AN ANALYSIS, FROM A SOUTH AFRICAN CASE LAW PERSPECTIVE, OF THE DEDUCTIBILITY OF LOSSES DUE TO EMBEZZLEMENT, FRAUD, THEFT, DAMAGES AND COMPENSATION

A mini thesis submitted in partial fulfilment of the requirements for the degree of

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by

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Declaration

I, Adelaide Gamuchirai Jachi, declare that the work presented in this thesis is my own original work. It has not been presented for a degree in any other university or institution. Where other people's works have been used, it is specifically indicated otherwise by way of acknowledgement, accompanied by the appropriate references. It is hereby submitted in partial fulfilment of the requirements for the award of the Master of Commerce (Taxation) of Rhodes University.

Signature: ……………………………………………………………

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Abstract

When calculating the income tax payable for a year of assessment, a taxpayer deducts from his or her or its income, allowable deductions in terms of the preamble to section 11 and section 11(a) as read with section 23(g) of the Income Tax Act, 58 of 1962. Amongst the expenditure and losses incurred by a taxpayer during a year of assessment, a claim may be sought for the deduction of losses incurred due to embezzlement, fraud and theft as well as damages and compensation. The requirements of the preamble and section 11(a) include the requirement that expenditure and losses must be incurred "in the production of the income". Losses incurred due to defalcations, as well as expenditure on damages and compensation must satisfy this requirement to be allowed as deductions. The objective of the research was to analyse the judicial decisions dealing with "in the production of the income" in granting a deduction for income tax purposes in cases dealing with embezzlement, fraud and theft, and damages and compensation, to establish why the courts grant or disallow the deduction of expenditure and losses. A *doctrinal* research methodology was applied to the research. The provisions of the Income Tax Act, relevant case law relating to embezzlement, fraud and theft, and damages and compensation, and the contributions of the revenue authority and tax experts in articles of accredited journals, textbooks and other writings were analysed. The major conclusions drawn from the research were that losses due to defalcations are regarded as having been incurred "in the production of the income" if the taxpayer discharges the onus of proof that the risk of the act leading to misappropriation is an incidental risk of the business. Expenditure on damages and compensation is deductible provided the expense is attached to the performance of a business operation *bona fide* performed for the purpose of earning income and the expense is so closely connected with the business operation as to be regarded as part of the cost of performing it. Where negligence is attached to an expense or loss, the South African courts have held that negligence does not increase the likelihood of disallowing an expense or loss as not having been incurred "in the production of the income".

Key Words: damages and compensation, embezzlement, fraud, theft, "in the production of the income", Section 11(a) of the Income Tax Act.

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CHAPTER 1: INTRODUCTION

1.1. Research context

The general requirements for the successful deduction of an amount from a taxpayer's income, in determining the taxable income, are found in the preamble to section 11 and section 11(a), read with section 23(g) of the Income Tax Act, 58 of 1962 (referred to as "the Income Tax Act"). These sections are referred to as "the general deduction formula". The preamble to section 11, headed "General deductions allowed in determination of taxable income" and section 11(a) state that:

> 11. For the purpose of determining the taxable income derived by any person from carrying on any trade, there shall be allowed as deductions from the income of such person so derived—
>
> (a) expenditure and losses actually incurred in the production of the income, provided such expenditure and losses are not of a capital nature;

The preamble to section 23 headed "Deductions not allowed in determination of taxable income" and section 23(g) state that:

> 23. No deductions shall in any case be made in respect of the following matters, namely—
>
> (g) any moneys, claimed as a deduction from income derived from trade, to the extent to which such moneys were not laid out or expended for the purposes of trade;

For the purposes of the present research, only the following requirement of section 11(a) is relevant: the expenditure or losses must be incurred "in the production of the income". The other requirements are beyond the scope of this research. The Income Tax Act does not provide any explanation of what "in the production of the income" encompasses and therefore it is necessary to consider judicial decisions in which the courts have been required to provide clarity on what the requirement entails. The case law relating to the deductibility of expenditure and losses is extensive, but the present analysis deals only with the court decisions which relate to the deductibility of losses due to embezzlement, fraud and theft, and damages and compensation.

A taxpayer may suffer a loss as a result of defalcations made by his or her or its employees, or as a result of theft, embezzlement or fraud by third parties. According to the South African

Revenue Service (referred to as SARS) (2014:2) the term embezzlement means "the misappropriation of funds entrusted to a person (for example, an employee or trustee) for care or management". The revenue authority also defines fraud as "an unlawful and intentional making of a misrepresentation which causes actual prejudice, or which is potentially prejudicial to another". Theft is described as "the act or crime of stealing money". Stolen money is defined as "money obtained from embezzlement, fraud or theft". Where such acts of embezzlement, fraud or theft have occurred, the taxpayer who has suffered the loss will seek to claim the loss as a deduction. It is necessary to establish the circumstances under which the taxpayer can successfully deduct the losses as having been incurred "in the production of the income".

Taxpayers may also be involved in circumstances where accidents or mishaps may occur, either through their own fault or their employees in consequence of which they are required to pay damages and compensation to the victim. In the Legal Dictionary (Online), damages are defined as a "monetary compensation that is awarded by a court in a civil action to an individual who has been injured through the wrongful conduct of another party". It is further explained that damages attempt to measure in financial terms the extent of harm a complainant has suffered because of a defendant's actions. The Legal Dictionary (Online) defines compensation as "a pecuniary remedy that is awarded to an individual who has sustained an injury in order to replace the loss caused by said injury, such as Workers' Compensation". Costs are defined in the Legal Dictionary (Online) as "the expenses incurred as a result of bringing a lawsuit and which the court may order the losing party to pay". The deduction of such expenditure is also subject to the requirement of having been incurred "in the production of the income". Thus, a case law analysis is undertaken in this thesis of the deductibility of losses due to embezzlement, fraud and theft, and damages and compensation, to establish whether the amounts are regarded as having been incurred "in the production of the income" in terms of section 11(a).

The earliest South African case to provide the meaning of "in the production of the income" was *Lockie Bros Ltd v Commissioner for Inland Revenue*, 1922 TPD 42, 32 SATC 150. The interpretation of the phrase by Mason J (at 151-152) was that deductible expenditure is incurred "in the production of the income" if it is incurred "in the course of and by reason of the ordinary operations undertaken for the purpose of conducting the business of the

taxpayer". In the *Lockie Bros Ltd* case, the taxpayer had incurred a loss from amounts misappropriated by the manager of the company. The court decision did not favour the taxpayer and disallowed the deduction of the loss because the loss was not the result of any operation undertaken for the purposes of the business of the taxpayer company.

