the company and therefore to increase its production capacity.¹⁴⁴ The court allowed the deduction of expenditure from the company's gross income.¹⁴⁵

In this section of the chapter it has been shown that for expenditure to qualify as a deduction it must have been incurred for the purposes of producing income. If expenditure is *bona fide* incurred for the purposes of producing income it must be deductible. In *Nemojim* and *Mobile Telephone Network* cases it was established that if expenditure is incurred for a dual purpose

¹³⁴ *Ibid.*

¹³⁵ *Ibid.*

¹³⁶ *Ibid.*

¹³⁷ *Ibid.*

¹³⁸ *Ibid.*

¹³⁹ *Ibid.*

¹⁴⁰ *Ibid.*

¹⁴¹ *Ibid.*

¹⁴² *Ibid.*

¹⁴³ *Ibid.*

¹⁴⁴ *Ibid.*

¹⁴⁵ *Ibid.*

and apportionment may be appropriate in such circumstances.¹⁴⁶ However, expenditure which is incurred for the purposes of preventing extinction of the business is not deductible.¹⁴⁷

The next section will discuss whether or not a taxpayer has to prove that the expenditure was incurred in the current year of assessment in order for it to be deductible.

2.3.1 Production of income in future years

In the case of *Sub-Nigel Ltd v CIR*¹⁴⁸ (referred to as the *Sub-Nigel* case) the court established that the words “in the production of income” do not mean that in order for expenditure to rank as a deduction it must have produced a part of income for that year of assessment. Centlivres CJ held that one has to look at the purpose of the expenditure and whether it was incurred for the purposes of earning income.¹⁴⁹ Briefly, the facts of the case were as follows: a mining company took out insurance against loss incurred by fire.¹⁵⁰ The company had to pay premiums in terms of this agreement.¹⁵¹ The company claimed a deduction in respect of the insurance premiums.¹⁵² The issue which came before the court was whether the insurance premiums paid by the taxpayer were incurred in the production of income and whether they constituted expenditure of a capital nature.¹⁵³

The court held that the expenditure was incurred in the production of income and it was not of a capital nature. Centlivres CJ stated that the main reason why companies are formed is to make profit and taking out these policies is to ensure that these profits are maintained.¹⁵⁴ The insurance was taken out as a provision to maintain profits in the event that the company suffers loss as a result of a fire. The court used an objective criterion in its application. It looked at the purpose of the expenditure. The court allowed the deduction despite the fact that no income was produced. It stated that the purpose of the expenditure was to have income in the event that fire would have prevented the production of income. This case provides authority for the fact that the production of income requirement does not necessarily mean the immediate production of income from the business operations of the taxpayer. If a taxpayer

¹⁴⁶ *CIR v Nemojim* 45 SATC 241, 1983 (4) SA 935 (A) and *Commissioner for the South African Revenue Service v Mobile Telephone Networks Holding (Pty) Ltd* 2014 ZASCA; 2014 (5) SA 366 (SCA).

¹⁴⁷ *Ward and Co Ltd v Commissioner of Taxes* 1923 AC 145,39 TLR 90.

¹⁴⁸ 1948 (4) SA 580 (A), 15 SATC 381.

¹⁴⁹ *Sub-Nigel Ltd v CIR* 1948 (4) SA 580 (A), 15 SATC 394.

¹⁵⁰ *Ibid.*

¹⁵¹ *Ibid.*

¹⁵² *Ibid.*

¹⁵³ *Ibid.*

¹⁵⁴ *Ibid.*

manages to prove that the purpose of the expenditure is to produce income the deduction must be allowed.

In *ITC 1847*¹⁵⁵ the court confirmed the assertion which was made in *Sub-Nigel* case when it was stated that the production of income requirement does not always mean that the expenditure is only deductible once the income has been produced. The court allowed the deduction of marketing fees from the taxpayer's income.¹⁵⁶ The court looked at the purpose of the expenditure and stated that the purpose of the expenditure was to produce income. Hence the expenditure must be deductible.¹⁵⁷ Companies spent money on advertising and building relationships with purchasers and potential purchasers. These expenses are incurred before the production of income. The expenditure is incurred for the purpose of generating additional income for the taxpayer. Therefore, the fact that income will be produced in the future does not preclude the deduction of expenditure if it was incurred for the purposes of producing income.

Nestadt JA, who gave the minority judgment in the case of *CIR v Pick 'n Pay Wholesalers (Pty) Ltd*, stated that the words in the "production of income" do not mean that expenditure has to produce income in that particular year of assessment for it to be deductible.¹⁵⁸ Income can be earned in the following year of assessment. The learned judge based his opinion on the decision in the *Sub Nigel case*.¹⁵⁹ Nestadt JA held that the same principle can be applied to allow deductions of expenditure relating to the income of a previous year.¹⁶⁰ Furthermore, the judge stated that there must be a sufficient and direct relationship between the expenditure incurred and the income earning operations of the taxpayer.

Haupt submits that where an expense is incurred after the income is earned it will be very difficult for the taxpayer to prove that the expenditure was incurred for the purposes of a trade.¹⁶¹ Moreover, the Commissioner can argue that the expense is voluntary and it would not have affected the production of income which has already been earned by the taxpayer.¹⁶² However, if a taxpayer manages to prove that the expenditure was incurred for the purposes

¹⁵⁵ (2011) 73 SATC 118 at 129.

¹⁵⁶ *Ibid.*

¹⁵⁷ *Ibid.*

¹⁵⁸ *CIR v Pick 'n Pay Wholesalers (Pty) Ltd*, 1987 (3) SA 453 (A), 49 SATC 132.

¹⁵⁹ *Ibid.*

¹⁶⁰ *Ibid.*

¹⁶¹ Haupt, P. (2015) *Notes on South African Income Tax* 4ed at 125.

¹⁶² *Ibid.*

of producing income, and if it is closely linked to the income earning operations it would be deductible.

The next section will discuss how the courts have determined whether or not there is a sufficient and close relationship between the expenditure and the taxpayer's income earning operations.

2.4 Connection between expenditure and income earning operations

The case of *CIR v Drakensberg Gardens Hotel (Pty) Ltd*,¹⁶³ considered whether there was a close connection between expenditure and the production of income. This requirement was developed in the *Port Elizabeth Tramway* case. The *Drakensberg Gardens* case concerns a taxpayer company that borrowed money to buy shares in another company which owned the premises from which it conducted its business.¹⁶⁴ The company bought the shares to ensure security of tenure on the premises from which it conducted its business.¹⁶⁵ The taxpayer paid interest and claimed a deduction from its taxable income.¹⁶⁶ The Commissioner argued that the company bought shares to obtain dividends which are exempt from tax and hence the expenditure incurred was not deductible.¹⁶⁷ Furthermore, the Commissioner contended that the link between the purchase of shares and the income earning operations was not sufficiently close to secure a deduction of interest.¹⁶⁸

The court held that the taxpayer's purpose in buying the shares was to gain control over the premises and to maintain its business.¹⁶⁹ The taxpayer managed to prove that there was a sufficient and close relationship between the interest paid on the loan to purchase the shares and the income earning operations.¹⁷⁰ The court found that the payment of interest and the production of income were sufficiently closely connected to warrant a deduction.¹⁷¹

In *ITC 121*¹⁷² the court disallowed expenditure incurred by the taxpayer in previous years because it was not linked to the taxpayer's income earning operations. The taxpayer was an

¹⁶³ 1960 (2) SA 475 (A) at 479H–480A, 23 SATC 251 at 257.

¹⁶⁴ *CIR v Drakensberg Gardens Hotel (Pty) Ltd* 1960 (2) SA 475 (A) at 479H–480A, 23 SATC 251.

¹⁶⁵ *Ibid.*

¹⁶⁶ *Ibid.*

¹⁶⁷ *CIR v Drakensberg Gardens Hotel (Pty) Ltd* 1960 (2) SA 475 (A) at 479H–480A, 23 SATC 251.

¹⁶⁸ *Ibid.*

¹⁶⁹ *Ibid.*

¹⁷⁰ *Ibid.*

¹⁷¹ *Ibid.*

¹⁷² 1928 4 SATC 114(U).

owner of a farm that was let to tenants.¹⁷³ During that period, the government implemented a program whereby it made it compulsory for locust destruction at farms.¹⁷⁴ The owner of the farm on which locust destruction took place had to reimburse the government for money that had been paid out in destroying the locusts.¹⁷⁵ The taxpayer was called upon to pay some of the money and sought to set it off against the income earned in the year of assessment.¹⁷⁶ The court had to determine whether there was a close connection between the income earning operations and the expenditure.¹⁷⁷ The court found that there was no connection between the expenditure and the taxpayer's business operations.¹⁷⁸ The taxpayer's income came from letting the farm and there was no link between the business and the expenditure incurred.¹⁷⁹

Tredgold CJ, in *Provider v COT*¹⁸⁰ (referred to as the *Provider* case), held that voluntary payments were made in the production of income. The issue which came before the court was whether the amounts paid by the taxpayer to dependants under a life insurance scheme were deductible as expenditure incurred in the production of income.¹⁸¹ As a motivation to its employees, the taxpayer company paid a bonus on retirement to any employee who had been in the company for a certain period.¹⁸² The company also paid a benefit to the dependants of an employee who died while in the taxpayer's service.¹⁸³ The court held that the fact that the payments were made voluntarily and not under contract was not material.¹⁸⁴ It stated that many voluntary payments are made in the production of income.¹⁸⁵ Furthermore, the court gave an example of advertising expenses which are voluntary payments that are made by businesses to increase profits and these expenses are incurred in the production of income.¹⁸⁶ Similarly, in the case of *ITC 1847*¹⁸⁷, the court allowed the deduction of marketing fees. Companies incur these expenses to boost the production of income. (Marketing fees are also voluntary payments.) Tredgold CJ contended that the purpose of the expenditure in the *Provider* case was for commercial reasons. It was aimed at providing satisfactory conditions

¹⁷³ *ITC 121* 1928 4 SATC 114(U).

¹⁷⁴ *Ibid.*

¹⁷⁵ *Ibid.*

¹⁷⁶ *Ibid.*

¹⁷⁷ *Ibid.*

¹⁷⁸ *Ibid.*

¹⁷⁹ *Ibid.*

¹⁸⁰ 1950 SR 161, 17 SATC 40.

¹⁸¹ *Provider v COT* 1950 SR 161, 17 SATC 40.

¹⁸² *Provider v COT* 1950 SR 161, 17 SATC 40.

¹⁸³ *Ibid.*

¹⁸⁴ *Ibid.*

¹⁸⁵ *Ibid.*

¹⁸⁶ *Ibid.*

¹⁸⁷ (2011) 73 SATC 118 at 129.

of employment and to provide a benefit to the dependants of an employee.¹⁸⁸ Moreover, the court also looked at the link between the payment of the benefits and the production of income.¹⁸⁹ The court held that it was closely linked to the production of income. In its reasoning, the court stated that the benefit was in gratitude for past services.¹⁹⁰ The fact that employees enter into the service knowing that if they die, their dependants will receive certain benefits, is an inducement for employees to enter the service of the company.¹⁹¹

In contrast to the case of *Provider v COT*, in the case of *W F Johnstone & Co v CIR*¹⁹² (referred to as the *W F Johnstone* case) the court disallowed the deduction of an *ex-gratia* lump sum payment and pension paid to the taxpayer's employees. The court held that the expenditure was not incurred in the production of income. The court found that these payments were made for the past services and did not satisfy the requirements of section 11(a).¹⁹³ The court stated that the main reason that influenced the taxpayer to make these payments was to recognise past services rendered to the company. Hence, these expenses were not incurred in the production of income and they did not form part of the ordinary operations of the taxpayer's business. The difference between the *Provider* case and the *W F Johnstone* case is that in the *Provider* case the court allowed the deduction because the taxpayer was able to establish that the purpose of paying the benefits and bonuses to the employees was to attract and keep employees. Therefore, in *Provider* case, the court found that there was a close link between the production of income and the expenditure incurred. However, in the *W F Johnstone* case, the court disallowed the deduction because there was no link between the production of income and the expenditure incurred by the taxpayer. The court found that the purpose of the expenditure was in recognition of the past services rendered to the company. The expenditure was not incurred for the purposes of earning income and therefore not deductible.

In *ITC 1600*,¹⁹⁴ the court held that a strict approach in assessing the connection between expenditure incurred and production of income would require an investigation into the business efficacy of taxpayers. In addition the court stated that this further enquiry would not

¹⁸⁸ *Provider v COT* 1950 SR 161, 17 SATC 40.

¹⁸⁹ *Ibid.*

¹⁹⁰ *Ibid.*

¹⁹¹ *Ibid.*

¹⁹² 1951 (2) SA 283 (A), 17 SATC 235.

¹⁹³ Section 11(a) of the Income Tax Act 58 of 1962 provides that in order for expenditure and losses to be deductible they must have been incurred in the production of income, provided such expenditure and losses are not of a capital in nature.

¹⁹⁴ (1995) 58 SATC 131.

have been intended by the Income Tax Act.¹⁹⁵ This case concerned a taxpayer who hired computer equipment for its business.¹⁹⁶ As result of various considerations, the taxpayer found that its business could be carried out by cheaper and more efficient personal computers.¹⁹⁷ The taxpayer and the lessor of the equipment agreed to cancel the lease.¹⁹⁸ Later the taxpayer paid a lump sum to the lessor for the outstanding monies and claimed a deduction in terms of section 11(a) of the Income Tax Act.¹⁹⁹ The Commissioner argued that the expenditure in question was not incurred in the production of income.²⁰⁰ Furthermore, the Commissioner contended that on termination of the lease the main-frame computer was not used by the taxpayer and it ceased to be used as part of the taxpayer's trade. The Commissioner was of the opinion that was no longer being used in the production of income.

The court held that the requirement which calls for a close connection between expenditure and the income earning operations must not be strictly applied.²⁰¹ The court stated that it is not important to make an enquiry into the business efficacy of a taxpayer.²⁰² If the expenditure was *bona fide* incurred for the purposes of producing income it must be deductible.²⁰³ The court held that the expenditure was made in good faith and the taxpayer was entitled to a deduction.²⁰⁴

The next section will discuss the inevitable concomitant test.

2.4.1 Inevitable concomitant

The connection between an expense and the taxpayer's income operations can be established by looking at whether that particular expense is an inevitable concomitant of a taxpayer's business.²⁰⁵ This enquiry looks at whether the expense is inevitably associated with the income earning operations of the taxpayer. In *ITC 1490*,²⁰⁶ the court disallowed the deduction of traffic fines on the basis that the expenditure did not form part of the income earning operations and the fines were not an inevitable concomitant of the taxpayer's

¹⁹⁵ *ITC 1600* 1995) 58 SATC 131.

¹⁹⁶ *Ibid.*

¹⁹⁷ *Ibid.*

¹⁹⁸ *Ibid.*

¹⁹⁹ *Ibid.*

²⁰⁰ *Ibid.*

²⁰¹ *Ibid.*

²⁰² *Ibid.*

²⁰³ *ITC 1600* 1995) 58 SATC 131.