In contrast to the decision in the *Lockie Bros Ltd* case is *Income Tax Case 1383*, 46 SATC 90, in which the court arrived at a different conclusion. The taxpayer was a bank. Its secretary made some systematic defalcations and stole an amount of money. In his reasoning, Hill AJ expressed doubt relating to the general applicability of Mason J's decision. The learned judge argued (at 92) that: "It does not appear that Mason J intended to lay down a rule that in any event a loss sustained as a result of theft by a servant in the course of handling operations of the employer's business is not deductible." The court, in *Income Tax Case 1383*, held that the loss was incurred "in the production of the income" because it is necessary for a commercial bank to allow its employees to handle large sums of money in the ordinary course of its business and the risk of theft is an ever-present factor in the administration of its business and must be regarded as inseparable from it.

The manager in the *Lockie Bros Ltd* case was clearly a senior employee. According to Goldswain, Heyns and Wilcocks (2016), the nature of the duties performed by the employee in *Income Tax Case 1383* qualified him as a senior employee of the taxpayer. The employees in the two cases were both in senior positions, but the courts came to different conclusions. Although the *Lockie Bros Ltd* case was authoritative at the time on the deduction of losses due to misappropriations, Mason J's decision did not clearly highlight the distinction between senior employees, junior employees or proprietors in granting a deduction for a loss due to their defalcations.

The decision in *Income Tax Case 1383* established that a loss is incurred "in the production of the income" of the taxpayer if the risk of the theft is inseparable from the taxpayer's business operations, and the loss was allowed as a deduction. The unresolved issue at present is whether losses by the defalcations of senior employees or managers remain disallowed as a deduction. It can be noted that these cases dealt with perpetrations by employees. The courts have not yet dealt with third-party theft. The question also arises as to how the courts would

deal with theft by third parties, applying the approach that there needs to be an inherent risk of the embezzlement, fraud or theft in the taxpayer's business.

In the leading South African case on the meaning of "in the production of the income", *Port Elizabeth Electric Tramway Company Ltd v Commissioner for Inland Revenue*, 1936 CPD 241, 8 SATC 13, Watermeyer AJP established two principles relating to "in the production of income" by raising two questions (at 16), namely: (a) whether the act, to which the expenditure is attached, is performed in the production of income, and (b) whether the expenditure is linked closely enough to it. The taxpayer in the *Port Elizabeth Electric Tramway* case had incurred expenditure on damages and compensation, following the death of one of its employees who was injured in an accident. The court held that the compensation paid was regarded as part of the cost of the company's operations for the purpose of earning income and thus deductible.

According to Kleyn and Viljoen (2010:59), the principle of judicial precedent requires that "the law which was applied to a specific factual situation should be applied to similar situations". Where the facts of the cases are not materially the same, the two cases can be distinguished. The *Lockie Bros Ltd* case concerned the deduction of a loss due to embezzlement of funds by a manager of a business selling rice and can be distinguished from the *Port Elizabeth Electric Tramway* case, which concerned the deduction of expenditure on damages and compensation paid by a taxpayer carrying on a tram car business as a result of an accident involving an employee. The facts and circumstances in the two cases were clearly different. Watermeyer AJP departed from the test applied in the *Lockie Bros Ltd* case and the basis of Watermeyer AJP's decision was the application of the dual test for the "in the production of the income" to the facts of the *Port Elizabeth Electric Tramway* case, which differed from the test applied in the *Lockie Bros Ltd* case.

Ten years later, Watermeyer CJ, as he later became, in *Joffe and Co (Pty) Ltd v Commissioner for Inland Revenue*, 1946 AD 157, 13 SATC 354, gave a different decision in establishing whether the damages paid out by the taxpayer company were expenditure incurred "in the production of the income". The taxpayer company had paid damages and costs relating to an accident which killed one of its plumbers who was working on an uncompleted building. In the *Port Elizabeth Electric Tramway* case, Watermeyer AJP (at 17)

had made an *obiter* remark 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". In the *Joffe and Co (Pty) Ltd* case, he held (at 358) that the expenditure had not been incurred for the purpose of earning income because it had not been established that negligent construction was a "necessary concomitant" of the trading operations of a reinforced concrete engineer. Thus, the damages paid in respect of the accident were not incurred "in the production of the income". Goldwain and Swart (2015) argue that the taxpayers in both cases should have been granted a deduction of the damages because there were similar economic circumstances and the accidents occurred whilst they undertook their business operations. The decision in the *Joffe and Co (Pty) Ltd* case appears to suggest that when a business that is run in a negligent manner by the taxpayer or the taxpayer's employees, this would increase the likelihood of a successful deduction.

The uncertainty created by ostensibly conflicting case law has prompted an analysis of both the facts and the judicial decisions dealing with "in the production of the income" in relation to embezzlement, fraud and theft, and damages and compensation, to establish the reasons why the courts reached different conclusions.

1.2. Goals of the research

The goal of the research was to analyse the judicial decisions dealing with "in the production of the income" in granting a deduction for income tax purposes in cases dealing with embezzlement, fraud and theft, and damages and compensation, to establish reasons why the courts grant or disallow the deduction of expenditure and losses. The following sub-goals were addressed:

(i.) to explore what the requirement "in the production of the income" encompasses in determining the deductibility of expenditure and losses;
(ii.) to analyse and compare the facts and court decisions in the cases dealing with "in the production of the income" in relation to embezzlement, fraud and theft, and damages and compensation, to establish why the court decisions differ in granting or denying a deduction of expenditure and losses; and
(iii.) to conclude on the circumstances under which a taxpayer can successfully deduct an expense or loss as having been incurred "in the production of the income".

1.3. Methods, procedure and techniques

An interpretative research approach was adopted for the present research as it seeks to understand and describe (Babbie & Mouton: 2009). The research methodology applied can be described as a *doctrinal* research methodology. This methodology provides a systematic exposition of the rules governing a specific legal category (in the present case the legal rules relating to the deduction of expenditure and losses incurred "in the production of the income"), analyses the relationships between the rules, explains areas of difficulty and is based purely on documentary data (McKerchar: 2014).

The research was conducted in the form of an extended natural language argument, supported by documentary evidence. The documentary data to be used for the research consisted of:

- legislation (the Income Tax Act);
- relevant case law;
- South African Revenue Service Interpretation Notes, Regulations, Notices, Binding Rulings (which provide clarity regarding the expenditure which the Commissioner allows as deductible expenditure incurred "in the production of the income");
- articles in accredited journals; and
- textbooks and other writings.

The validity and reliability of the research and the conclusions was promoted 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 a preponderance of credible evidence; and
- the rigour of the arguments.

1.4. Ethical Considerations

As all the data are publicly available, no ethical considerations arose in relation to their use. Interviews were not conducted; opinions were considered in their written form. Data was not exaggerated or filtered, or results interpreted to support a specific viewpoint. All sources of data were appropriately acknowledged, and full references provided.