²⁰⁴ *Ibid.*

²⁰⁵ *Joffe & Co Pty Ltd v CIR* 1946 AD 157, 13 SATC 354.

²⁰⁶ 1990, 53 SATC 108 (T).

business. Furthermore, the court held that it would be contrary to public policy if such deductions are allowed.²⁰⁷ The taxpayer company incurred expenditure in the form of traffic fines and it sought to deduct the fines from its taxable income.²⁰⁸ The issue which came before the court was whether these traffic fines were deductible as expenditure incurred in the production of income.²⁰⁹ The appellant contended that the expenditure was deductible because it was incurred in the production of income and it was an inevitable concomitant of its trade.²¹⁰ The managing director, who testified on behalf of appellant, stated that the risk of paying fines was inherent in the transport business and it was not possible to conduct business without committing such offences.²¹¹ However, contradicting his testimony, the managing director later stated that it is possible to conduct business without committing these offences.²¹² The court held that incurring such fines was not an inevitable concomitant of the taxpayer's business.²¹³ Melamet J looked at whether the expenditure was an inevitable concomitant to the taxpayer's business and found that the traffic fines were not necessary for the income earning operations and they were not incurred in the production of income. The expenditure was not an inevitable concomitant of the taxpayer's business.

Another major case which looked at whether the expenditure was an inevitable concomitant of the business was the case of *Joffe & Co Pty Ltd v CIR*.²¹⁴ The taxpayer was an engineering company specialising in reinforced concrete.²¹⁵ One of the concrete structures which had been built by the taxpayer collapsed and killed a workman.²¹⁶ A delictual action was instituted against the company and it was established that the company was negligent in carrying out its mandate.²¹⁷ The company failed to take proper precautions to prevent the accident from happening.²¹⁸ The taxpayer company was ordered to pay damages to the dependants of the workman.²¹⁹ The Commissioner refused to allow the deduction and associated legal costs incurred in defending the action.²²⁰ The court was tasked with

²⁰⁷ *ITC 1490* 1990, 53 SATC 108 (T).

²⁰⁸ *Ibid.*

²⁰⁹ *Ibid.*

²¹⁰ *Ibid.*

²¹¹ *Ibid.*

²¹² *Ibid.*

²¹³ *Ibid.*

²¹⁴ 1946 AD 157, 13 SATC 354.

²¹⁵ *Joffe & Co Pty Ltd v CIR* 1946 AD 157, 13 SATC 354.

²¹⁶ *Ibid.*

²¹⁷ *Ibid.*

²¹⁸ *Ibid.*

²¹⁹ *Ibid.*

²²⁰ *Ibid.*

determining whether or not the damages and legal costs were incurred in the production of income.²²¹

The court held that the negligence which caused the damages was not an inevitable concomitant of the taxpayer's business.²²² Watermeyer CJ stated that "[t]here is nothing in the stated case to suggest that such negligence, and the consequent liability which negligence entailed, were necessary concomitants of the trading operations of a reinforced concrete engineer". The court stated that it is not enough to prove that the expenses were connected to the taxpayer's business operations. The expenditure must have been incurred for the purpose of earning profits. The learned judge, Watermeyer CJ, held that the damages and legal costs were not incurred in the production of income. He went on to say that the taxpayer failed to prove that such negligence was a necessary concomitant of the trading operations of a reinforced concrete engineer. The court held, *per* Watermeyer CJ, that the expenditure was not incurred *bona fide* for the purposes of carrying on the taxpayer's trade. Hence, the court disallowed the expenditure as not having been incurred in the production of income. Arguably, it can be submitted that the reason why Watermeyer CJ refused to allow the deduction is because the taxpayer failed to discharge the onus. Watermeyer CJ stated that the taxpayer had not presented any evidence which showed that negligent construction was a necessary concomitant of the taxpayer's trade.

In *ITC 1242*²²³ the taxpayer company sought to deduct losses that it incurred as a result of money stolen by two of its employees. The court adopted the test that was laid down in *COT v Rendle*.²²⁴ The test requires a taxpayer to prove that the risk of incurring loss is inseparable from the carrying on a particular business. Watermeyer J, who delivered the decision, stated that:²²⁵

Before a taxpayer can succeed he must show that the risk of the loss which he seeks to deduct from his income is inseparable from, or a necessary ingredient of, the carrying on of the particular business. If it is, then. . . it would be proper, natural or reasonable to regard the loss as part of the cost of performing the business operations *bona fide* performed for the purpose of earning income.

²²¹ *Ibid.*

²²² *Ibid.*

²²³ (1975) 37 SATC 306(C).

²²⁴ 1965 (1) SA 59.

²²⁵ *ITC 1242* (1975) 37 SATC 306(C).

In its reasoning, the court made reference to the leading case on embezzlement – *Lockie Bros Ltd v CIR*²²⁶ (referred to as the *Lockie Bros* case). In the *Lockie Bros* case the manager of an English company embezzled money from the company. When the company sought to deduct the loss, it was held not to be deductible. The court held that embezzlement cannot be viewed as a process undertaken for the purposes of operating a business, and the loss was not deductible since it was not incurred in the production of income.²²⁷ In ITC 1242 Watermeyer J applied the test which was enunciated in *COT v Rendle and* the learned judge identified the act which entailed the expenditure as the employment of the clerks.²²⁸ The court stated that the publishing company needed the help of clerks to undertake its business operations.²²⁹ These clerks had a duty to handle small amounts of money and to place orders on behalf of the company.²³⁰ The court held that the company managed to prove that the risk of the losses occurring was inseparable from its business and hence the losses were incurred in the production of income.

In the case of *Warner Lambert SA (Pty) Ltd v CSARS*,²³¹ Conradie JA, stated the following:

Deductible expenditure has certain characteristics: it must be incurred in the production of income (s 11(a)) and will not be allowed as a deduction against gross income if it is not laid out or expended for the purposes of trade. Up to and including the 1992 year of assessment such moneys must have been ‘wholly or exclusively laid out or expended for the purposes of trade’ (s 23(g)). From the 1993 year of assessment onwards expenditure was not permitted as a deduction save ‘to the extent to which such moneys were...laid out or expended for the purposes of trade’.

In *Ticktin Timbers CC v Commissioner for Inland Revenue 1999 (4) SA 939 (SCA)* (1999 (11) JTLR 29) at 942F-G Hefer JA called the purpose for which expenditure was incurred, ‘the decisive consideration in the application of 23(g)’. He quoted the following passage from the judgment of Corbett JA in *Commissioner for Inland Revenue v Standard Bank of SA Ltd 1985 (4) SA 485 (A)* at 500H-J:

²²⁶ 1922 TPD 42.

²²⁷ *ITC 1242* (1975) 37 SATC 306(C).

²²⁸ *Ibid.*

²²⁹ *Ibid.*

²³⁰ *Ibid.*

²³¹ 2003 (5) SA 344 (SCA) 350.

‘Generally, in deciding whether money outlaid by a taxpayer constitutes expenditure incurred in the production of income (in terms of the general deduction formula) important and sometimes overriding factors are the purpose of the expenditure and what the expenditure actually effects; and in this regard the closeness of the connection between the expenditure and the income-earning operations must be assessed’.

As to how close this connection must be, the Court in *Port Elizabeth Electric Tramway Co v Commissioner for Inland Revenue 1936 CPD 241* explained that

‘...income is produced by the performance of a series of acts and attendant upon them are expenses. Such expenses are deductible expenses provided that they are so closely linked to such acts as to be regarded as part of the cost of performing them....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 facts of the case were as follows, the taxpayer company was a South African subsidiary of an American company.²³² One of the company’s obligations was to comply with the United States Sullivan Code, which required all the subsidiary companies to implement a social responsibility program.²³³ The taxpayer company incurred expenditure in implementing the program and it sought to deduct it from its income.²³⁴ The Commissioner contended that the expenditure was not incurred in the production of income.²³⁵ Furthermore, the Commissioner disputed the expenditure which was incurred in the furtherance of the taxpayer’s social responsibility program.²³⁶ The program was aimed at eliminating laws and customs that hindered social, economic and political justice.²³⁷ The taxpayer company argued that it stood to lose income if it failed to comply with the Code and this was an instruction of its parent company.²³⁸ The issue which came before the court was whether the social responsibility

²³² *Warner Lambert SA (Pty) Ltd v CSARS 2003 (5) SA 344 (SCA)*.

²³³ *Ibid.*

²³⁴ *Ibid.*

²³⁵ *Ibid.*

²³⁶ *Ibid.*

²³⁷ *Ibid.*

²³⁸ *Ibid.*

expenditure claimed as a deduction by the taxpayer was deductible under section 11(a) read with section 23(g) of the Income Tax Act.²³⁹

The court held that the expenditure was incurred in the production of income.²⁴⁰ The court stated that the purpose of the expenditure was to protect the treasured subsidiary status of the company.²⁴¹ The expenditure was incurred to insure against the risk of losing the subsidiary status.²⁴² Conradie JA held that the fact that the link between the taxpayer's trade and the social responsibility is not close and obvious does not mean that the connection is too remote.²⁴³ The learned judge went on to say that the absence of a profit motive does not exclude a transaction from being a part of a taxpayer's trade.²⁴⁴ The court found that the expenses were *bona fide* incurred for the purposes of the taxpayer's income-producing operations.²⁴⁵ Hence, the requirements of section 11(a) and section 23(a) of the Income Tax Act were met and the deduction was allowed.²⁴⁶

2.5 Concluding Comments

The above cases demonstrate the development of the broad test which was initially laid down by Watermeyer AJP in the *Port Elizabeth Tramway* case. This test had been cited with approval in different cases and developed further in certain cases. The first enquiry looks at the purpose of the act which caused the expenditure. Williams is of the opinion that the purpose referred to in this instance is the subjective purpose of the taxpayer and not the purpose of the expenditure.²⁴⁷ After establishing the purpose of the act, the next enquiry is to look at the connection between the expenditure and the income earning operations. In relation to this enquiry, Watermeyer AJP stated that the link between the expenditure and the income earning operations must be close. In the *Gemm* case, the court stated that in determining the closeness of the link that must exist between the expenditure and the production of income, there must be an enquiry as to whether it would proper, natural or reasonable to regard the expenses as part of cost of performing the business operation.²⁴⁸ In the *Joffe* case the court

²³⁹ *Ibid.*

²⁴⁰ *Ibid.*

²⁴¹ *Ibid.*

²⁴² *Ibid.*

²⁴³ *Warner Lambert SA (Pty) Ltd v CSARS* 2003 (5) SA 344 (SCA) 353 para 16.

²⁴⁴ *Ibid.*

²⁴⁵ *Warner Lambert SA (Pty) Ltd v CSARS* 2003 (5) SA 344 (SCA).

²⁴⁶ Income Tax Act 58 of 1962.

²⁴⁷ Williams *Income Tax in South Africa* 366.

²⁴⁸ *Ibid.*

developed the necessary concomitant test.²⁴⁹ In terms of this test, the taxpayer has to prove that the expenditure was a necessary concomitant of the taxpayer's business. The risk of having to incur liability must be inseparable from the taxpayer's trading operations.

The courts have agreed on the fact that expenditure is deductible if it can be proved that it was *bona fide* incurred for the purposes of earning income. If expenditure is *bona fide* incurred for the purposes of producing income it must be deductible. In the *Nemojim* and *Mobile Telephone Network* cases it was established that if expenditure is incurred for a dual purpose the court may order for apportionment in such circumstances. The apportionment must be fair and reasonable.

In the *Sub-Nigel* and *ITC 1847* cases, it was established that the "in the production of income" requirement does not necessarily mean that expenditure is only deductible once the income has been produced. If expenditure was incurred for the purposes of producing income it must be deductible. In *ITC 1847*²⁵⁰ the court allowed the deduction of marketing fees as expenditure incurred in the production of income.

The deductibility of damages is dependent upon meeting the requirements of section 11(a) read with section 23(g) of the Act. A taxpayer usually incurs legal costs in resisting a claim for damages. Section 11(c) of the Act provides for the deduction of legal costs and imposes certain requirements before a deduction is allowed. The next chapter will compare and contrast the requirements of section 11(a) and 11(c).

²⁴⁹ *Joffe & Co Pty Ltd v CIR* 1946 AD 157, 13 SATC 354.

²⁵⁰ (2011) 73 SATC 118.

CHAPTER 3

COMPARING THE REQUIREMENTS OF SECTION 11(a) AND SECTION 11(c) OF THE INCOME TAX ACT

3.1 Introduction

The Income Tax Act provides for the deductibility of expenditure in general, and for specific types of expenditure. In terms of section 23B, if expenditure is not deductible under a specific provision of the Act, then its deductibility falls to be considered in terms of the so called general deduction formula.²⁵¹ Damages, if they qualify, are deductible in terms of the preamble to section 11 and section 11(a) read with section 23(g) of the Act.²⁵² On the other hand, section 11(c) is a specific provision which provides for the deduction of legal costs.²⁵³ The two provisions (section 11(a) and section 11(c)) share similar requirements, but they also have distinctly different requirements. The purpose of this chapter is to compare the different requirements of the two provisions and also discuss the common requirements. The importance of this chapter lies in the connection between damages and associated legal costs. The deduction of damages and the associated legal costs depend upon each other. The chapter will proceed in five sections. The first section introduces the chapter. The second section and subsections investigate the common requirements of the preamble to section 11, section 11(a) and section 11(c). Thereafter, the following section will discuss and contrast the distinct requirements of the two provisions.

The general deduction formula comprises the preamble to section 11 and section 11(a) read with section 23(g).²⁵⁴

The preamble to section 11 and section 11(a) provide as follows:²⁵⁵

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 –

²⁵¹ The general deduction formula consist of the preamble to section 11 and section 11(a) read in conjunction with section 23(g) of the Income Tax Act.

²⁵² Income Tax Act 58 of 1962.

²⁵³ *Ibid.*

²⁵⁴ *Ibid.*

²⁵⁵ *Ibid.*

a) expenditure and losses actually incurred in the production of income, provided such expenditure and losses are not of a capital nature.

Section 23(g) prohibits the deduction of expenditure 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.”²⁵⁶

Section 11(a) provides for the deductibility of expenditure and losses which are incurred in the production of income and not of a capital nature.²⁵⁷ In order to rank as a deduction, the expenditure must have been incurred in the production of income. The phrase “in the production of income” has been interpreted by the courts to mean that the expenditure must have been incurred for the purposes of producing income and it must be closely connected to the income earning operations.²⁵⁸ For damages to be deductible, the taxpayer must prove that the damages were incurred in the production of income. The damages must have been incurred for the purposes of producing income and it must be proved that they were closely connected to the income earning operations.²⁵⁹

When a person is defending a damages claim, he or she incurs legal costs through the process. Legal expenses incurred by a taxpayer in defending a claim for damages cannot produce income.²⁶⁰ In the *Port Elizabeth Tramway* case the court allowed the deduction of compensation paid to the dependants of a driver who was killed in an accident, but refused to allow the deduction of legal expenses because they were not incurred in the production of income.²⁶¹ The legislature intervened after the *Port Elizabeth Tramway* case and provided a special provision for the deductibility of legal expenses. Section 11(c) of the Act now provides for the deduction of legal expenses.²⁶²

In order to fall within the scope of this provision, the expenditure must have been incurred “in respect of any claim, dispute or action at law arising in the course of or by reason of the

²⁵⁶ *Ibid.*

²⁵⁷ Income Tax Act 58 of 1962.

²⁵⁸ *Port Elizabeth Electric Tramway Co Ltd v CIR* 1936 CPD 241, *CIR v Genn & Co (Pty) Ltd* 1955 (3) SA 293 (A), 20 SATC 113.

²⁵⁹ *Ibid.*

²⁶⁰ In *Port Elizabeth Electric Tramway Co Ltd v CIR* 1936 CPD 241 at 243, Watermeyer AJP stated that expenditure does not produce income. Income is produced by a series of acts such as work and labour.

²⁶¹ *Port Elizabeth Electric Tramway Co Ltd v CIR* 1936 CPD 241.

²⁶² Income Tax Act 58 of 1962.

ordinary operations undertaken in the carrying on of trade”.²⁶³ The provision limits this deduction to so much thereof as –²⁶⁴

- (i) is not of a capital nature; and
- (ii) is not incurred in respect of any claim made against the taxpayer for the payment of damages or compensation if by reason of the nature of the claim or the circumstances any payment which is or might be made in satisfaction or settlement of the claim does not or would not rank for deduction from his income under paragraph (a); and
- (iii) is not incurred in respect of any claim made by the taxpayer for the payment to him of any amount which does not or would not constitute income of the taxpayer; and
- (iv) is not incurred in respect of any dispute or action at law relating to any such claim as is referred to in paragraph (ii) or (iii) of this proviso . . .

3.2 Common requirements

As mentioned above, section 11(a) and 11(c) have similar requirements in relation to the deductibility of damages and associated legal costs. This section will discuss those common requirements. The discussion of these requirements is important as it will establish what a taxpayer needs to prove in order to secure a deduction for damages and associated legal costs. In addition, an understanding of these requirements will help to form a foundation for clarifying the circumstances in which a payer of damages and associated legal costs would be able to claim a deduction from its taxable income. These requirements are discussed below. The common requirements are namely:²⁶⁵

- a) carrying on a trade;
- b) the expenditure must have been actually incurred during the year of assessment; and
- c) the expenditure must not be a of capital nature.

²⁶³ *Ibid.*

²⁶⁴ Section 11(c) of the Income Tax Act 58 of 1962.

²⁶⁵ Section 11(a) and 11(c) of the Income Tax Act 58 of 1962.

3.2.1 Carrying on a trade

In order to qualify as a deduction, expenditure or a loss must have been incurred in the course of carrying on a trade. The Act does not define what “carrying on of a trade” means. Section 1 of the Act, however, defines a trade 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, 1952, ... or any design as defined in the Designs Act, 1967 ... or any trade mark as defined in the Trade Marks Act, 1963 ... or any copyright as defined in the Copyright Act, 1965 ... or any other property which in the opinion of the Commissioner is of a similar nature.

In *Burgess v CIR*²⁶⁶ the court considered the meaning of carrying on a trade. The court gave a wide interpretation of the word trade. The court was of the opinion that the word trade should be interpreted to include a venture. However, the court also noted that, although the word venture connotes an element of risk, it does not mean that the element of risk has to be there for it to be considered a trade. There are certain business ventures which are not risky but they are considered to be trades. Therefore, a taxpayer can be considered to be carrying on a trade despite the fact that the business venture does not involve a risk.

What constitutes “carrying on of a trade” has been considered by our courts in various decisions. In *ITC 1653*²⁶⁷ the court looked at the main purpose of the taxpayer’s venture in establishing whether or not she was carrying on a trade. The taxpayer purchased a residential property in a suburb of Bulawayo. She considered the property to be a long term investment. At the time when the taxpayer bought the property there was a rent order in force in terms of the rent regulations which fixed the rent at \$1000. The taxpayer leased the property to tenants. The taxpayer incurred a loss when one of the tenants elected not to renew the lease. The taxpayer sought to deduct the expenses incurred in connection with the property. The court held that the existence of a rent order meant that there was no possibility of making profit in short or medium term.²⁶⁸ The court found that when the taxpayer purchased the

²⁶⁶ 55 SATC 185.

²⁶⁷ 61 SATC 120.

²⁶⁸ *Ibid.*

property her main purpose was not to carry on the trade of leasing the property.²⁶⁹ The court held that the expenditure was not incurred for the purposes of the trade.²⁷⁰

In some cases, courts have used the profit motive to establish whether or not a taxpayer is carrying on a trade. In *ITC 1292*²⁷¹ Myburgh J stated that the test for the deductibility of expenditure is the “real hope to make profit. Such hope must not be based on fanciful expectations but on reasonable possibility”. However, the absence of profit does not preclude a transaction from being part of the taxpayer’s trade. This proposition was stated in the case of *CIR v De Beers Holdings Pty Ltd*²⁷², where Corbett JA stated that:

The attainment of profit is not necessarily the hallmark of a trading transaction. A trader may for commercial reasons elect to resell goods at a loss. Conceivably also he may elect to resell goods at a loss in order to gain some other commercial advantage for his business.

Williams argues that some moneys are disbursed on the grounds of commercial expediency or in order to indirectly facilitate the carrying on of the taxpayer’s trade.²⁷³ Therefore, not all trades are carried on for the purposes of producing profit. The principle of carrying on trade without making profit was also illustrated by Jenkins LJ in the case of *Morgan v Tate and Lyle Ltd*,²⁷⁴ where the learned judge stated that a transaction entered into with the purpose of not making a profit, or in fact registering a loss must, in order to satisfy section 23(g), be shown to have been connected with the pursuit of the taxpayer’s trade. The issue of making profit cannot always be used as a factor to establish that someone is carrying on a trade. Hence, each case has to be treated on its own merit. In order for an expense to be deductible in terms of either section 11(a) or section 11(c) the taxpayer must be carrying on a trade.

3.2.2 Actually incurred

The expenditure or losses must have been actually incurred in order to be deductible in terms of section 11(a) and section 11(c). The question is what the meaning is of “expenditure” and

²⁶⁹ *Ibid.*

²⁷⁰ *Ibid.*

²⁷¹ 41 SATC 163.

²⁷² 1986 (1) SA 8 (A), 47 SATC 229.

²⁷³ Williams, R.C (2005) *Income Tax In South Africa: Cases & Materials 2 ed* at 181.

²⁷⁴ 1953 Ch 601 at 637-638.

“losses”. These words are not defined in the Act, hence it is necessary to look to case law for their meaning. In the *Port Elizabeth Tramway* case the court stated that the word loss can mean the loss of floating capital employed in the trade which produces income.²⁷⁵ In the *Joffe* case²⁷⁶ the court made a distinction between the words “expenditure” and “losses”. The learned judge Watermeyer CJ stated that the word loss:²⁷⁷

... in relation to trading operations the word is sometimes used to signify a deprivation suffered by the loser, usually an involuntary deprivation, whereas expenditure usually means a voluntary payment of money.

In *CSARS v Labat*²⁷⁸ the court considered the meaning of the word “expenditure”. The court held that the word expenditure refers to “...the action of spending funds, disbursement or consumption and hence the amount of money spent.” However, the word expenditure is not limited to the disbursement of money alone, but it also includes spending of amounts in a form other than cash.²⁷⁹ Stiglingh *et al* provide the following example: “ ... if a merchant was required to pay for his goods by tendering land or shares in a company, the value of land or shares would constitute expenditure in terms of section 11(a) and would be deductible.”²⁸⁰

In order for an expenditure or loss to qualify as a deduction in terms of the Act, it must have been “actually” incurred in the year of assessment in which the deduction is claimed. The phrase “actually incurred” is not defined in the Act, therefore the meaning of the phrase can be found in case law. In the *Port Elizabeth Tramway*²⁸¹ case Watermeyer AJP stated that the words in the statute are “actually incurred” and not “necessarily incurred”.²⁸² The learned judge, Watermeyer AJP, pointed out that the use of the words “actually incurred” as opposed to “necessarily incurred” may widen the deductibility of expenditure.²⁸³ Watermeyer AJP was of the opinion that:²⁸⁴

²⁷⁵ 1936 CPD 241.

²⁷⁶ 1946 AD 157, 13 SATC 354.

²⁷⁷ 1946 AD 157, 13 SATC 354 at 360.

²⁷⁸ 2011 ZASCA 157.

²⁷⁹ Stiglingh, M *et al* (2014) *SILKE: South African Income Tax* at 140.

²⁸⁰ *Ibid.*

²⁸¹ *Port Elizabeth Electric Tramway Co Ltd v CIR* 1936 CPD 241.

²⁸² *Port Elizabeth Electric Tramway Co Ltd v CIR* 1936 CPD 241 at 207.

²⁸³ *Ibid.*

²⁸⁴ *Port Elizabeth Electric Tramway Co Ltd v CIR* 1936 CPD 241 at 207.

...one man may conduct his business inefficiently or extravagantly, actually incurring expenses which another man does not incur, such expenses therefore are not 'necessary' but they are actually incurred and therefore deductible.

From the above extract by Watermeyer AJP, it can be submitted that in order to rank as a deduction the expenditure or loss must have been actually incurred. As stated in the dictum of *Port Elizabeth Tramway* case, there is no need to enquire into the business efficacy of the taxpayer. The taxpayer only has to prove that the expenditure was actually incurred. Therefore, even if the expenditure is not necessarily incurred it is still deductible if it was actually incurred by the taxpayer. According to Stiglingh *et al* the word "incurred" does not necessarily mean "paid".²⁸⁵ The expenditure is deductible as long as the liability to pay has arisen. In *ITC 1587*²⁸⁶ the court stated that the meaning of the word "incurred" "... is not limited to defrayed, discharged or borne, but does not include a loss or expenditure which is no more than impending, threatened or expected."

In *Edgars Stores Ltd v Commissioner for Inland Revenue*²⁸⁷ the court established that for an expense to be deductible in terms of section 11(a) it must be unconditional and must not be contingent. The taxpayer conducted its business in leased premises. The leases provided for a basic rental and a turnover rental. The periods of the leases ended on different dates depending on the commencement of the lease. In situations where the lease ended after the taxpayer's year of assessment it was very difficult to ascertain the net annual turnover rental for the purposes of the taxpayer's income tax return for that particular year. The taxpayer sought to deduct the turnover rental in the year in which the liability arose, but not in the year in which it was paid. Furthermore, the taxpayer sought to deduct an estimate of the amount by which the rental turnover exceeded the basic rental for the lease year.

The issue which came before the court was whether or not the estimate of the liability for turnover rental was actually incurred. The court held that the provisions of the leases relating to turnover rental created a contingent liability which was only determined at the end of the lease year. Hence, the expenditure was not actually incurred in a tax year which ended before the termination of the lease year.

²⁸⁵ Stiglingh, M *et al* (2014) *SILKE: South African Income Tax* at 140.

²⁸⁶ (1994) 57 SATC 97 at page 103.

²⁸⁷ 1988 (3) SA 876 (A), 50 SATC 81.

This discussion has highlighted that in order for an expenditure or loss to be deductible it must have been “actually incurred”. The *Port Elizabeth Tramway* case established that the words “actually incurred” do not mean necessarily incurred.²⁸⁸ Therefore, the enquiry must not focus on whether the taxpayer was conducting its business efficiently, but on whether the expenditure or loss was actually incurred.

The next section will focus on the requirement that the expenditure or loss must not be of a capital nature.

3.2.3 Not of a capital nature

The two provisions, section 11(a) and section 11(c), require that an expense must not be of a capital nature. The Income Tax Act does not provide a definition of what constitutes “capital expenditure”. The main test that was developed by the courts in determining whether an expense is of a capital nature is the income-producing structure *versus* the income earning operations. This test was applied by Watermeyer CJ in *New State Areas Ltd v CIR*,²⁸⁹ where the learned judge held that:

... The conclusion to be drawn from all (the) cases seems to be that the true nature of each transaction must be enquired into in order to determine whether the expenditure attached to it is capital or revenue expenditure. Its true nature is a matter of fact and the purpose of the expenditure is the important factor; if it is incurred for the purpose of acquiring a capital asset for the business it is capital expenditure, even if it is paid in annual instalments; if on the other hand, it is in truth no more than part of the cost incidental to the performance of the income producing operations, as distinguished from the equipment of the income producing machine, then it is revenue expenditure even if it is paid in a lump sum.

In the *New State Areas* case, the court considered the purpose of the expenditure in determining whether expenditure is closely linked to the income producing structure or to the income earning operations.²⁹⁰ Watermeyer CJ held that revenue expenditure cannot be

²⁸⁸ *Port Elizabeth Electric Tramway Co Ltd v CIR* 1936 CPD 241 at 207.

²⁸⁹ 1946 AD 610, 14 SATC 155.

²⁹⁰ 1946 AD 610, 14 SATC 155.

differentiated from capital expenditure by enquiring whether or not the expenditure was incurred in the production of income.²⁹¹ Furthermore, the learned judge stated that both these forms of expenditure can be incurred in the production of income. Therefore, the purpose of the expenditure needs to be determined to establish whether it is capital or revenue in nature.

Neither section 11(a) nor section 11(c) allows the deduction of expenditure of a capital nature.²⁹² Both expenditure of a capital and revenue nature can be incurred in the production of income. However, the deduction of expenditure of a capital nature is not allowed by either section 11(a) or section 11(c). In the *New Areas State* case, Watermeyer CJ made a distinction between floating capital and fixed capital. The learned judge stated that when money employed in a business is frequently changing its form from money to goods and then vice versa, it is floating capital, if it is done for the purposes of making profit. The Act therefore prohibits the deduction of fixed capital expenditure and not of floating capital expenditure.

In *CIR v George Forest Timber Co Ltd*,²⁹³ Innes CJ held that:

.... money spent in creating or acquiring an income-producing concern must be capital expenditure. It is invested to yield future profit; and while the outlay does not recur the income does. There is a great difference between money spent in creating or acquiring a source of profit, and money spent in working it. The one is capital expenditure, the other is notThe reason is plain; in the one case it is spent to enable the concern to yield profits in the future, in the other it is spent in working the concern for the present production of profit.

From the above extract, it can be submitted that if an expense is incurred for the purposes of acquiring an income producing structure and if it is closely connected to it, it is regarded as capital expenditure. On the other hand, if an expense is closely connected to the income earning operations it is revenue in nature. There are other supplementary tests which have been used by the courts to determine whether an expense is of a capital nature.

²⁹¹ *Ibid.*

²⁹² Income Tax Act 58 of 1962.

²⁹³ 1924 (1) SATC 20.