1.5. Overview of the research

The research comprises five chapters. Chapter 1 introduces of the research and describes the uncertainties relating to the requirement that an expense or loss must be incurred "in the production of the income", particularly losses due to embezzlement, fraud and theft and expenditure on damages and compensation. The goals of the research, methods, procedures and techniques applied in the research as well as the ethical considerations are set out in this chapter.

Chapter 2 explores the meaning of the requirement that an expense or loss must be incurred "in the production of the income" for it to be deductible in terms of section 11(a) of the Income Tax Act. Case law that explains what the provision entails is analysed, including the reasoning by the judiciary in formulating the principles applying to the requirement.

In chapter 3, case law dealing with the deductibility of losses due to embezzlement, fraud and theft is examined. A comparison is made of the facts in cases dealing with defalcations by different perpetrators, as well as the judicial decisions, to attempt to determine why the courts came to different decisions. In the process, a brief comparative analysis is undertaken on what the Australian and Zimbabwean courts have considered regarding losses due to embezzlement, fraud and theft as having been incurred "in the production of the income". The Australian statute is similar to the South African Income Tax Act, as stated by Watermeyer CJ (at 358) in the *Joffe and Co (Pty) Ltd* case. The Zimbabwean courts have on occasions also referred to the South African cases relating to the provision.

Chapter 4 examines case law dealing with the deductibility of expenditure on damages and compensation. The analysis is undertaken of the facts of the cases in which taxpayers were successful and unsuccessful in claiming the deduction of damages and compensation, including reasoning of the courts in handing down the decisions. This analysis seeks to

identify the circumstances under which a taxpayer can successfully deduct the damages and compensation as having been incurred "in the production of the income". A comparative analysis is also undertaken of the decisions in cases in relevant foreign jurisdictions in dealing with damages and compensation.

Chapter 5 is the final chapter of the research. It reports the findings in relation to the research goals and synthesises and summarises the major conclusions reached in the research. It outlines what the requirement "in the production of the income" entails and the circumstances under which a taxpayer can successfully secure the deduction of an expense incurred for damages and compensation or a loss due to defalcations, as having been incurred "in the production of the income" in terms of section 11(a) of the Income Tax Act.

CHAPTER 2: THE MEANING OF "IN THE PRODUCTION OF THE INCOME"

2.1. Introduction

In the introductory chapter, the context of the research indicated that the Income Tax Act does not provide the meaning of the requirement that expenditure or losses must be incurred "in the production of the income" in order to be allowed as a deduction in terms of section 11(a). An analysis of this requirement forms the basis of the research. It is the aim of this chapter to explore what the words "in the production of the income" encompass in determining the deductibility of expenditure and losses. This process is undertaken by analysing case law that explains what the provision entails, including the reasoning by the judiciary in formulating the principles to be applied in determining the meaning. The analysis also refers to the writings of experts who have discussed the meaning of the concept.

2.2. Analysis of case law on the meaning of "in the production of the income"

The requirement that an expense or loss must be incurred "in the production of the income" has occupied the court's attention on several occasions. The courts have, in a number of cases, been required to determine whether expenditure or a loss could be regarded as having been incurred "in the production of the income". Selected case law, which dealt with the meaning of the phrase, is analysed in this section. These cases are dealt with in chronological order.

2.2.1. *Lockie Bros Ltd v Commissioner for Inland Revenue*

The South African judiciary had the opportunity to provide clarity on what the meaning of "in the production of the income" entails in *Lockie Bros Ltd v Commissioner for Inland Revenue*. The case concerned the deduction of amounts that were misappropriated by the manager of the taxpayer company. The taxpayer company carried on the business of selling rice in South Africa. It employed a manager who had full power to operate the company's bank account. The company discovered that the manager had made large defalcations through withdrawals from the bank to cover fictitious purchases of rice, misappropriations of petty cash, and charges for transport that the company did not incur. In calculating its taxable income for the tax year in question, the taxpayer company claimed a deduction of the total amount as a loss due to the misappropriations by the manager. The Commissioner declined to allow the loss as a deduction. The main issue before the court was whether the taxpayer

company was entitled to deduct the loss for the amount that had been embezzled by the manager.

Mason J and De Waal J delivered the judgment in the Transvaal Provincial Division (now the Gauteng High Court). The starting point for Mason J in delivering the Court's judgment was stating the relevant provision authorising the deduction of expenditure and losses, being losses and outgoings actually incurred "in the production of the income". The learned judge first questioned the meaning of the words "in the production of the income", which are not defined in the Income Tax Act. He stated that the words cannot be taken in their literal sense, because a loss cannot produce income, and where a full year's business has resulted in a loss, the outgoings cannot be incurred in the production of non-existent income. Mason J (at 151-2) interpreted the phrase "in the production of the income" stating that:

> The usual meaning which … an ordinary person would attach to these words in connection with a business is that deductions are to be allowed for any losses or outgoings actually incurred in the course of and by reason of the ordinary operations undertaken for the purpose of conducting the business, not being losses or outgoings of a capital nature.

It must be noted that at this time no meaning for this requirement had yet been established. Mason J (at 152) stated that: "No decisions on the construction of these words of the statute have been discovered by counsel". This meant that it was left to the judiciary to clarify the meaning of the phrase "in the production of the income". Mason J found it convenient to refer to decisions of the English courts as they had provisions comparable to those in the South African Income Tax Act. He also noted that they were taken from the New South Wales Act.

Mason J established that expenditure and losses are incurred "in the production of the income" if actually incurred in the course of and by reason of the ordinary operations undertaken for the purpose of conducting the business. In deciding whether the loss in question was deductible, Mason J applied the meaning he ascribed to the words "in the production of the income" to facts of the *Lockie Bros Ltd* case. He stated that the loss due to embezzlement by the manager was incurred during the course of the taxpayer's business operation. *Prima facie*, the loss was incurred "in the production of the income" in terms of the meaning he had established. The learned judge, however, questioned whether the loss was

due to the taxpayer's operations. Mason J concluded that the embezzlement was not an operation undertaken for purposes of the taxpayer's business. Mason J held that the provisions of the Income Tax Act do not include the deduction of a loss due to sums embezzled, as in the *Lockie Bros Ltd* case, and consequently the loss was not incurred "in the production of the income" and not deductible in terms of the present section 11(a) of the Income Tax Act. The reasoning by the learned judge implies that a loss may be incurred in the course of, but not due to, the taxpayer's business operations and therefore is not deductible.

De Waal J applied a different reasoning from Mason J and stated that a taxpayer is authorised to deduct expenditure incidental to its enterprise. He considered that the nature and scope of the manager's employment in the *Lockie Bros Ltd* case was to manage company funds, and not to steal the funds. According to the learned judge, the court had to determine whether the defalcations by the manager were incidental to the production of the taxpayer company's income. De Waal J stated that if the loss had been incurred for purposes incidental to the company, it would have been a loss incurred "in the production of the income", and deductible. In the present case the moneys were drawn for the manager's own purposes and failed to meet the requirement. Although De Waal J used a different reasoning, he came to the same decision as Mason J, that the loss was not incurred "in the production of the income", and hence not deductible.

Mason J clearly stated that expenditure and losses are incurred "in the production of the income", if incurred by reason of the ordinary operations of the taxpayer's business. Broomberg (in Hattingh, Roeleveld and West, 2015) argues that Mason J ascribed a narrow meaning to the word "ordinary" in reference to the taxpayer's business operations. It follows that losses may be incurred even in the irregular activities of the taxpayer's business operations carried out for the purpose of earning the taxpayer's income. According to Kruger, Stein, Dachs and Davey (2012), expenditure cannot only be incurred in the course of, or arising as a result of, or connected with the taxpayer's trade but should be sufficiently closely connected to the taxpayer's business operations to be regarded as part of the cost of performing the business operations, as held in the *Port Elizabeth Electric Tramway* case. The authors also assert that the meaning established by Mason J is not wide enough to cover losses arising from embezzlement of funds by a senior employee of the taxpayer. Broomberg

(in Hattingh *et al*, 2015) also argues that holding that theft by a lowly employee is deductible, while theft by a senior employee is not, is in the economic sense, irrational. Goldswain and Swart (2015) assert that the interpretation is not wide enough to take into account the economic and other non-economic realities of how business is carried out in the 21st century. Goldswain *et al* (2016) criticised Mason J's decision that "embezzlement was not an operation undertaken for the purposes of business", arguing that it is not a valid reason for disallowing the loss. Goldswain *et al* (2016) further argue that although the embezzlement by the manager for his own benefit resulting in the business suffering a loss, in the authors' view, these losses resulted from the manner in which the business as a whole was conducted and were therefore closely connected with the ordinary business operations.

The principle established in the *Lockie Bros Ltd* case is that an expense or loss is incurred "in the production of the income", if incurred in the course of, and by reason of the ordinary operations undertaken for the purpose of conducting business. This decision by Mason J is important because the legislators applied the wording in section 11(c) of the Income Tax Act in relation to the deductibility of legal expenses.

2.2.2. *Port Elizabeth Electric Tramway v Commissioner for Inland Revenue*

The Cape Provincial Division (now the Western Cape Division of the High Court of South Africa) also provided clarity on "in the production of the income" in the leading *Port Elizabeth Electric Tramway* case. In this case, the taxpayer carried on business as a tramway company. The driver of one of its tramcars lost control whilst descending a steep gradient and the tramcar ran into a building. The driver sustained injuries from which he subsequently died. Before the driver died, he had claimed compensation under the Workmen's Compensation Act. The taxpayer company resisted the claim and legal proceedings were instituted against it by the driver's widow. Judgment was awarded against the taxpayer company and it was obliged to pay the compensation. The company incurred legal costs in defending the claim. The taxpayer company sought to deduct from its income for the tax year, *inter alia*, the compensation paid to the driver's widow and the associated legal costs. The Commissioner disallowed the deduction as the compensation was not incurred "in the production of the income", as required by the relevant section. The issue before the court was whether the compensation and legal costs incurred by the taxpayer, were incurred "in the production of the income" and deductible.

Watermeyer AJP began his judgment by stating the provisions governing the deduction of expenditure and losses, that are covered by sections 11(a) and 23(g) of the Income Tax Act. He stated that the language used in the provisions revealed difficulties. The first problem that the learned judge identified was to construe the meaning of the phrase "expenditure and losses incurred" "in the production of the income". In determining whether an expense or loss is incurred "in the production of the income", Watermeyer AJP stated (at 16) that "two questions arise: (a) whether the act to which the expenditure is attached is performed in the production of income, and (b) whether the expenditure is linked to it closely enough". The learned judge (at 16-17) answered the first question by stating that "the purpose of the act entailing expenditure must be looked to. If it is performed for the purpose of earning income, then the expenditure attendant upon it is deductible". Watermeyer AJP further held (at 17) that "provided the act is *bona fide* done for the purpose of carrying on the trade which earns the income, the expenditure attendant upon it is deductible".

It is submitted, with respect, that the learned judge could have made the task of interpreting the words "in the production of the income" simpler, by referring to the conclusion by Mason J in the *Lockie Bros Ltd* case. It is submitted that the doctrine of judicial precedent, which is applied where the existing decision applies to cases with similar material facts, may justify his departure from Mason J's interpretation. The *Lockie Bros Ltd* case concerned the deduction of a loss due to embezzlement of funds by a manager of a business selling rice and can be distinguished from the *Port Elizabeth Electric Tramway* case, which concerned the deduction of expenditure for damages and compensation paid by a taxpayer carrying on a tram car business as a result of an accident involving an employee.

In further explaining the second question relating to the meaning of "in the production of the income", Watermeyer AJP referred to the English case of *Strong and Co. of Romsey Ltd v Woodfield,* 1906 A.C. 448. In this case, the taxpayer was a brewery that owned an inn. A guest was injured by the collapse of a chimney that had negligently not been repaired. The taxpayer company had to pay compensation to the injured guest. It was considered that the expense was not incidental to the trade itself. Consequently, the court held that the expense could not be deducted. Watermeyer AJP referred to the suggestion of Lord Davey in the English case, that a railway company that is obliged to compensate injured passengers could deduct such compensation on the grounds that payment of the compensation in such cases

would be an expense attendant upon the operations of railway transport and because no amount of care could prevent it arising from time to time. Such expenditure would be so closely connected with such operations as to form part of the cost of performing them. Watermeyer AJP (at 17-18) then made these remarks in further explaining the second question relating to the meaning of "in the production of the income":

> . . . all expenses attached to the performance of a business operation *bona fide* performed for the purpose of earning income are deductible, whether such expenses are necessary for its performance or attached to it by chance, or are *bona fide* incurred for the more efficient performance of such operation, provided they are so closely connected with it that they may be regarded as part of the cost of performing it.

It is important to note that the court, *per* Watermeyer AJP, distinguished three types of expenditure, namely necessary expenditure, chance expenditure and expenditure to achieve "more efficient performance", which would satisfy the requirement in the second question: "whether the expenditure is linked to it closely enough".

In considering the circumstances of the taxpayer, it was stated that employment of drivers was necessary in carrying out a tramcar business. The employment of drivers carried with it a necessary consequence of paying compensation if drivers were injured in the course of their employment. It is submitted that this would qualify the expenditure as necessary expenditure. It was found that this potential liability was ever present and was inseparable from the employment of the drivers, hence inseparable from the taxpayer's business. The court held that the amounts paid as compensation under the Workmen's Compensation Act to the driver's widow were regarded as part of the cost of performing the company's operations for the purpose of earning income, and thus incurred "in the production of the income" and deductible.