In *CIR v African Oxygen*²⁹⁴ Steyn CJ stated that capital expenditure is money spent in creating or acquiring an income producing concern, a source of profit or a capital asset. On the other hand, revenue expenditure is the cost incidental to the performance of the income producing operations. Williams pointed out that the judgement by Steyn CJ in *CIR v African Oxygen* explains further the point that had been raised in previous cases that expenditure does not produce income.²⁹⁵ Steyn CJ stated that what is important is the link between expenditure and income. Hence, if the expenditure is incurred in creating a capital asset, it is capital expenditure. On the other hand, if the expenditure is part of the cost of operating the taxpayer's income-earning machine it is revenue expenditure.

The so called "once and for all" test has been used by the courts to determine whether the expenditure is capital or revenue. If expenditure is incurred once-off it is likely to be capital and if it is recurrent it is likely to be revenue. In *Vallambrosa Rubber Co Ltd v Farmer*²⁹⁶ Lord Dunedin held that capital expenditure is a thing that is spent once and for all and income expenditure is a thing that is going to recur every year. The learned judge, Lord Dunedin, made it clear that this test is not a final test or a determinative test; it must be used with other tests in order to determine whether the expenditure is capital or revenue.

The enduring benefit test was laid down in *British Insulated & Helsby Cables v Atherton*²⁹⁷ where Lord Cave held that when expenditure is incurred not once and for all but with the view of bringing into existence an asset or an enduring benefit to the trade it must be treated as capital expenditure. In *ITC 1528*²⁹⁸ the court held that:

The test that an expenditure will be regarded as an expenditure of a capital nature if it achieves a benefit or advantage of an enduring nature was adopted and applied by Steyn CJ in considering the peculiar facts in *Commissioner for Inland Revenue v African Oxygen Ltd 1963(1) SA 681(A)* at 689 ... It will be seen from the foregoing decisions that in as much as the expenditure brought the taxpayer no asset of any nature, nor did it enhance or preserve an asset it was found that there was no advantage or enduring benefit of the trade and that the expenditure was therefore not of a capital but of a revenue nature.

²⁹⁴ 1963 (1) SA 681 (A) 25 SATC 63 at 240.

²⁹⁵ In *Port Elizabeth Electric Tramway Co Ltd v CIR* 1936 CPD 241 at 243, Watermeyer AJP stated that expenditure does not produce income. Income is produced by a series of acts such as work and labour.

²⁹⁶ 1910 (SC) 519.

²⁹⁷ 1926 AC 205.

²⁹⁸ (1991) 54 SATC 243(T) at 248-249.

The above extract emphasises the fact that if an expense creates an enduring benefit to the trade it is capital. The enduring benefit test had been affirmed in English cases, where the courts have held that “enduring” means that capital has a long-lasting benefit.²⁹⁹

In the matter of *Smith v SIR*³⁰⁰ the court allowed the deduction of legal expenses incurred by the taxpayer in defending himself in a case of fraud and contravention of the Companies Act. The taxpayer was a registered public accountant and auditor. He also held directorship in several companies. The taxpayer was charged with fraud and contravention of the Companies Act. The taxpayer incurred legal expenditure in defending himself against these charges. When the matter went to trial he was found not guilty. The taxpayer sought to claim the legal expenditure in terms of section 11(c) of the Act.

The issue which came before the court was whether or not the legal expenditure was of a capital nature. In its reasoning the court stated that in deciding the nature of the transaction it was imperative to establish the purpose of the expenditure. The Commissioner argued that the expenditure was incurred for the purposes of protecting the taxpayer’s goodwill and it was of a capital nature. The court held that the expenditure was not incurred for the purposes of protecting the taxpayer’s goodwill, but to prevent the conviction of the taxpayer. Hence, the expenditure was not of a capital nature and was deductible in terms of the Act.

In *C:SARS v Thor Chemicals SA (Pty) Ltd*,³⁰¹ the taxpayer company manufactured mercury products. Some of its employees were exposed to mercury poisoning. An investigation into the causes of mercury poisoning was carried out by the Department of Manpower in terms of the Machinery and Occupational Safety Act, 6 of 1983. The taxpayer Company sought legal counsel to represent it in the inquiry and to protect its employees against self-incrimination or incrimination by other employees. The findings of the inquiry were handed over to the Attorney-General to decide whether or not a criminal prosecution could be successfully instituted against the company or its employees. Later the company and some of its employees were charged with culpable homicide and contraventions of the Machinery and Occupational Safety Act. The company pleaded guilty to some of the charges relating to contravention of the Act, but it was acquitted on the charge of culpable homicide, and was

²⁹⁹ De Koker, A.P. and Williams, R.C. 2012. *Silke on South African Income Tax* at para 7.9 (LexisNexis electronic version).

³⁰⁰ 1968 (2) SA 4800 (A).

³⁰¹ (2000) 62 SATC 308 (N).

found not guilty on all other charges. The taxpayer company sought to deduct the legal expense in terms of section 11(c) of the Act. The Commissioner disallowed the deduction on the basis that it was of a capital nature, and the dominant purpose of the expenditure was to protect the taxpayer's goodwill.

The issue which came before the court was whether or not the expenditure was deductible in terms of section 11(c) of the Act. The court considered the requirement imposed by section 11(c) that the expenditure must have been incurred in the course of or by reason of the ordinary operations of the taxpayer in the carrying on of its trade. The court held that the expenditure arose in the course of the taxpayer's business. The court also applied the test which was developed in the *Joffe* case and it stated that the deductibility of legal costs must depend on whether or not the expenditure is a necessary concomitant of the taxpayer's business operations. The court found that the risk of mercury poisoning is an inherent risk of the taxpayer's trading operations. The court held that the dominant intention was to defend the taxpayer's stance that it was not negligent and it had not contravened the Machinery and Occupational Safety Act.³⁰² Hence, protection of the company's goodwill was not the dominant intention. The legal expenses were held to be deductible and were not of a capital nature.

In *ITC 1242*³⁰³ the court allowed the deduction of legal expenses and it held that they are not of a capital nature. The taxpayer was a scrap-metal merchant. It erected a crushing machine on land that was owned by the Municipality. The land was reserved for residential purposes by the Municipality. The Municipality gave notice to the taxpayer calling for the removal of the machine from the site. The taxpayer failed to take action and the Municipality applied for a court order to force the removal of the machine. In an attempt to gain time and continue the profitable use of the machine, the company decided to use all legitimate avenues to resist the order. At the same time the company was making efforts to look for another suitable site for the machine. The court held that:³⁰⁴

the legal expenses incurred did not create or enhance any asset, they did not bring about any advantage for the enduring benefit of trade, and they were more closely related to the appellant's income-earning operations than to its income-earning structure [T]he appellant took a calculated risk, and the expenditure was in

³⁰² *C:SARS v Thor Chemicals SA (Pty) Ltd* (2000) 62 SATC 308 (N).

³⁰³ (1975) 37 SATC 300.

³⁰⁴ *ITC 1242* (1975) 37 SATC 300 at 306.

truth no more than part of the cost incidental to the performance of the income-producing operations.

The court held that legal expenses were deductible in terms of section 11(c), and they were not of a capital nature.³⁰⁵ The court held that the cost of the legal proceedings was the price that the taxpayer had to pay to continue operating on a profitable basis. It was stated that the legal expenses were more closely related to the taxpayer's income earning operations than to its income earning structure. Hence, the expenditure was incidental to the performance of the income earning operations. From the above *dictum* it can be submitted that the scope of section 11(c) is wide. Opposing proceedings can be regarded as an action at law. In the present case, the taxpayer incurred legal costs in opposing proceedings and these expenses were held to have been incurred in the course of the ordinary operations undertaken by the taxpayer in carrying on its trade.

It has been discussed in this section that for an expenditure or loss to be deductible in terms of the Act it must not have been of a capital nature. The main test which has been developed by the courts to determine whether or not expenditure is of capital nature is the income producing structure *versus* income earning operations.³⁰⁶ If expenditure is closely connected to the income producing operations it is considered to be revenue in nature. The courts have also developed other tests to determine whether or not expenditure is in capital nature. The other tests are the "once and for all" test and the "enduring benefit" test. If expenditure is incurred once and for all and if it results in an enduring benefit to the taxpayer it is considered to be capital expenditure. In *Smith v SIR*³⁰⁷ the court stated that the purpose of expenditure can be used to determine whether or not expenditure is of a capital nature.

3.2.4 Laid out or expended for the purposes of trade

Both section 11(a) and section 11(c) are subject to the "trade" requirement stated in the preamble to section 11, which applies in respect of all sub-sections unless specifically provided otherwise. Both sub-sections must therefore be read together with 23(g) in determining the deductibility of expenditure. Section 23(g) contains the negative part of the so called general deduction formula and prohibits the deduction of "any moneys, claimed as a

³⁰⁵ *ITC 1241* (1975) 37 SATC.

³⁰⁶ *New State Areas Ltd v CIR* 1946 AD 610, 14 SATC 155.

³⁰⁷ 1968 (2) SA 4800 (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.”

The enquiry as to whether the deduction of expenditure is prohibited in terms of section 23(g) is a question of law.³⁰⁸ However, the question of purpose in incurring the expenditure is a question of fact.³⁰⁹ Hefer JA, in *Tickin Timbers CC v CIR*,³¹⁰ stated that the decisive consideration in the application of section 23(g) is the purpose for which the expenditure was incurred.

In the United Kingdom the words “expended for the purposes of trade” have been considered by the courts. In *Strong & Co Romsey Ltd v Woodfield*,³¹¹ the court interpreted the words to mean for the purposes of enabling the taxpayer to carry on and earn profits in his trade.

The Appellate Division of the High Court of Southern Rhodesia, in *COT v BSA Co Ltd*,³¹² noted that the word “purposes”, in the context of expenditure incurred for the purposes of a taxpayer’s trade, refers to the use to which the trading stock acquired by the expenditure is to be put in the scheme of profit making. However, it does not refer to the motive with which it was acquired.

The implications of the general deduction formula are that the word “trade” used in section 23(g) refers only to the taxpayer’s trade.³¹³ This consideration was discussed in the case of *Solaglass Finance Co (Pty) Ltd v CIR* (referred to as the *Solaglass* case).³¹⁴ The facts of the case were as follows: the taxpayer was a banker of a group of companies. The taxpayer earned income from the loans that it managed and advanced. The issue that came before the court was whether or not the loss it had suffered on one of the loans which had been written off as irrecoverable was deductible. The losses were held to have been incurred in the production of income and not of a capital nature.

The next enquiry which was addressed by the court was whether or not the losses were incurred for trade purposes. The minority took the view that the purpose of the taxpayer’s business was to make profit. The taxpayer provided a benefit to the group to which it

³⁰⁸ *Secretary for Inland Revenue v Ineson* (1980) 42 SATC 125(A).

³⁰⁹ *Ibid.*

³¹⁰ (1999) 61 SATC 399.

³¹¹ 1906 AC 448.

³¹² 1966 (1) SA 530 (SR AD), 28 SATC 1.

³¹³ De Koker, A.P. and Williams, R.C. 2012. *Silke on South African Income Tax* at para 7.11 (LexisNexis electronic version).

³¹⁴ (1991) 53 SATC 1.

belonged. Hence, it was not disqualified from claiming a deduction of the loss it had suffered, since its main aim was to promote its business. However, the majority took a different view. The majority stated that the losses did not satisfy the requirement of section 23(g). The court held that the evidence showed that the taxpayer's business was designed for a dual purpose. The taxpayer's business was aimed at furthering the interests of the group and making profit for itself. The court held that the link between the taxpayer's activities and the furthering of the interests of the group was sufficiently close. Hence, the losses were held not to have been wholly and exclusively incurred for trading purposes (as section 23(g) then required).

In *ITC 1706*³¹⁵ the court disallowed expenditure incurred by the taxpayer on the instruction of its parent company. The court held that the expenditure was mainly incurred for the benefit of the parent company and some of its subsidiaries. Hence, there was no direct benefit which accrued to the taxpayer. The deduction was prohibited by section 23(g).

In *Solaglass Finance Co (Pty) Ltd v CIR*³¹⁶ the court held that there are no hard and fast rules in determining whether the taxpayer's expenditure falls within or outside the ambit of section 23(g). The court further stated that it is not possible to devise any precise universal test for determining whether expenditure was laid out or expended for the purposes of trade.³¹⁷

From an analysis of the above case law, it can be submitted that in order for expenditure to be deductible it must have been expended for the purposes of trade. The main decisive consideration in the application of section 23(g) is the purpose for which the expenditure was incurred.³¹⁸ If the expenditure was incurred for the purposes of the taxpayer's trade it is considered deductible. Moreover, the words "for the purposes of trade" have been interpreted to mean for purposes enabling the taxpayer to carry on and earn profits in his trade.³¹⁹

Although there does not appear to be any case law relating to the relationship between carrying on a trade and section 11(c), the tests applied in the case law discussed above would also apply.

The next section will discuss the distinct requirement of sections 11(a) and 11(c).

³¹⁵ (1998) 63 SATC 334.

³¹⁶ (1991) 53 SATC 1.

³¹⁷ *Ibid.*

³¹⁸ *Ticktin Timbers CC v CIR* (1999) 61 SATC 399.

³¹⁹ *Strong & Co Romsey Ltd v Woodifield* 1906 AC 448.

3.3 Distinct requirement

3.3.1 Section 11(a)

In the production of income

In terms of section 11(a) of the Act, the expenditure must have been incurred in the production of income in order to be deductible.³²⁰ This requirement imposes a heavy onus on the taxpayer to prove that expenditure was incurred for the purposes of producing income. Therefore the taxpayer has to prove that the expenditure is attached to the business operations, it was *bona fide* incurred for the purposes of producing income and it is so closely connected to taxpayer's business operations that it would be proper and reasonable to regard the expense as part of the cost performing the operation.³²¹ The interpretation of the phrase "in the production of income" was covered in the previous chapter.

3.4 Section 11(c)

Arising in the course of or by reason of the ordinary operations undertaken by the taxpayer

Section 11(c) provides for a deduction of legal expenses if the expenditure was incurred in respect of any claim, dispute or action at law.³²² The Act does not define the words "claim, dispute or action at law". A "claim" is defined in the Oxford Dictionary as asking for something which one has the right to have.³²³ According to Rossouw the words "claim" or "dispute" are not qualified by the phrase "at law".³²⁴ Rossouw further contends that the words "claim" or "dispute" are widely interpreted to include litigation or any other action which does not involve the courts at all.³²⁵

The section also provides for a deduction if the expenditure was incurred in the course of or by reason of the ordinary operations undertaken by the taxpayer in carrying on his trade.³²⁶ Therefore, for expenditure to qualify as a deduction in terms of section 11(c), the taxpayer has to prove that the claim, dispute or action at law arose in the course of or by reason of the ordinary operations undertaken by the taxpayer in carrying on his trade. In contrast to section

³²⁰ Income Tax Act 58 of 1962.

³²¹ *Commissioner of Taxes v Rendle* (1965) 26 SATC 326.

³²² Income Tax Act 58 of 1962.

³²³ Soanes, C and Hawker, S.(2006) *Compact Oxford Dictionary for University and College Students* 175.

³²⁴ Rossouw, H. (1989) *Legal expenses: when are they tax deductible* 127.

³²⁵ *Ibid.*

³²⁶ Section 11(c) of the Income Tax Act 58 of 1962.