Broomberg (in Hattingh *et al*, 2015) referred Watermeyer AJP as a reductionist. According to the author (2015:200), a reductionist is "a person who believes that a complex thing can be understood by analysing it into its simple parts". It is clear from the judgment that Watermeyer AJP provided a two-step approach to describe the meaning of "in the production of the income". The questions require answers in the order in which they are presented. In determining whether an expense or a loss is incurred "in the production of the income", an

enquiry is made, firstly, into the purpose of the act entailing the expenditure, and secondly, whether the expenditure attendant upon the act is sufficiently closely connected to the act entailing the expenditure (Goldswain: 2005). The two questions cannot be asked separately. They must be applied together to contribute to the final conclusion in granting a deduction for an expense or loss incurred "in the production of the income".

Kruger and Scholtz (2003:193) acknowledge that "it is settled law that in determining whether expenditure has been incurred 'in the production of income', the purpose of the act entailing the expenditure must be looked at". Williams (2009: 444) also states that "the principles laid down in the *Port Elizabeth Electric Tramway* case have never been doubted and have been restated many times in the same or similar words". Goldswain *et al* (2016:66) assert that the decision attempts to set limits for interpretation of the phrase "in the production of the income" as used in section 11(a) of the Income Tax Act. This assertion by the authors indicates that the meaning is authoritative as to what the phrase "in the production of the income" encompasses. Thus, expenditure is incurred "in the production of the income" if the purpose of the act entailing the expenditure is to produce income, and the expenditure is sufficiently closely linked to the business operations.

Goldswain *et al* (2016) referred to Watermeyer AJP's dual test as the "purpose" test and the "close connection" test. Williams (2009:447) asserts that the "purpose of the act entailing the expenditure" referred to by Watermeyer AJP meant "the subjective purpose of the taxpayer in performing the act" and when the learned judge referred to the requirement that the expenditure be closely connected with the business operations, he meant "the objective link between the expenditure and the taxpayer's business operations". Goldswain (2005) remarks that if the purpose of the expenditure is to earn non-income, such as dividends or to preserve capital, for example to prevent the partial or total extinction of the business from which the taxpayer's income was derived, then no further enquiry is required, and the expenditure in not deductible.

The court held that expenditure may be incurred as a necessity, by chance, or to achieve more efficient performance of the taxpayer's business operations. According to Williams (2009), Watermeyer AJP considered the employment of drivers a necessary act, which entailed the expenditure, because the claim against the taxpayer company was brought as an action in

terms of the Workmen's Compensation Act, which imposes a statutory liability arising from the employer-employee relationship. Goldswain and Swart (2015) concluded that this was a logical point made by the learned judge, for without the drivers, no income could be earned. The authors agree with Watermeyer AJP's decision that the compensation was incurred "in the production of the income", because there was unquestionable evidence that there had previously been two similar tram accidents on the route the accident occurred.

There are some concerns that have been identified with Watermeyer AJP's dual test. Kruger *et al* (2012:252), view the meaning given by Watermeyer AJP to the phrase "in the production of the income" as being "too mechanical and contrived" to be applied in the real world of commerce and industry. Goldswain and Swart (2015) suggest that this criticism was attributed to *obiter* remarks made by Watermeyer AJP in the course of his judgment, which may incorrectly have been interpreted as being part of the *ratio decidendi,* and the disallowance of the associated legal expenses incurred by the taxpayer. Goldswain *et al* (2016:66) enlarged on the problem, stating that the words used in the judgment are "vague, confusing and even impractical and inevitably set the scene for contradictory and even absurd judgments", as shown in the *Joffe and Co (Pty) Ltd* case discussed in the following section. In addition, Ostler (2013) also points out the problem with Watermeyer AJP's "close connection" test, in that the taxpayer may have difficulties in proving the link between the expenditure and the trade.

Williams (2009) contends that some logical inconsistency emerged from the judgment by Watermeyer AJP in the *Port Elizabeth Electric Tramway* case, when he held that the compensation was deductible and that legal expenses were not deductible. This view has also been supported by Goldswain and Swart (2015). The authors pointed out that the Income Tax Act remedied the judgment by enacting section 11(c). The legal costs are deductible if they resulted from a claim arising in the course of, or by reason of the ordinary operations undertaken in the carrying on of trade.

2.2.3. *Joffe and Co (Pty) Ltd v Commissioner for Inland Revenue*

Watermeyer CJ, as he later became, again had to deal with the requirement that expenditure and losses must be incurred "in the production of the income" in *Joffe and Co (Pty) Ltd v Commissioner for Inland Revenue*. The taxpayer in the case was a private company employed

in the business of reinforced concrete engineering. In execution of one of its contracts it erected a cantilever hood that collapsed and killed one of its plumbers working beneath the uncompleted building. It was discovered that the reinforcing steel rods had been displaced and weakened the structure, causing it to collapse. The dependants of the plumber instituted an action against the taxpayer company, claiming damages based on the fact that the taxpayer was negligent by not taking precautions to ensure that the steel rods were not displaced during the construction of the building. Judgment was given against the taxpayer, and the taxpayer company paid damages and costs. It claimed as a deduction the damages and costs it was ordered to pay, as well as associated legal costs. The Commissioner disallowed the deduction.

Watermeyer CJ began by outlining the provisions for allowable deductions. The learned judge found it necessary to divide the expenditure in question into three distinct items; namely damages, the cost paid by the taxpayer to the successful parties in the action against him and the taxpayer's own costs. He first dealt with damages and enquired whether the expenditure was actually incurred "in the production of the income". Watermeyer CJ referred to the English case of *Strong and Co. of Romsey Ltd.*, where Lord Davey held that expenditure is deductible if it is necessarily attached to the performance of the operations which constitute the operation of the income-earning trade and is *bona fide* incurred for the purpose of carrying out trading operations. Relying on the decision in the English case, Watermeyer CJ (at 358) held that:

> The damages paid … were paid out to discharge a debt or legal liability to the plumber's dependants, arising out of appellant's negligence in performing a trading operation. There 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; nor was it shown that the liability was incurred *bona fide*, for the purpose of carrying on any trading operation

The court found that there was nothing to show that the taxpayer's method of conducting business necessarily led to accidents. The court held that the expenditure had not been incurred for the purpose of earning income, because it had not been established that negligent construction was a necessary concomitant of the trading operations of a reinforced concrete engineer. Thus, the damages paid in respect of the accident were not incurred "in the

production of the income" and thus not deductible, and neither were the costs incurred in contesting the claim.