11(a), section 11(c) does not require the expenditure to have been incurred in the production of income.

In *Lockie Bros v CIR*³²⁷ the court interpreted the phrase the “in the production of income” to mean “actually incurred in the course of and by reason of the ordinary business operations undertaken for the purpose of conducting the business”. The taxpayer company incurred losses as result of money embezzled by the manager and it sought to deduct it from its gross income. The court held that embezzlement by a manager was not an operation undertaken for the purposes of the business.

According to Kruger and Scholtz, Mason J in the *Lockie Bros* case provides a less onerous test in the interpretation of the phrase “in the production of income”.³²⁸ They further contend that Watermeyer AJP’s interpretation of the phrase “in the production of income” in *Port Elizabeth Tramway* case is too mechanical and contrived.³²⁹ Kruger and Scholtz submit that if Watermeyer AJP had used the test which was laid down by Mason J in the *Lockie Bros* case, both taxpayers in the *Port Elizabeth Tramway* and *Joffe* cases would have been allowed a deduction from their taxable income.

Goldswain holds the view that the test which was laid down by Mason J in the *Lockie Bros* case is not as wide as suggested by Kruger and Scholtz.³³⁰ The interpretation of the phrase “in the production of income” in the *Lockie Bros* case does not cover losses arising as a result of the embezzlement of funds by a senior manager of the taxpayer. It was held in the *Lockie Bros* case that the loss was incurred as a result of a senior manager and was not incurred in the course of or by reason of the taxpayer’s business operation.³³¹ Furthermore, Goldswain submits that the absurd result of the test can be shown in the *Rendle* case. In *Rendle*, a clerk who was working for a firm embezzled money from clients and from the firm.³³² The court allowed the deduction of money embezzled by the clerk belonging to two clients but disallowed the deduction of money embezzled by the same employee from the firm.³³³

The next section will contrast the different requirements of section 11(a) and 11(c).

³²⁷ 1922 TPD 42, 32 SATC 150 at 152.

³²⁸ Kruger, D and Scholtz, W. (2003) *Broomberg on Tax Strategy 4 ed* at 223.

³²⁹ *Ibid.*

³³⁰ Goldswain, G.K and Swart, O. (2015) *The Port Elizabeth Tramway case: Is the meaning ascribed to the phrase “in the production of income” by Watermeyer AJP in Port Elizabeth Tramway case still religiously followed today?* South African Business Review Special Edition Tax Stories at 80.

³³¹ *Lockie Bros Ltd v CIR* 1922 TPD 42, 32 SATC 150.

³³² 1965 (1) SA 59 (SARD), 26 SATC 326.

³³³ *Ibid.*

3.5 Contrasting the requirements of section 11(a) and section 11(c)

The difference between the “in production of income” requirement contained in section 11(a) and the requirement in section 11(c) which states that the expenditure must have been incurred in the “course of or by reason of the ordinary operations” of the taxpayer is that the production of income is a strict requirement. The “in production of income” requirement does not allow the deduction of expenditure which has not been incurred for the purposes of producing income. This requirement forms part of the so called general deduction formula.

The *Port Elizabeth Tramway* case is the leading case on the interpretation of the phrase in the production of income. In the *Port Elizabeth Tramway* case the court developed a twofold test which can be applied in the determination of whether or not the expenditure was incurred in the production of income.³³⁴ The first enquiry is to look at whether the act which caused the expenditure was incurred for the purposes of producing income. The second enquiry looks at whether the expenditure is closely connected to the taxpayer’s business operations that it may be regarded as part of the cost performing it.³³⁵ There has to be a connection between the act which caused the expenditure and the production of income. If the act was not performed for the purposes of producing income it is not deductible.³³⁶ The production of income requirement limits the deduction of expenditure.

However, the test applying in relation to section 11(c) is wide; it does not limit the deduction of expenditure on the basis of the production of income. It allows expenditure to be deductible if it was incurred in the course or by reason of the ordinary operations of the taxpayer. In contrast to the general deduction formula, the language employed in section 11(c) does not require legal expenses to produce income. The provision only requires that the legal expense must have been incurred in the course or by reason of the ordinary operations undertaken by the taxpayer in the carrying on of his trade.³³⁷ Section 11(c) offers a less onerous criterion for deductibility of legal expenses; the taxpayer does not have to prove that the expenses were incurred in the production of income.

In respect of the deductibility of associated legal costs section 11(c)(ii) imposes a further requirement.³³⁸ Associated legal costs are only deductible if the damages would have

³³⁴ *Port Elizabeth Electric Tramway Co Ltd v CIR* 1936 CPD 241.

³³⁵ *Ibid.*

³³⁶ *Ibid.*

³³⁷ Section 11(c) of the Income Tax Act 58 of 1962.

³³⁸ Section 11(c)(ii) of the Income Tax Act 58 of 1962.

qualified as a deduction under the general deduction formula. Therefore the damages must have been incurred in the production of income in order for associated legal costs to qualify as a deduction in terms of section 11(c) of the Act.³³⁹ Therefore the damages and associated legal costs are directly related and the taxpayer must prove that the damages are deductible before the associated legal costs can be deducted.

3.6 Conclusion

Sections 11(a) and 11(c) have common requirements, but they also have distinct requirements. In order for expenditure or a loss to rank as a deduction in terms of section 11(c) and section 11(a), the expenditure or loss must have been incurred in the course of carrying on a trade and it must have been actually incurred. In the *Port Elizabeth Tramway*³⁴⁰ case Watermeyer AJP established that the words in the statute are “actually incurred” not “necessarily incurred”.³⁴¹ The legislature did not intend to impose an enquiry into the business efficacy of the taxpayer. Therefore it does not matter how the taxpayer conducts his or her business operations.³⁴² It is required by both section 11(a) and 11(c) that the expenditure must not have been of a capital nature. However, section 11(a) and 11(c) have distinct requirements. Section 11(a) requires that in order for expenditure to be deductible it must have been incurred in the production of income. On the other hand, section 11(c) does not require expenditure to have been incurred in the production of income. Section 11(c) allows a deduction if expenditure was incurred in the course of or by reason of the ordinary operations undertaken by the taxpayer in carrying on his trade.³⁴³

It has been discussed in this chapter that the deductibility of damages and associated legal costs are clearly related. Hence, the taxpayer must prove that the damages were incurred in the production of income.³⁴⁴ Associated legal costs are only deductible if the damages qualify as a deduction in terms of section 11(a).³⁴⁵ The next enquiry is to determine under what circumstances a payer of damages and associated legal costs would be able to deduct the damages from income. This will be discussed in the next chapter.

³³⁹ Section 11(a) of the Income Tax Act 58 of 1962.

³⁴⁰ *Port Elizabeth Electric Tramway Co Ltd v CIR* 1936 CPD 241.

³⁴¹ *Port Elizabeth Electric Tramway Co Ltd v CIR* 1936 CPD 241 at 207.

³⁴² *Ibid.*

³⁴³ Section 11(c) of the Income Tax Act 58 of 1962.

³⁴⁴ Section 11(a) of the Income Tax Act 58 of 1962.

³⁴⁵ Section 11(c)(ii) of the Income Tax Act 58 of 1962.

CHAPTER 4

DEDUCTIBILITY OF DAMAGES AND ASSOCIATED LEGAL COSTS

4.1 Introduction

In the previous chapter it was shown that the deductibility of damages and associated legal costs are related. Associated legal costs can only be deductible under section 11(c) of the Act if the damages qualify as a deduction under section 11(a). The taxpayer, therefore, has to prove that the damages were incurred in the production of income, that they are not of a capital nature and that they were expended for the purposes of trade.³⁴⁶ This chapter will focus on the main research question, which will highlight the circumstances under which a payer of damages can claim a deduction from income. Moreover, this chapter seeks to determine whether or not the issue of fault (particularly negligence) is a relevant consideration in the deduction of damages and associated legal costs.

4.2 Case law relating to the deduction of damages

In order for damages to qualify as a deduction from a taxpayer's income they must have been incurred in the production of income. The leading case on the deduction of damages is the *Port Elizabeth Tramway* case.³⁴⁷ In this case the court considered whether or not compensation and legal costs paid by the taxpayer to the deceased's family were deductible in terms of the Act. A driver of a tramway company was injured during the course of his employment. The driver later died as a result of those injuries. The deceased's wife sued for damages and the taxpayer had to pay compensation and legal costs. The taxpayer sought to deduct the compensation and legal costs from its taxable income.

Watermeyer AJP developed a twofold test which can be used in determining whether or not an expense was incurred in the production of income.³⁴⁸ The test is as follows:

- (a) The first enquiry is to look at whether the act which caused the expenditure was incurred for the purposes of producing income.³⁴⁹
- (b) The second enquiry looks at whether the expenditure is so closely connected to the act that it may be regarded as part of the cost performing it.³⁵⁰

³⁴⁶ Section 11(a) read in conjunction with section 23(g) of the Income Tax Act 58 of 1962.

³⁴⁷ *Port Elizabeth Electric Tramway Co Ltd v CIR* 1936 CPD 241.

³⁴⁸ *Ibid.*

³⁴⁹ *Ibid.*

The learned judge Watermeyer AJP identified the act which involved the expenditure in the *Port Elizabeth Tramway* case as the driving of the tramway car.³⁵¹ Watermeyer AJP held that the employment of drivers carried in itself an inherent risk that if such drivers are injured during the course of the employment, the company might have to pay compensation.³⁵² The learned judge went on to say that the compensation was not paid as a penalty or an infraction of the law but on the basis of the employment contract.³⁵³ Watermeyer AJP further stated that it does not matter who is at fault, be it the tramway company or the driver of the tram; the compensation has to be paid if such a liability ensues.³⁵⁴ It is submitted, with respect, that the learned judge seems to have contradicted himself with the *obiter* remark that he made in this case, having earlier stated that it did not matter who was at fault. In his *obiter* remark, the learned judge stated that if an expense is caused by negligence or an unlawful act, it may not be deductible.³⁵⁵ However, despite making an unnecessary comment on the issue of negligence Watermeyer AJP allowed the deduction of damages. The learned judge pointed out that the potential liability of having to pay compensation if a driver is injured was inseparable from the employment of drivers.³⁵⁶ The court found that the compensation was incurred in the production of income and it was closely connected to the taxpayer's business operations.³⁵⁷

In *Joffe & Co Pty Ltd v CIR*³⁵⁸ the court developed the “necessary concomitant” test, which can be used to determine whether or not damages are deductible from a taxpayer's income. The facts of the case were as follows: the taxpayer was a company which carried on business of reinforced concrete engineering.³⁵⁹ The company was contracted to supply a building contractor with steel reinforcement. The material was required to build a cantilever hood.³⁶⁰ The cantilever hood was erected by the taxpayer.³⁶¹ The cantilever hood later collapsed and killed a plumber who was working below it.³⁶² The dependants of the plumber sued for damages against the taxpayer. During the trial it was established that the collapse of the

³⁵⁰ *Port Elizabeth Electric Tramway Co Ltd v CIR* 1936 CPD 241.

³⁵¹ *Ibid.*

³⁵² *Ibid.*

³⁵³ *Ibid.*

³⁵⁴ *Ibid.*

³⁵⁵ *Ibid.*

³⁵⁶ *Ibid.*

³⁵⁷ *Ibid.*

³⁵⁸ 1946 AD 157, 13 SATC 354.

³⁵⁹ *Joffe & Co Pty Ltd v CIR* 1946 AD 157, 13 SATC 354.

³⁶⁰ *Ibid.*

³⁶¹ *Ibid.*

³⁶² *Ibid.*

cantilever hood was caused by the taxpayer's negligence.³⁶³ The taxpayer was ordered to pay damages to the plumber's dependants. The taxpayer sought to deduct the damages and legal costs incurred in opposing the action. The issue which came before the court was whether or not the damages paid by the taxpayer to the plumber's dependants were deductible under section 11(a) of the Act. The court considered whether or not the damages were incurred in the production of income. The court, *per* Watermeyer CJ, held that:³⁶⁴

All expenditure, therefore, necessarily attached to the performance of the operations which constitute the carrying on of the income-earning trade, would be deductible and also all expenditure which, though not attached to the trading operations of necessity, is yet *bona fide* incurred for the purpose of carrying them on, provided such payments are wholly and exclusively made for that purpose and are not expenditure of a capital nature.

The court considered whether or not the expenditure was incurred for the purposes of trade. In considering the issue of purpose, Watermeyer CJ, found authority in the case of *Strong & Co Romsey Ltd v Woodifield*; in this case Lord Davey stated that for an expenditure or loss to be deductible it must have been incurred for the purposes of carrying on and earning profits in the taxpayer's trade.³⁶⁵ Lord Davey further stated that it is not enough to say that the expenditure was incurred in the course of the taxpayer's trade but that it must also have been for the purposes of earning income. The learned judge, Watermeyer CJ, stated that the payment of damages was not made for the purposes of trade.³⁶⁶ Watermeyer CJ found that the damages were paid to cover a legal liability to the deceased's family. The learned judge went on to say that there was nothing in the stated case which suggests that such negligence and consequent liability which entailed the expenditure were necessary concomitants of the taxpayer's business operations.³⁶⁷ The court stated that the damages were not *bona fide* incurred for the purposes of the taxpayer's trade.³⁶⁸ The court found that the damages in question were not incurred in the production of income.³⁶⁹ Counsel for the taxpayer argued

³⁶³ *Ibid.*

³⁶⁴ *Joffe & Co Pty Ltd v CIR* 1946 AD 157, 13 SATC 354 at 163.

³⁶⁵ *Joffe & Co Pty Ltd v CIR* 1946 AD 157, 13 SATC 354 at 163.

³⁶⁶ *Ibid.*

³⁶⁷ *Ibid.*

³⁶⁸ *Ibid.*

³⁶⁹ *Ibid.*

that the expenditure in question arose from the business methods of a reinforced concrete engineer and that it was a necessary incurrence.³⁷⁰

Watermeyer CJ refuted the argument on the basis that there was nothing in the stated case which showed that the taxpayer's method of conducting business lead to accidents.³⁷¹ From the learned judge's dictum it appears that, if the taxpayer was conducting his business in a more reckless manner, the deduction would have been allowed. In that case the expenditure would have been an inseparable risk to the taxpayer's business. Williams argued that: "the bizzare corollary of this line of reasoning would be that irresponsible and reckless engineers would be entitled to the fiscal benefit of a tax deduction for damages paid by them, whereas careful and responsible engineers would be denied the benefit."³⁷²

Arguably, in the *Joffe* case the claim was disallowed because the taxpayer failed to prove that the accidents of that nature which led to the payment of damages were an inherent risk of the taxpayer's business. The issue of onus plays an important role in the deduction of damages and associated legal costs.³⁷³ The taxpayer has to prove on a balance of probabilities that that the damages incurred were a necessary concomitant of the taxpayer's business. The *Joffe* case points out that in order for damages to be deductible they must have been incurred for the purposes of a trade. It can be submitted that the deduction of damages is dependent upon meeting the requirements of section 11(a) read in conjunction with section 23(g) of the Act.³⁷⁴

In *Weinberg v CIR*³⁷⁵ the taxpayer paid damages and legal costs as a result of an accident which was caused by one of his employees. The taxpayer was a garage owner.³⁷⁶ He derived his income from rents, salary and interest.³⁷⁷ The taxpayer entered into a verbal agreement with one his clients.³⁷⁸ In terms of the agreement the taxpayer was obliged to keep the car in a garage, dust it and polish it once a month.³⁷⁹ One of the employees took the car to his own home and on his way back the employee drove the car into a building.³⁸⁰ A claim for

³⁷⁰ *Joffe & Co Pty Ltd v CIR* 1946 AD 157, 13 SATC 354 at 164.