The decision in the *Joffe and Co (Pty) Ltd* case established that deductible expenditure is regarded as expenditure incurred "in the production of the income", if it is a necessary concomitant of the taxpayer's business operations. The act that necessitates the consequent liability should be a necessary concomitant of trade and the liability should be incurred *bona fide* for the purpose of carrying on the taxpayer's business operations. According to Goldswain *et al* (2016), the "close connection" test in the *Port Elizabeth Electric Tramway* case can be referred to as the "inevitable concomitant" test in the *Joffe and Co (Pty) Ltd* case. Watermeyer CJ gave a different decision to the decision ten years earlier in the *Port Elizabeth Electric Tramway* case. In that case, the learned judge stated (at 17) that "[i]f 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". Broomberg (in Hattingh *et al*, 2015) averred that a comparison of Watermeyer CJ's own judgments regarding the "in the production of the income" test in the *Port Elizabeth Electric Tramway* case and the *Joffe and Co (Pty) Ltd* case demonstrates the problem of the reductionist approach. The learned judge allowed as a deduction the compensation paid by the company in the *Port Elizabeth Electric Tramway* case as expenditure incurred "in the production of the income" but disallowed the deduction of the compensation in the *Joffe and Co (Pty) Ltd* case, as expenditure not incurred "in the production of the income".

2.2.4. *Sub-Nigel Ltd v Commissioner for Inland Revenue*

In *Sub-Nigel Ltd v Commissioner for Inland Revenue*, 1948 (4) SA 580 (A), 15 SATC 381, the taxpayer company for many years carried on the business of mining for gold. Its practice was to take out insurance policies against loss of net profits and standing charges occasioned by fire. The insurance against the loss of net profits was undertaken in order for the company to maintain a steady rate of dividend to its shareholders, notwithstanding a cessation of operations in part, or in whole, by reason of fire. The insurance in respect of standing charges was designed to enable the company to conduct essential services without loss, notwithstanding any cessation of mining operations. No claim was made by the taxpayer company on its insurer under the policies taken out for loss of net profits and standing charges caused by fire. The taxpayer company sought to deduct from income derived from

activities other than mining, an amount paid as a premium for an insurance policy against loss of net profits occasioned by fire. It also claimed a deduction from income derived from mining for gold the amount paid as a premium under an insurance policy against loss of standing charges during a period when production of gold might be interrupted as a result of destruction of plant by fire. The Commissioner disallowed the deduction of these amounts. The issue before the court was whether the taxpayer company was entitled to deduct these amounts.

Centlivres JA, who delivered the judgment in the Appellate Division (now the Supreme Court of Appeal), began by considering the section that provides for permissible deductions. He observed that the first question that arose was whether the expenditure was incurred "in the production of the income". The learned judge referred to the words of Watermeyer AJP in the *Port Elizabeth Electric Tramway* case, when he dealt with the meaning of the phrase that expenditure and losses do not directly produce income. Centlivres JA stated (at 392-393) (at 392-393) that income is produced in diverse ways including "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". In undertaking such activities, expenditure and losses may be incurred. Consequently, the purpose of the act entailing expenditure must be looked to. The expenditure is deductible if the act is performed for the purpose of earning income.

Centlivres JA referred to these remarks by Watermeyer AJP to justify his view that the fact that no income resulted in the year in which the expenditure was incurred, did not mean it was not deductible. According to the learned judge, the same view articulated by Watermeyer AJP had been previously been stated by Mason J in the *Lockie Bros Ltd* case, that a loss cannot produce income. According to Mason J, where a full year's business resulted in a loss, expenditure or loss cannot be said to be incurred in the production of a non-existent income. The test by Mason J was that expenditure and losses are incurred "in the production of the income" if actually incurred in the course of and by reason of the ordinary operations undertaken for the purpose of conducting the business.

From these views, Centlivres JA concluded that the Court is not concerned whether a particular item of expenditure produced any part of the income, but it is concerned with

whether that item of expenditure was incurred for the purpose of earning income. He questioned whether the act entailing expenditure of the amounts paid by way of premiums was performed for the purpose of earning income. The learned judge held in the affirmative, that the act entailing the expenditure of the amounts paid by way of premium was performed for the purpose of earning income. He further held that the mere fact that no income actually resulted was irrelevant, as the purpose was to obtain income in the event of a fire, which would prevent the carrying on of income-producing operations. Accordingly, the expenditure on the insurance premiums for the policies concerned was incurred "in the production of the income". It was admissible expenditure in terms of section 11(2)(a) of the Income Tax Act, the equivalent of the present section 11(a) of the Income Tax Act.

The importance of this case is the principle that the words "incurred in the production of the income" do not mean that before expenditure can be deducted it must be shown that it produced any part of the income for the same tax year. According to Haupt (2015:125):

> the term "in the production of the income" does not mean that the expenditure may only be deducted once the income has been produced. As long as the purpose of the expense is to enable the taxpayer to earn income, the income may be earned in a later year. The expenditure is still deductible in the earlier year.

It is not necessary to match the expenditure to the income produced in the same tax year. Goldswain and Swart (2015) stated that this decision clarified and widened the meaning of "in the production of the income", as originally postulated by Watermeyer AJP in the *Port Elizabeth Electric Tramway* case. Goldswain *et al* (2016) pointed out a possible problem that could arise from the interpretation by Centlivres JA. The authors (2016:58) assert that taxpayers try "to get a deduction upfront which could shelter other income from tax until the income of the scheme finally accrues, sometimes many years later" as a tax avoidance scheme. SARS has become aware of these types of schemes and the Income Tax Act has limited such schemes with anti-tax avoidance provisions.

2.2.5. *Commissioner for Inland Revenue v Genn and Co (Pty) Ltd*

The principles laid down in the *Port Elizabeth Electric Tramway* case were cited with approval by the Appellate Division (now the Supreme Court of Appeal) in the case of *Commissioner for Inland Revenue v Genn and Co (Pty) Ltd*, 1955 (3) SA 293 (A), 20 SATC

113. The case dealt with the deduction of interest and raising fees, being finance charges on a loan. The taxpayer was a private company that carried on business as hardware and timber merchants. It purchased its stock-in-trade locally and also imported some of the stock-in-trade on a large scale. The taxpayer company engaged the services of shippers who financed the taxpayer company and charged bank interest on the amount involved, and a commission.

It later changed the method of financing the purchase of its stock-in- trade and obtained short term loans from the shippers, for which it was charged interest and a raising fee. The taxpayer company claimed a deduction described as "interest and finance charges" on loans, which included commission, bank charges and interest paid to the shippers. The Commissioner disallowed the deduction. The question before the court was whether the total amount of the commission paid by the taxpayer company was a deductible expenditure in terms of the equivalent sections of the general deduction formula in the present Income Tax Act.