³⁷¹ *Ibid.*

³⁷² *Williams Income Tax in South Africa Cases & Materials* at 373.

³⁷³ Section 102, Tax Administration Act 28 of 2011.

³⁷⁴ Income Tax Act 58 of 1962.

³⁷⁵ 1946 CPD 429, 14 SATC 210.

³⁷⁶ *Weinberg v CIR* 1946 CPD 429, 14 SATC 210.

³⁷⁷ *Ibid.*

³⁷⁸ *Ibid.*

³⁷⁹ *Ibid.*

³⁸⁰ *Ibid.*

damages was instituted against the taxpayer.³⁸¹ As a result of the suit, the taxpayer had to pay damages and legal costs that were incurred in defending the matter.³⁸² The taxpayer sought to deduct the expenses from his taxable income.³⁸³ The Commissioner argued that the expenses were not incurred in the production of income.³⁸⁴

The issue which came before the court was whether or not the damages and associated legal costs were incurred in the production of income. The court cited the principles which were laid down in the *Port Elizabeth Tramway* case.³⁸⁵ The court stated that the first enquiry was to determine whether or not the act which caused the expenditure was attached to the production of income. The second enquiry was to establish whether or not the expenditure was closely connected to the production of income.³⁸⁶ In answering the first enquiry, the court considered the series of acts which produced the income. The court identified three acts which led to the production of income.³⁸⁷ The first act was keeping the car at the garage.³⁸⁸ Secondly, the taxpayer was obliged to dust the car and polish it once a month.³⁸⁹ Lastly, in terms of the agreement, one of the taxpayer's workers was supposed to go with the client to his home and drive the car back to the garage.³⁹⁰ What happened in this case was that the employee took the car to his own home and on his way back, drove the car into a building.³⁹¹ The court held that the act which caused the accident was not part of the series of acts which produced income.³⁹² The court stated that there was no point in moving on to the next enquiry since it had established that the act which caused the expenditure was not attached to the production of income.³⁹³ The court held that the damaging of the car was not an inevitable result of the contract between the taxpayer and the client.³⁹⁴ The court found that the damages were not incurred in the production of income.³⁹⁵ In the above *dictum* it can be submitted that the identification of the act which caused the expenditure is important. If the act which caused the expenditure is not attached to the income-earning operations the deduction is

³⁸¹ *Ibid.*

³⁸² *Ibid.*

³⁸³ *Ibid.*

³⁸⁴ *Ibid.*

³⁸⁵ *Weinberg v CIR* 1946 CPD 429, 14 SATC 210.

³⁸⁶ *Ibid.*

³⁸⁷ *Weinberg v CIR* 1946 CPD 429, 14 SATC 210 at 437.

³⁸⁸ *Ibid.*

³⁸⁹ *Ibid.*

³⁹⁰ *Ibid.*

³⁹¹ *Ibid.*

³⁹² *Ibid.*

³⁹³ *Ibid.*

³⁹⁴ *Ibid.*

³⁹⁵ *Ibid.*

disallowed. The taxpayer has to prove that the risk of incurring the liability is inherent to its business.

In *ITC 1710*³⁹⁶ the taxpayer was a farm owner. One of the taxpayer's employees started a fire which spread to the neighbouring farm and caused damages.³⁹⁷ The taxpayer's employee was employed as an ordinary farm labourer.³⁹⁸ As a result of the fire an action of damages was instituted against the taxpayer.³⁹⁹ The owner of the neighbouring farm argued that the taxpayer was vicariously liable for the employee's actions.⁴⁰⁰ Hence, the taxpayer was responsible for the payment of damages as the employee acted in the course and scope of his employment.⁴⁰¹ The issue which came before the court was whether or not the damages and legal costs were deductible in terms of the Act.

The court again applied the test which was developed in the *Port Elizabeth Tramway* case.⁴⁰² The first question which was addressed by the court was whether the expense was connected by chance to the performance of the act.⁴⁰³ The second enquiry was to look at the connection between the expense and the production of income.⁴⁰⁴ And lastly, the enquiry would be whether it would be proper, natural or reasonable to regard the expense as part of the costs of the performance.⁴⁰⁵ The court stated that the employment of the farm labourers was integral to the taxpayer's farming activities.⁴⁰⁶ The employees were in the habit of smoking while they worked in the vineyards. It was found that there was an inherent risk in the taxpayer's farming activities during the summer.⁴⁰⁷ A farm labourer could light a match and smoke a cigarette that may cause a fire which could damage the neighbouring farm.⁴⁰⁸ The court found that there was a sufficient causal connection between the expense and the income generating activities.⁴⁰⁹ Hence, it was proper, natural and reasonable to regard the expenditure as part of the cost of the performance. The damages were held to be deductible in

³⁹⁶ 63 SATC 403.

³⁹⁷ *ITC 1710* 63 SATC 403.

³⁹⁸ *Ibid.*

³⁹⁹ *Ibid.*

⁴⁰⁰ *Ibid.*

⁴⁰¹ *Ibid.*

⁴⁰² *Ibid.*

⁴⁰³ *Ibid.*

⁴⁰⁴ *Ibid.*

⁴⁰⁵ *Ibid.*

⁴⁰⁶ *Ibid.*

⁴⁰⁷ *Ibid.*

⁴⁰⁸ *Ibid.*

⁴⁰⁹ *Ibid.*

terms of section 11(a) of the Act. Consequently, the legal costs were held to be deductible in terms of section 11(c) of the Act.

Another case in which damages were held to be deductible is *ITC 49*⁴¹⁰. The taxpayer sold petrol lamps which were subject to a guarantee.⁴¹¹ One of the lamps exploded, causing injuries to the purchaser.⁴¹² The purchaser claimed damages for these injuries under the guarantee.⁴¹³ The court held that the damages were incurred in the production of income and therefore they were deductible.

In *ITC 233*,⁴¹⁴ the taxpayer conducted a business of stevedores. An accident occurred when they were unloading cargo from a vessel and an article fell out of the net and killed a passer-by.⁴¹⁵ The dependants of the person killed claimed damages from the taxpayer and the taxpayer settled the claim.⁴¹⁶ The taxpayer claimed a deduction of these expenses from its income.⁴¹⁷ The court found that the damage or loss was incidental to the business of stevedoring and therefore was a legitimate expense in connection with the earning income as stevedores. Hence, the expenditure or loss was deductible.⁴¹⁸ This judgement supports the proposition that if expenditure is attached to the business operations and if it was incurred for the purposes of producing income, it must be deductible.

In *COT v Cathcart*⁴¹⁹ the court established that damages are deductible if they were paid in pursuance of a legal liability. The taxpayer was an architect and was in partnership with Hendry.⁴²⁰ The taxpayer entered into a contract in which he designed a building for Kaufman Sons and Co Ltd.⁴²¹ The contract required the taxpayer to provide a guarantee that the building would be waterproof.⁴²² The building subsequently leaked and Kaufman Sons and Co Ltd sued the taxpayer and Hendry for breach of the guarantee.⁴²³ The company claimed damages against the taxpayer which arose as a result of leaks in the building.⁴²⁴ The taxpayer

⁴¹⁰ (1926) 2 SATC 122 NA.

⁴¹¹ *ITC 49* (1926) 2 SATC 122 NA.

⁴¹² *Ibid.*

⁴¹³ *Ibid.*

⁴¹⁴ 6 SATC 259.

⁴¹⁵ *ITC 233* 6 SATC 259.

⁴¹⁶ *Ibid.*

⁴¹⁷ *Ibid.*

⁴¹⁸ *Ibid.*

⁴¹⁹ 1965 (1) SA 507 (SRAD), 27 SATC 1.

⁴²⁰ *COT v Cathcart* 1965 (1) SA 507 (SRAD), 27 SATC 1.

⁴²¹ *Ibid.*

⁴²² *Ibid.*

⁴²³ *Ibid.*

⁴²⁴ *Ibid.*

opposed the claim but after consulting with his legal counsel he made an out-of-court settlement.⁴²⁵ The taxpayer agreed to pay damages and costs.⁴²⁶ The taxpayer sought to deduct the damages and costs from his taxable income.

The issue which came before the court was whether or not the taxpayer would be entitled to claim a deduction for damages and costs.⁴²⁷ This was an appeal case in which the Commissioner was appealing against the decision of the court *a quo*.⁴²⁸ The Commissioner contended that the taxpayer failed to prove that the expenditure was wholly and exclusively incurred for the purposes of the taxpayer's trade.

The court interpreted section 13(2)(a) (which is substantially identical to the section 11(a) of the South African Income Tax Act).⁴²⁹ The learned judge, Lewis AJA, was of the opinion that the correct interpretation of section 13(2)(a) was found in the case of *COT v Rendle*. In *COT v Rendle*⁴³⁰ two types of expenditures were described, which were incurred for the purposes of trade. The first type was voluntary expenditure which was spent by the taxpayer for the purpose of his trade.⁴³¹ The second type was involuntary expenditure which was spent because of mischance or misfortune which had overtaken the taxpayer.⁴³² The learned judge stated that the contingent liability to pay damages if a misfortune has happened was *bona fide* undertaken for the purposes of earning an income.⁴³³ Lewis AJA further stated that if a taxpayer undertakes a risk of incurring liability in a contract, when that risk occurs and the expenditure has been incurred and the expenditure is closely connected to the taxpayer's business operation, that it would be proper, natural or reasonable to regard it as part of the cost of performing the business operation.⁴³⁴

In its reasoning, the court stated that the fact that architects do not give guarantees is irrelevant.⁴³⁵ Lewis AJA stated that in cases where an architect gives a guarantee in order to secure work which earned his income, such guarantee carried with it the inherent risk that the

⁴²⁵ *Ibid.*

⁴²⁶ *Ibid.*

⁴²⁷ *Ibid.*

⁴²⁸ *Ibid.*

⁴²⁹ *COT v Cathcart* 1965 (1) SA 507 (SRAD), 27 SATC 1.

⁴³⁰ 1946 AD 157 at 163.

⁴³¹ *COT v Cathcart* 1965 (1) SA 507 (SRAD), 27 SATC 1.

⁴³² *COT v Cathcart* 1965 (1) SA 507 (SRAD), 27 SATC 1 at 508.

⁴³³ *Ibid.*

⁴³⁴ *Ibid.*

⁴³⁵ *Ibid.*

income might be diminished by the cost of fulfilling that guarantee.⁴³⁶ The expenditure would be deductible if the risk materialised and the cost was actually incurred.⁴³⁷ The taxpayer also has to prove that the expenditure was so closely connected with the business operations that it would be reasonable to regard it as part of the cost of performing the operations.⁴³⁸ The taxpayer gave a guarantee that the building would be free from defects.⁴³⁹ Therefore, if defects occur in the building, the cost of restoring the building would be deductible.⁴⁴⁰ The court reiterated the assertion that was made in the *Rendle* case; it stated that the Commissioner should not direct how the taxpayer conducts his business. The court found that it was irrelevant to enquire whether or not the taxpayer was running his business efficiently.⁴⁴¹ The court disallowed the claim because the taxpayer paid the damages in question not in pursuance of a legal liability to pay.⁴⁴² The taxpayer was not liable to pay the damages, but he paid the damages in order to prevent the expense of litigation.⁴⁴³ The learned judge found that the expenditure was not incurred for the purposes of producing income since it was incurred for the purposes of avoiding litigation.⁴⁴⁴ The court held that the taxpayer failed to prove on a balance of probabilities that he was liable to pay the damages.⁴⁴⁵

In light of the above discussion, it can be submitted that damages can only be deductible if they were incurred in the production of income and if they were expended for the purposes of trade. The taxpayer has to prove that the act which caused the payment of damages is attached to its income earning operations. There has to be a sufficiently close connection between the expenditure and the income earning operations.

The payment of damages is usually accompanied by the payment of legal costs. The next section of the chapter will discuss the deductibility of associated legal costs.

4.3 Case law relating to deductibility of associated legal costs

The deductibility of associated legal costs is dependent upon the deductibility of damages. Section 11(c)(i) provides that legal costs will only be deductible if the damages or

⁴³⁶ *Ibid.*

⁴³⁷ *Ibid.*

⁴³⁸ *Ibid.*

⁴³⁹ *Ibid.*

⁴⁴⁰ *Ibid.*

⁴⁴¹ *COT v Cathcart* 1965 (1) SA 507 (SRAD), 27 SATC 1 at 508.

⁴⁴² *Ibid.*

⁴⁴³ *Ibid.*

⁴⁴⁴ *Ibid.*

⁴⁴⁵ *Ibid.*

compensation are deductible under section 11(a).⁴⁴⁶ The damages or compensation must have been incurred in the production of income. The taxpayer has to prove that the damages were incurred in the production of income in order to be allowed a deduction for associated legal costs. To clarify, the legal costs which are important for the purposes of this research are legal costs associated with the claim for damages or compensation, and not legal costs in general. A case which explains the deductibility of associated legal costs is *ITC 1837*.⁴⁴⁷ The taxpayer was a Premier of a province in South Africa.⁴⁴⁸ A former member of the taxpayer's cabinet raised allegations of corruption and mismanagement in the governance of the province.⁴⁴⁹ As a result of these allegations, the taxpayer called a press conference to defend himself and the reputation of the Provincial government.⁴⁵⁰ The taxpayer made certain remarks against the person who raised the allegations of corruption and mismanagement.⁴⁵¹ The taxpayer was sued for defamation of character and he paid compensation to that individual.⁴⁵² The Premier paid R35 000 for the damages claimed, however the legal costs were far in excess the judgment amount and the taxpayer had to pay the amount of R451 952.⁴⁵³ The taxpayer sought to claim the legal costs under section 11(c) of the Act.⁴⁵⁴ The issue which came before the court was whether or not the legal expenses would be deductible under section 11(c) of the Act.⁴⁵⁵ Hence, the onus was placed on the taxpayer to prove that the expenses had been incurred "in respect of any claim, dispute or action at law arising in the course of or by reason of the ordinary operations undertaken in the carrying on of trade".⁴⁵⁶ The other enquiry was to determine whether or not the damages paid by the taxpayer were deductible in terms of section 11(a) of the Act.⁴⁵⁷

The court found that the claim for damages arose during the course and scope of the taxpayer's employment as a Premier.⁴⁵⁸ Moreover, the court held that at the time the defamatory statement was made, the taxpayer was discharging his duties as the Premier and

⁴⁴⁶ Income Tax Act 58 of 1962.