Schreiner JA pointed out that in the circumstances of the case there was no difference in treatment between the interest on the loans and the commissions, thus the commission and interest formed in effect one consideration, which the taxpayer company had to pay for the use of the money for the period of the loan. In determining the deductibility of expenditure, Schreiner JA (at 120) referred to the *Port Elizabeth Electric Tramway* case when he stated that the significance of the case was the reference "to the factor of the closeness of the link which must exist between the expenditure and the production of the income in order to make the expenditure deductible". The learned judge commented (at 120) that the words "they may be regarded" in the "close connection" test by Watermeyer AJP meant that "it would be proper, natural or reasonable to regard the expense as part of the cost of performing the operation". Schreiner JA (at 120) further stated that "whether the closeness of the connection would properly, naturally or reasonably lead to such treatment of the expenses must remain dependent on the court's view of the circumstances of the case before it". He supported the requirement of causality established in the *Port Elizabeth Electric Tramway* case and held (at 121) that: "In deciding how the expenditure should properly be regarded, the Court clearly has to assess the closeness of the connection between the expenditure and the income-earning operations, having regard both to the purpose of the expenditure and to what it actually effects."

The court, *per* Schreiner JA, held that interest paid on money borrowed and used for the purposes of a business, constituted expenditure actually incurred "in the production of the income" of the business, regardless of whether the loan was for the acquisition of fixed or floating capital.

The *Genn and Co (Pty) Ltd* case confirmed and slightly modified the dual test in the *Port Elizabeth Electric Tramway* case. According to Williams (2009:447), the words "proper, natural or reasonable" imply that: "Expenditure is sufficiently closely linked to an income-earning operation if it would be proper, natural, and reasonable to regard the expenses as part of the cost of performing it, having regard both to the purpose of the expenditure and what it actually effects."

The other tests that were dealt with by the court in the *Genn and Co (Pty) Ltd* case are beyond the scope of the present analysis. If the purpose of the expenditure and what it actually effects is more closely connected with the income-earning operations, the expenditure is revenue in nature and therefore deductible. On the other hand, if the purpose of the expenditure is more closely connected with the income-earning structure, it is capital expenditure and not deductible. The importance of the *dictum* of Watermeyer AJP and Schreiner JA was paraphrased by Kruger and Scholtz (2003) in stating that it is not important whether expenditure incurred is necessary for the performance of the business operations, by chance or for the more efficient performance of such business operations. The expenditure may be deducted provided that there is a sufficiently close connection between the expenditure and the taxpayer's income-earning operations, for it to be regarded as being part of the cost of performing the taxpayer's operations

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2.2.6. *Commissioner of Taxes v Rendle*

The Rhodesian Appellate Division (now the Zimbabwean High Court) in *Commissioner of Taxes v Rendle*, 1965 (1) SA 59 (SRAD), 26 SATC 326, also dealt with the requirement that an expense or loss must be incurred "in the production of the income". The case involved the deduction of losses caused by the defalcations made by clerks of the taxpayer. The taxpayer was a chartered accountant, who carried on practice in partnership with another accountant. Two property-owning companies were among the partnership's clients. These companies disposed of several plots of land to various purchasers, which were paid for in monthly

instalments. The taxpayer's partnership was employed to receive the monthly payments from the purchasers, to issue receipts in the name of the client company concerned for all moneys received, and to deposit all amounts received into the respective bank account of the two companies. The actual work of issuing receipts and thereafter of banking moneys in the companies' accounts was carried out by clerks employed by the partnership.

Some cash payments by the purchasers of properties from one of the companies had not been deposited into the company's bank account. The taxpayer's partnership considered it desirable to have an investigation carried out by independent accountants. This investigation revealed that one of the clerks had in fact misappropriated amounts received by the partnership from the property-owning companies, together with some of the partnership's own moneys. This investigation came at a fee. The taxpayer's partnership sought legal advice as to its position. It thereafter paid the two property companies the respective amounts involved in the defalcations. The taxpayer sought to deduct his proportionate share of the cost of investigation, the legal fees and the amounts misappropriated. The Commissioner of Taxes disallowed the deduction of payments made to the clients in reimbursement, the cost of the investigation and legal fees. The question before the court was whether the amounts were deductible expenses, or losses, in terms of the relevant section of the Zimbabwean Income Tax Act, 16 of 1954.

Beadle CJ delivered the Court's judgment. After considering the evidence by the taxpayer, Beadle CJ was satisfied that the dishonest removal of funds in the circumstances of the facts was a reasonably incidental risk to the production of the partnership income. In determining the deduction of the amounts, the learned judge described two heads of expenditure, namely designed expenditure and fortuitous expenditure. The learned judge (at 329) described designed expenditure as "money voluntarily and designedly spent by the taxpayer for the purpose of his trade", and fortuitous expenditure as "money which is … involuntarily spent because of some mischance or misfortune which has overtaken the taxpayer". He stated that the deduction of fortuitous expenditure presented a very difficult legal problem, which formed the matter before the court in the *Rendle* case.

In considering the proper test to apply, Beadle CJ pointed out that for the purposes of allowable deductions, section 13(2)(a) of the Zimbabwean (Rhodesian) Income Tax Act and

the present section 11(a) of the Income Tax Act of South Africa could be regarded as almost identical. He referred to the *Port Elizabeth Electric Tramway* case and remarked that it was the universally applied broad test and is now regarded as the standard test of "in the production of the income". The learned judge noted that this test was altered slightly in the wording in the *Genn and Co (Pty) Ltd* case. He summarised the principles enunciated by Watermeyer AJP (at 330) stating that:

> (Note: This is Watermeyer A.J.P.'s test as modified by the Appellate Division).
> It will be seen that this passage deals with three types of expenditure:
> (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 these types of expenditure are deductible provided that they are so closely connected with the performance of the business operation that it would be "proper, natural or reasonable to regard them as part of the cost of performing the operation".

The learned judge reaffirmed the three types of expenditure in Watermeyer AJP's "close connection" test, namely, necessary expenditure, chance expenditure, and expenditure incurred for the efficient performance of the taxpayer's business. Beadle CJ stated that the fortuitous expenditure in the *Rendle* case fell within the category (2) of expenditure attached to the performance of the business operations by chance. The learned judge held (at 331) that:

> In deciding whether such an expenditure is deductible, …. the inquiry must be whether the 'chance' of such expenditure being incurred is sufficiently closely connected with the business operation. The inquiry is not whether the actual expenditure itself (should it ever eventuate) is sufficiently closely connected … it can only be the 'chance' or the 'risk' of it being incurred which must be the links connecting it with that business operation.

With regard to "in the production of the income" requirement, the court held in favour of the taxpayer that the expenditure incurred by the taxpayer's partnership in the reimbursement of the companies in respect of the moneys misappropriated by the partnership's employee was sufficiently closely connected with the business operations of the partnership as to be regarded as part of the cost of performing those operations. It was further held that the costs

of the investigation and legal advice were inseparably related to the embezzlements and were allowable as deductions on the same grounds.

Goldswain and Swart (2015) argue that the decision in the *Rendle* case is an absurd result emerging from following the meaning of "in the production of the income" in the *Port Elizabeth Electric Tramway* case. The authors argue that the taxpayer in the *Rendle* case did not discharge the onus of proof that the misappropriations were sufficiently closely connected the taxpayer's business operations, but the claim for deduction of the loss of misappropriated funds was granted. Nonetheless, the significance of the *Rendle* case is the emphasis on the principles enunciated in the *Port Elizabeth Electric Tramway* case, that expenditure is incurred "in the production of the income" if such expenditure incurred is sufficiently closely connected with the business operations of the taxpayer.