⁴⁴⁷ (2009) 17 SATC 177.

⁴⁴⁸ *ITC 1837* (2009) 17 SATC 177.

⁴⁴⁹ *ITC 1837* (2009) 17 SATC 177.

⁴⁵⁰ *Ibid.*

⁴⁵¹ *Ibid.*

⁴⁵² *Ibid.*

⁴⁵³ *Ibid.*

⁴⁵⁴ *Ibid.*

⁴⁵⁵ *Ibid.*

⁴⁵⁶ Section 11(c) of the Income Tax Act 58 of 1962.

⁴⁵⁷ *ITC 1837* (2009) 17 SATC 177.

⁴⁵⁸ *Ibid.*

political head of the Government of the province.⁴⁵⁹ In that regard, the court found that the defamation claim was sufficiently closely linked to the taxpayer's trading operations.⁴⁶⁰ The legal costs incurred in defending the claim arose as a result of the taxpayer's trade.⁴⁶¹ The court went on to establish that there was a sufficient causal connection between the taxpayer's trade and the defamation action.⁴⁶² Therefore the damages were held to be deductible.⁴⁶³ Having established that the damages were deductible in terms of section 11(a) of the Act, the court held that the legal costs were also deductible. Subsection 11(c)(ii) imposes a further requirement on the deductibility of associated legal costs. The expenditure can only be deducted if the claim for damages had been deductible in terms of section 11(a). To elaborate further, the damages must have been incurred in the production of income for the associated legal costs to qualify as a deduction in terms of section 11(c). The court found that the risk of incurring liability was inseparable from the taxpayer's trading operations. The court held that politicians are public figures. They are often required to take a stance on certain issues of public concern and the possibility of making defamatory statements is an inherent risk associated with the profession.⁴⁶⁴ The court allowed the deduction of associated legal costs.

Another case which illustrates the relationship between section 11(a) and 11(c) is *ITC 1310*.⁴⁶⁵ In this case, the court allowed deduction of damages and associated legal costs. The taxpayer was an accountant and he incurred damages and legal costs while opposing arbitration proceedings.⁴⁶⁶ The taxpayer violated a restraint of trade agreement that he had entered upon earlier with his partners.⁴⁶⁷ In terms of this agreement the retiring partner was restricted for two years from the date of termination of the partnership, to practice within a radius of 42 miles.⁴⁶⁸ The issue which came before the court was whether or not the damages and associated legal costs were deductible in terms of the Act.⁴⁶⁹ The court found that the damages were acceptable as a deduction in terms of section 11(a). The court allowed the deduction of legal costs on the basis that the damages were acceptable in terms of section

⁴⁵⁹ *Ibid.*

⁴⁶⁰ *Ibid.*

⁴⁶¹ *Ibid.*

⁴⁶² *Ibid.*

⁴⁶³ *Ibid.*

⁴⁶⁴ (2009) 17 SATC 177 at 185 para 16.

⁴⁶⁵ (1979) 42 SATC 177 (NC).

⁴⁶⁶ *1310* (1979) 42 SATC 177 (NC).

⁴⁶⁷ *Ibid.*

⁴⁶⁸ *Ibid.*

⁴⁶⁹ *Ibid.*

11(a).⁴⁷⁰ The deduction of legal costs was allowed in terms of section 11(c).⁴⁷¹ The court found that the associated legal costs were incurred during the course of the taxpayer's trade as an accountant.⁴⁷² Moreover, the opposition to the arbitration proceedings was motivated by the dominant purpose to earn income.

This section of the chapter has shown that the deduction of damages is related to the deduction of the associated legal costs. Associated legal costs are only deductible in terms of section 11(c) if the damages had qualified as a deduction under section 11(a). The taxpayer has to prove that the damages were incurred in the production of income and that they were expended for the purposes of trade.

The next section of the chapter will address the question whether or not the issue of fault affects the deductibility of damages and associated legal costs.

4.4 The issue of negligence and the deductibility of damages and associated legal costs

The question which needs to be addressed in this section is whether or not negligence is a relevant consideration in assessing the deductibility of damages and associated legal costs. This question emanated from the *obiter* remark which was made by Watermeyer AJP in the *Port Elizabeth Tramway*⁴⁷³ case. The learned judge stated that "if the act done is unlawful or negligent and the attendant expense is occasioned by the unlawfulness or, possibly, the negligence of the act, then it would probably not be deductible." This *obiter* remark seems to suggest that if the act which caused the expenditure was unlawful or negligent the expenditure would not have been deductible.

Watermeyer AJP cited two English cases which supported the proposition that if expenditure is occasioned by an act of unlawfulness or negligence in carrying on the business operations, it is not deductible. The first case which provides authority for that opinion is *CIR v Van Glehn and Co Ltd*,⁴⁷⁴ In this case a trader was trading with an enemy during the course of his business. The trader was fined for trading with an enemy. Moreover, when the trader sought to deduct the fine from his taxable income it was disallowed. The court held that the taxpayer could not deduct the fine. In terms of South African law this fine would not

⁴⁷⁰ *Ibid.*

⁴⁷¹ *Ibid.*

⁴⁷² *Ibid.*

⁴⁷³ *Port Elizabeth Electric Tramway Co Ltd v CIR* 1936 CPD 241 at 246.

⁴⁷⁴ 1920 (2) KB 553.

presently be deductible because of the introduction in 2005 of section 23(o) of the Income Tax Act⁴⁷⁵, which prohibits the deduction of any fine charged for contravention of the law.⁴⁷⁶

The second case which was cited by Watermeyer AJP in the *Port Elizabeth Tramway* case is *Strong & Co Romsey Ltd v Woodifield*⁴⁷⁷. In this case, an innkeeper incurred liability towards a guest in his inn as a result of a chimney which had collapsed. The court held that this expense was not deductible. The facts of the case were as follows: the taxpayer company owned an inn. One of the guests in the inn was injured by the fall of a chimney. The chimney collapsed due to the negligence of the company's employees. The taxpayer was sued and had to pay damages to the customer. The taxpayer sought to deduct the damages from its taxable income. The court held that the taxpayer was not entitled to a deduction although the loss was incurred in the course of the taxpayer's trade. Lord Davey found that the loss was not expended for the purposes of trade. The learned judge was of the opinion that the words "for the purposes of trade" must be interpreted to mean for the purposes of enabling a taxpayer to carry on and earn profits in the trade. From the judgment itself it appears that the issue of fault did not play any part in disallowing the deduction. The court did not disallow the loss because the expenditure was incurred due to the negligence of the taxpayer's employees.

The sentiments expressed by Watermeyer AJP in both the *Port Elizabeth Tramway* and *Joffe* cases seem to point out that if expenditure is occasioned by unlawfulness or negligence it will not be deductible. From his *obiter* remark, in *Port Elizabeth Tramway* case the learned judge stated that if expenditure is incurred by negligence or an unlawful act it would probably not be allowed. In the *Joffe* case Watermeyer CJ disallowed the deduction of damages and legal costs because the taxpayer did not prove that the negligence which caused the expenditure was a necessary concomitant of the taxpayer's business. The learned judge found authority in two English cases *Strong & Co Romsey Ltd v Woodifield* and *CIR v Van Glehn and Co Ltd*. Unfortunately these two cases did not clearly provide authority on the deductibility of damages incurred as a result of negligence or an unlawful act. The *obiter* remark in *Port Elizabeth Tramway* case cannot be relied on since it is not binding. And the *Joffe* case only

⁴⁷⁵ Section 23(o) of the Income Tax Act 58 of 1962 disallows any expenditure incurred—

(i) where the payment of that expenditure or the agreement or offer to make that payment constitutes an activity contemplated in Chapter 2 of the Prevention and Combating of Corrupt Activities Act, 2004 (Act No. 12 of 2004); or

(ii) which constitutes a fine charged or penalty imposed as a result of an unlawful activity carried out in the Republic or in any other country if that activity would be unlawful had it been carried out in the Republic.

⁴⁷⁶ Section 23(o) of the Income Tax Act.

⁴⁷⁷ 1906 AC 448.

pointed out that there was no evidence in that particular case that negligence was a necessary concomitant of the taxpayer's business. Hence, the *Joffe* case did not provide authority for the view that if expenditure is incurred by negligence or an unlawful act it is not deductible.

Kruger and Scholtz argue that the deductibility of damages or compensation has never quite recovered from the jerky start in the *Port Elizabeth Tramway* case.⁴⁷⁸ The *Port Elizabeth Tramway* case did not provide clarity for the position of the law regarding the deductibility of expenditure incurred as a result of negligence or an unlawful act. The learned judge Watermeyer AJP did not investigate whether or not there was fault on the part of the taxpayer. Williams argued that the reason why Watermeyer AJP did not enquire whether or not such motor accidents were inevitable concomitants of a tramway company is that the learned judge had already identified the act which entailed the expenditure as the employment of drivers.⁴⁷⁹ Hence, it was irrelevant to investigate whether or not the motor accidents were an inherent risk of conducting a tramway business.⁴⁸⁰

Williams was not persuaded by the reasoning of Watermeyer AJP in the *Joffe* case on the issue of negligence. Furthermore, Williams argued that the damages in question were incurred as a result of human error and posed the question as to whether a court requires evidence that error and negligence are inevitable in all human beings.⁴⁸¹ Williams was of the opinion that the question should be whether a particular hazard is an inherent risk of the taxpayer's business as a concrete engineer and not, as suggested by Watermeyer CJ, whether or not the taxpayer conducts its business in a way which would be likely lead to accidents.⁴⁸²

According to Emslie *et al*, Watermeyer CJ seemed to have adopted a strict approach to the deduction of damages.⁴⁸³ The *Joffe* case seems to have been based on public policy and that no deduction should be allowed if it has been caused by negligence. Emslie *et al* submitted that this approach is unduly harsh.⁴⁸⁴ Arguably, traders do not deliberately conduct their business in a negligent manner.⁴⁸⁵ In many professions, such as medical practitioners, people insure themselves against liability for negligence and the premiums are usually allowed as tax

⁴⁷⁸ Kruger, D and Scholtz, W (2003) *Broomberg on Tax Strategy 4 ed* at 223.

⁴⁷⁹ Williams *Income Tax in South Africa Cases & Materials* at 373.

⁴⁸⁰ *Ibid.*

⁴⁸¹ *Ibid.*

⁴⁸² *Ibid.*

⁴⁸³ Emslie, T.S *et al* (1995). *Income Tax Cases and Materials 2 ed* at 558.

⁴⁸⁴ *Ibid.*

⁴⁸⁵ *Ibid.*

deductions.⁴⁸⁶ Taxpayers are human and negligent acts may occur even if the taxpayer had tried to prevent the eventuality from happening.⁴⁸⁷ Emslie *et al* stated that negligence is an ever-present risk in certain professions or trades and it can be regarded as an inevitable concomitant of carrying on that trade or business.⁴⁸⁸

In *ITC 658*⁴⁸⁹ the court considered the issue of fault as a relevant consideration in disallowing a deduction. The taxpayer was a partner in a firm of building contractors.⁴⁹⁰ The firm was contracted by a company to build a block of flats according to the company's specifications.⁴⁹¹ The firm completed the building and handed it over to the company. After a considerable time the external walls of the building started revealing dampness.⁴⁹² It was later discovered that the building was not built according to the company's specifications.⁴⁹³ The company sued for damages against the firm.⁴⁹⁴ The firm opposed the action but later settled without admission of guilt.⁴⁹⁵ The taxpayer sought to deduct the expenditure from his taxable income.

The court stated that the departure from the specifications was either wilful or negligent.⁴⁹⁶ In reaching its conclusion the court relied on the *Port Elizabeth Tramway* case; in that case Watermeyer AJP stated *obiter* that if expenditure is caused by negligence or an unlawful act it would probably not be deductible.⁴⁹⁷ The court also made reference to the judgment of Watermeyer CJ in the *Joffe* case; in that case the court disallowed the deduction of damages because there was no evidence which suggested that the negligence which caused the expenditure was a necessary concomitant of the taxpayer's business.⁴⁹⁸ The court also found that in the present case there was nothing to suggest that the negligence in observing the details of the plans and specifications and the consequent liability are necessary concomitants of the trading operations of a building contractor.⁴⁹⁹ The court disallowed the deduction of expenditure because it had not been incurred in the production of income. The court seems to

⁴⁸⁶ *Ibid.*

⁴⁸⁷ *Ibid.*

⁴⁸⁸ *Ibid.*

⁴⁸⁹ (1948) 15 SATC 498.

⁴⁹⁰ *ITC 658* (1948) 15 SATC 498.

⁴⁹¹ *Ibid.*

⁴⁹² *ITC 658* (1948) 15 SATC 498.

⁴⁹³ *Ibid.*

⁴⁹⁴ *Ibid.*

⁴⁹⁵ *Ibid.*

⁴⁹⁶ *Ibid.*

⁴⁹⁷ *Port Elizabeth Electric Tramway Co Ltd v CIR* 1936 CPD 241 at 246.

⁴⁹⁸ *Joffe and Co (Pty) Ltd v CIR* 1946 AD 157, 13 SATC 354.

⁴⁹⁹ *ITC 658* (1948) 15 SATC 498.

have followed the reasoning of Watermeyer CJ in both the *Port Elizabeth Tramway* and the *Joffe* cases in disallowing expenditure on the basis of having been incurred as a result of negligence.

The issue of fault was also discussed in *ITC 1837*.⁵⁰⁰ In this case, the court allowed deduction of legal expenditure which had been incurred by the taxpayer in defending a defamation action. The learned judge, van Reenen J, seems to have clarified the position of the law in terms of the deductibility of expenditure incurred by a negligent act.⁵⁰¹ The learned judge stated that in the *Joffe* case the court did not state that if an expenditure is incurred as a result of a negligent act it is not deductible, but it held that the negligence in that case was not an inevitable concomitant of the taxpayer's business. There was no evidence which suggested that the negligence which caused the expenditure was a necessary concomitant of the taxpayer's business. On the issue of fault, the court relied in its decision on the case of *Commissioner for the South African Revenue Service v Thor Chemicals SA (Pty) Ltd*.⁵⁰² The court stated that in the *Thor Chemicals* case it was established that fault is not a relevant consideration in assessing the deductibility of damages and associated legal costs. In the *Thor Chemicals* case the court allowed the deduction of legal expenditure incurred by the taxpayer. The taxpayer company incurred legal expenditure in defending an action against it, which arose as result of mercury poisoning of its employees. In the *Thor Chemicals* case the court also stated that the *Joffe* case did not provide authority that expenses are only deductible if the taxpayer has proved that they were not incurred as a result of negligence or an unlawful act.

In *ITC 815*,⁵⁰³ Roper J held that negligence must not be used as a reason to disallow a deduction. The court held that there is no reason in principle why it should make a difference whether the negligence is that of the employer or the employee. The learned judge stated that:⁵⁰⁴

Negligence is an element of inefficiency, and an inefficient taxpayer is taxed upon the income which he actually earns and not upon that which he should have earned had he been efficient. Whether or not a loss caused by negligence would be deductible would depend upon the facts of the particular case and upon such

⁵⁰⁰ (2009) 17 SATC 177.

⁵⁰¹ *Ibid.*

⁵⁰² (2000) 62 SATC 308 (N).

⁵⁰³ (1955) 20 SATC 487 (T) at 492.

⁵⁰⁴ *Ibid.*

matters as the nature and degree of the negligence and the character of the business.

From the above *dictum* of Roper J, it can be argued that court must not enquire into the way the taxpayer conducts its business.⁵⁰⁵ The taxpayer is supposed to be taxed on the income that it receives and not on the income that it ought to have received.⁵⁰⁶ Therefore, it does not matter whether the taxpayer has been conducting its business efficiently or not.⁵⁰⁷ In that regard, negligence does not play any role in disallowing the deduction. In reaching its conclusion, the court cited *Port Elizabeth Tramways v Commissioner for Inland Revenue*, *Joffe and Company v Commissioner for Inland Revenue*, *Lockie Brothers Ltd. v Commissioner for Inland Revenue* and *Strong and Co. Ltd. v Woodifield*. The learned judge stated that the *Port Elizabeth Tramway* case cannot be used as authority for disallowing expenditure on the basis of the fact that the expenditure was caused by negligence or an unlawful act.⁵⁰⁸ Roper J contended that Watermeyer's *obiter* remark cannot be used as authority to disallow a deduction. In addition, the court examined the *Joffe* case and Roper J held that the *Joffe* case did not establish that if expenditure is incurred as a result of negligence it is not deductible.⁵⁰⁹ In the *Joffe* case Watermeyer CJ stated there was no evidence which suggested that the negligence which caused the expenditure was a necessary concomitant of the taxpayer's business operation.⁵¹⁰ Roper J stated that the deductibility of losses should not be based on whether or not they were incurred as a result of negligence. Each case has to be treated on its own merits.⁵¹¹

This section of the chapter has established that the issue of negligence is a consideration, but not necessarily a reason for disallowing the deduction. It can be submitted that a taxpayer may not be taxed on what he ought to have earned but on what he actually earned.⁵¹² Therefore, the issue of negligence may affect the deductibility of damages and associated legal costs, depending on the facts and circumstances of the case. It can be submitted that the *Joffe* case did not provide authority to the proposition that if expenditure is incurred as a result of negligence it is not deductible. It has been observed that the taxpayer in the *Joffe* case lost the

⁵⁰⁵ *ITC 815* (1955) 20 SATC 487 (T) at 492.

⁵⁰⁶ *Ibid.*

⁵⁰⁷ *ITC 815* (1955) 20 SATC 487 (T) at 492.

⁵⁰⁸ *Ibid.*

⁵⁰⁹ *Ibid.*

⁵¹⁰ *Ibid.*

⁵¹¹ *Ibid.*

⁵¹² *ITC 815* (1955) 20 SATC 487 (T) at 492.

case because it failed to prove that accidents of that nature were an inherent risk to its trading operations.⁵¹³

4.5 Conclusion

From the analysis presented in this chapter it can be submitted that the deduction of damages and associated legal costs is mainly dependent upon meeting the requirements of the general deduction formula. The main, and an onerous requirement, in the deduction of damages and associated legal costs is that the expenditure must have been “incurred in the production of income.”⁵¹⁴ The *Port Elizabeth Tramway* case is the leading case on the interpretation of the phrase “in the production of income”.⁵¹⁵ The first test is a subjective test; it considers whether or not the act which entailed the expenditure was performed for the purposes of producing income. The second test is an objective enquiry and considers whether there is a sufficiently close link between the expenditure and the act such that it may be regarded as part of the cost of performing it. This chapter also considered whether or not the issue of fault (particularly negligence) is a relevant consideration in the deduction of damages and associated legal costs. The current position of law is that fault is not a relevant consideration in the deduction of damages and associated legal costs. In *ITC 1837*, *ITC 815* and the *Thor Chemicals case* it was established that the deduction of damages is not affected by how the taxpayer conducts his/her business. The taxpayer is not taxed on the income that it ought to have earned, but on the income that it actually earned.⁵¹⁶ Therefore there is no need to enquire into efficacy of the taxpayer’s trading operations.

The following concluding chapter will provide a summary of what a taxpayer needs to prove in order to secure a deduction for damages and the associated legal costs. The chapter will demonstrate how the discussion provided in the preceding chapters addressed the stated goals of the research.

⁵¹³ Williams *Income Tax in South Africa Cases & Materials* at 373.

⁵¹⁴ Section 11(a) of the Income Tax Act 58 of 1962.

⁵¹⁵ *Port Elizabeth Electric Tramway Co Ltd v CIR* 1936 CPD 241.

⁵¹⁶ *ITC 815* (1955) 20 SATC 487 (T) at 492.

CHAPTER 5 – CONCLUSION

5.1 Goals of the research

The deductibility of damages is governed by section 11(a) read in conjunction with section 23(g) of the Income Tax Act.⁵¹⁷ The preamble to section 11 and section 11(a) provides for what may be deducted and section 23(g) provides for what may not be deducted. This constitutes what is referred to as the “general deduction formula”.⁵¹⁸ In order for damages to be deductible they must meet the requirements of the general deduction formula. The legal costs associated with the payment of damages was initially (at the time of the *Port Elizabeth Tramway* case) to be considered in terms of section 11(a), but subsequent to the unsuccessful claim for a deduction by the taxpayer, section 11(c) was introduced into the Act. The deduction of the legal costs associated with the payment of damages is subject to the damages being deductible in terms of section 11(a) (proviso (ii) to section 11(c)).

There is a degree of uncertainty with regard to the deductibility of damages. Courts have allowed deduction of damages in certain cases and in other cases not. In certain cases the courts have considered the issue of fault in determining whether or not an expenditure or loss should be deducted. Certain judgments appear to suggest that if an expenditure or loss is incurred as a result of a negligent or an unlawful act it is not deductible. On the other hand, in some judgments, the courts disregarded the issue of fault as a relevant consideration in disallowing a deduction.

The main research goal of this thesis was to investigate under which circumstances a payer of damages and associated legal costs is able to claim a deduction from his/her taxable income. In achieving this goal, the thesis first discussed the phrase “in the production of income”. The requirement that expenditure or a loss must be incurred in the production of income imposes a burden on the taxpayer to prove that the expenditure was incurred for the purposes of producing income. The Act does not provide a definition of the phrase “in the production of income”. In the second chapter it was demonstrated that in order for damages to be deductible they must have been incurred in the production of income. The leading authority on the deduction of damages and associated legal costs is the *Port Elizabeth Tramway* case. The court developed a twofold test which can be used in determining whether or not expenditure is

⁵¹⁷ Income Tax Act 58 of 1962.

⁵¹⁸ *Ibid.*

deductible.⁵¹⁹ The first enquiry looks at whether the act which caused the expenditure was incurred for the purposes of producing income.⁵²⁰ The second enquiry looks at whether the expenditure is so closely connected to the act that it may be regarded as part of the cost of performing it.⁵²¹ In the *Joffe* case, it was held that the taxpayer has to prove that the expenditure was a necessary concomitant of the taxpayer's trading operations.⁵²²

In *CIR v Standard Bank of SA Ltd*,⁵²³ it was held that in determining whether or not the expenditure was incurred in the production of income, the court must enquire into the purpose of the expenditure and what the expenditure actually affects. The taxpayer has to prove that the expenditure was expended for the purposes of producing income. In the *Sub-Nigel* case it was stated that the phrase "in the production of income" does not mean that in order for expenditure to be deductible it must have produced part of the income for that year of assessment. According to Kruger and Scholtz, Watermeyer AJP's interpretation of the phrase "in the production of income" in *Port Elizabeth Tramway* case was too mechanical and contrived.⁵²⁴ Kruger and Scholtz further contend that if Watermeyer AJP had used the test which was laid down by Mason J in the *Lockie Bros* case, both taxpayers in the *Port Elizabeth Tramway* and *Joffe* cases would have been allowed a deduction from their taxable income. In the *Lockie Bros* case, Mason J stated that an expense would be deductible if it was incurred in the course of or by reason of the ordinary operations undertaken by the taxpayer in carrying on of his trade.⁵²⁵ Goldswain contends that the test which was laid down by Mason J in the *Lockie Bros* case is not as wide as suggested by Kruger and Scholtz.⁵²⁶ The interpretation of the phrase "in the production of income" in the *Lockie Bros* case does not cover losses arising as a result of the embezzlement of funds by a senior manager of the taxpayer. It was held in the *Lockie Bros* case that the loss was incurred as a result of a senior manager and was not incurred for the taxpayer's business operation.⁵²⁷ Furthermore, Goldswain submits that the absurd result of the test can be shown in the *Rendle* case. In *Rendle*, a clerk who was working

⁵¹⁹ *Port Elizabeth Electric Tramway Co Ltd v CIR* 1936 CPD 241.

⁵²⁰ *Ibid.*

⁵²¹ *Port Elizabeth Electric Tramway Co Ltd v CIR* 1936 CPD 241.

⁵²² *Joffe & Co Pty Ltd v CIR* 1946 AD 157, 13 SATC 354.

⁵²³ 47 SATC 179, 1985 (4) SA 485 (A).

⁵²⁴ Kruger D and Scholtz W *Broomberg on Tax Strategy 4 ed* (2003) at 223.

⁵²⁵ *Lockie Bros Ltd v CIR* 1922 TPD 42, 32 SATC 150.

⁵²⁶ Goldswain, G.K and Swart, O. (2015). *The Port Elizabeth Tramway case: Is the meaning ascribed to the phrase "in the production of income" by Watermeyer AJP in Port Elizabeth Tramway case still religiously followed today?* South African Business Review Special Edition Tax Stories at 80.

⁵²⁷ *Lockie Bros Ltd v CIR* 1922 TPD 42, 32 SATC 150.

for a firm embezzled money from clients and the firm.⁵²⁸ The court allowed the deduction of money embezzled by the clerk belonging to two clients but disallowed the deduction of money embezzled by the same employee from the firm.⁵²⁹

Goldswain holds the view that the Supreme Court of Appeal has widened the meaning of the phrase “in the production of income” in the *Mobile Telephone Network* case.⁵³⁰ The court allowed the deduction of audit fees as expenditure incurred in the production of income.⁵³¹

The deductibility of damages and associated legal costs is related. Section 11(a) provides for the deductibility of damages, whilst section 11(c) provides for the deductibility of associated legal costs. Legal costs which are incurred in defending a damages claim are only deductible under section 11(c) if the damages qualify as a deduction under section 11(a). Therefore, the taxpayer has to prove that the damages were incurred in the production of income.

Fault is not a relevant consideration in the deductibility of damages and associated legal costs. The issue of whether or not fault is a relevant consideration emanated from the *obiter* remark which was made by Watermeyer AJP in the *Port Elizabeth Tramway* case. In this case the learned judge seems to have suggested that if expenditure is incurred as a result of an unlawful or negligent act it is not deductible. The learned judge found authority in two English cases which supported the fact that if expenditure is occasioned by an act of unlawfulness or negligence it is not deductible.⁵³² In the *Joffe* case, Watermeyer CJ stated that the negligence which caused the expenditure was not an inevitable concomitant of the taxpayer’s trading operations. The *Port Elizabeth Tramway* case and the *Joffe* case created uncertainty as to the deductibility of damages which had been incurred as a result of negligence or an unlawful act. As mentioned in Chapter Four, the *obiter* remark which was made by Watermeyer in the *Port Elizabeth Tramway* case is not binding and it cannot be relied on. In the *Joffe* case it can be argued that the taxpayer failed to discharge the onus that such negligence was a necessary concomitant of the taxpayer’s business operations and therefore failed to obtain a deduction.

⁵²⁸ 1965 (1) SA 59 (SARD), 26 SATC 326.

⁵²⁹ *Ibid.*

⁵³⁰ Goldswain, G.K and Swart, O.(2015). *The Port Elizabeth Tramway case: Is the meaning ascribed to the phrase “in the production of income” by Watermeyer AJP in Port Elizabeth Tramway case still religiously followed today?* South African Business Review Special Edition Tax Stories at 72.

⁵³¹ *CSARS v Mobile Telephone Network Holdings (Pty) Ltd* 2014 (5) SA 366 (SCA).

⁵³² Watermeyer AJP cited *CIR v Van Glehn and Co Ltd* 1920 (2) KB 553 and *Strong & Co Romsey Ltd v Woodifield* 1906 AC 448.

This decision cannot therefore be regarded as authority for a claim that the incidence of negligence would prevent the deduction of the damages.

Subsequent judgements seem to have clarified the deductibility of damages which have been incurred as a result of a negligent or unlawful act. It has been held that the deductibility of damages is not affected by whether or not the act which caused the expenditure was as a result of negligence or an unlawful act. In *ITC 1837* and the *Thor Chemicals* case, it was held that the *Joffe* case did not provide authority for the conclusion that if expenditure is incurred as a result of a negligent act it is not deductible. In the *Joffe* case it was stated that there was no evidence which suggested that the negligence which caused the expenditure was a necessary concomitant of the taxpayer's business operations. Roper J, in *ITC 815*, stated that negligence must not be used as a reason to disallow a deduction. In *ITC 815*,⁵³³ it was stated the taxpayer must be taxed on what it receives and not on the income that it ought to have received. Hence, there is no need to enquire into the business efficacy of the taxpayer's business operations. It can be submitted that negligence is not a relevant consideration in the deductibility of damages and associated legal costs.

5.2 Onus of proof

In any litigation the onus of proof plays a crucial role. The court does not have to investigate the disputed facts; the parties themselves have to prove their own version by placing evidence before the court. Section 102(1)(b) provides that a taxpayer bears the onus of proving that an amount is deductible or may be off-set.⁵³⁴ This provision seems to imply that if a taxpayer fails to prove on a balance of probabilities that an amount is deductible, the judgement will be entered in favour of the Commissioner. Of critical importance in the present research is what a taxpayer needs to prove in order to claim deduction for damages and the associated legal costs. The following principles emerge from the discussion of case law on the deductibility of damages and associated legal costs. The taxpayer must prove that the expenditure was:

- (a) attached to the performance of income-earning operations;
- (b) was *bona fide* incurred for the purposes of producing income;
- (c) was laid out or expended for the purposes of trade; and that

⁵³³ (1955) 20 SATC 487 (T) at 492.

⁵³⁴ Income Tax Act 58 of 1962.

- (d) there is a sufficient and close link between the expenditure and the income-earning operations such that it would be proper, natural or reasonable to regard the expense as part of the costs of the performance; and
- (e) that the risk of having to pay damages is a necessary concomitant of the taxpayer's trading operations.

The taxpayer has to satisfy the abovementioned requirements in order to secure a deduction for damages. As discussed above the main onerous requirement in assessing the deductibility of damages is the "in the production of income" requirement. The taxpayer has to prove that the expenditure or loss was incurred in the production of income and it was expended for the purposes of trade. It has been shown in this thesis that the deductibility of damages and the associated legal costs are related. Associated legal costs are only deductible if the damages incurred would have qualified as a deduction under section 11(a).

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