2.2.7. *Warner Lambert SA (Pty) Ltd v Commissioner for the South African Revenue Service*

The taxpayer in *Warner Lambert SA (Pty) Ltd v Commissioner for the South African Revenue Service,* 2003 (5) SA 344 (SCA), 65 SATC 346, was an American company operating in South Africa. It adopted the Sullivan Principles assembled into a code governing the conduct of business by American companies trading in South Africa. As a subsidiary of an American company, the taxpayer company was obliged to comply with United States Congress law. The taxpayer company was compliant, and its senior management was committed to social responsibility projects as dictated by the Sullivan Code. The Sullivan Code principles provided for the non-segregation of races in the workplace, equal and fair employment for all employees, equal pay, developing training programs, increasing the number of disadvantaged persons in management and supervisory positions and improving the quality of employees' lives outside the work environment. The social responsibility expenses are related to "Working to Eliminate Laws and Customs that Impede Social, Economic, and Political Justice" as part of the principles of the Sullivan Code. The taxpayer company incurred large amounts of the social responsibility expenditure and claimed the amounts as deductions. The Commissioner had first allowed the deductions, but then disallowed them in revised assessments. The question before the court was whether the social responsibility expenditure was deductible.

Conradie JA started by stating the characteristics of deductible expenditure and stated that it must be incurred "in the production of the income". The learned judge referred to the judgment of Corbett JA (at 196) in *Commissioner for Inland Revenue v Standard Bank of South Africa Ltd*, 1985 (4) SA 485 (A), 47 SATC 179 that:

> Generally, in deciding whether money outlayed by a taxpayer constitute 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.

To determine how close this connection must be, Conradie JA confirmed the explanation of the court in the *Port Elizabeth Electric Tramway* case that expenses are deductible if they are so closely connected to the taxpayer's business operations as to be regarded as part of the cost of performing them. He further confirmed that the purpose of the act entailing expenditure must be for the purpose of earning income

Conradie JA then held that if a taxpayer spends money to advance the interests of a group of companies to which it belongs, the money spent is not regarded as expenditure in the production of income for the reason that the link between the expenditure and the production of income is too tenuous. He also stated (at 351) that "moneys expended by a taxpayer from motives of pure liberality also fail to qualify as expenditure in the production of income". It was pointed out that if the Sullivan expenditure in the *Warner Lambert SA (Pty) Ltd* case was incurred for either of these purposes, the amounts would not have been incurred "in the production of the income". It was found that the Sullivan Code expenditure, constituting wage improvements and expenses of that kind, was incurred with the same motives, and produced exactly the same results as the social responsibility expenditure. All the Sullivan Code expenditure, including the social responsibility expenditure, was for the purpose of insuring against the risk of the taxpayer losing its treasured subsidiary status. If, therefore, the purpose of the expenditure was the same, their tax treatment would also be the same. It was implied that both were expended "in the production of the income" or neither was. To qualify the expenditure as incurred "in the production of the income", Conradie JA stated that the link between the taxpayer's trade and the social responsibility expenditure was not as close and obvious as the other Sullivan Code expenditure, but that did not mean that the connection

was too remote. The court held that the Sullivan Code expenses were *bona fide* incurred for the purposes of the taxpayer's income-producing operations and formed part of the cost of preforming it. Wage improvements and expenditure of that kind was incurred "in the production of the income". Consequently, the social responsibility expenditure was also incurred "in the production of the income" and thus deductible.

What the court in the *Warner Lambert SA (Pty) Ltd* case established in relation to the requirement of "in the production of the income", is that money spent by a taxpayer to advance the interests of a group of companies to which it belongs, is not regarded as expenditure "in the production of the income". The court further looked into the remoteness of the connection between the taxpayer's trade and the social responsibility expenditure. According to Goldswain and Swart (2015:88);

> … the use of the remoteness test is simply another way of establishing, analysing and confirming the closeness of the connection between the trade being carried on and the expenditure incurred. The remoteness test theoretically adheres to Watermeyer AJP's interpretation of the phrase, but if one looks at the facts of the *Warner Lambert* case, it is submitted that the interpretation of the phrase in that case goes far beyond that which Watermeyer AJP ever intended.

The court found a link that was not regarded as being too remote, between the continued trade of the company and the expenditure. It follows that where remoteness exists, there is very little or no connection between the expenditure and the production of income. For expenditure to be considered as having been incurred "in the production of the income", an unquestionable or sufficient link should exist between the expenditure and the production of income. If the relationship is weak, expenditure would not be incurred "in the production of the income" and hence not deductible.

Goldswain and Swart (2015) submit that the approach by Conradie JA provides for a wider scope of expenses that may be allowable as a deduction in terms of section 11(a) of the Income Tax Act. The authors further submit that economic and non-economic factors were taken into account in determining whether a business expense falls within the ambit of expenditure incurred "in the production of the income". In the *Warner Lambert SA (Pty) Ltd* case, the importance of social responsibility was considered, which most businesses now promote, and it forms part of the corporate culture.

2.2.8. *Commissioner for the South African Revenue Service v Mobile Telephone Networks Holdings (Pty) Ltd*

The Supreme Court of Appeal, in a more recent case, *Commissioner for the South African Revenue Service v Mobile Telephone Networks Holdings (Pty) Ltd,* 2014 ZASCA 4, 76 SATC 205, also dealt with what "in the production of the income" entails. The taxpayer company was a wholly owned subsidiary of the Mobile Telephone Networks Group Limited (MTN) and a holding company of a number of subsidiaries and joint ventures. The operating companies within the group operated mobile telecommunication networks. The taxpayer's primary source of income was dividends received from its subsidiaries. It also earned interest income on loans made to its group companies. It facilitated these loans through funds borrowed through a group employee debenture scheme. The taxpayer company employed auditors to perform a statutory audit of its financial statements for which it incurred expenditure on audit fees. It also incurred expenditure on fees for the installation of a Hyperion computer system by a firm of auditors, KPMG. The taxpayer company claimed as a deduction the audit fees and the fees for the Hyperion computer system. The Commissioner disallowed the computer system fee and allowed only portion of the audit fees. The question before the court, *inter alia*, was whether the amounts were deductible.

Ponnan JA, who delivered the judgment in the Supreme Court of Appeal, began by stating the provisions of the general deduction formula. He confirmed Corbett JA's remarks in *Commissioner for Inland Revenue v Standard Bank of SA Limited,* that in determining whether expenditure is incurred "in the production of the income", the court had to assess the closeness of the connection between the expenditure and the income-earning operations. Ponnan JA referred to Watermeyer CJ's judgment in the *Joffe and Co (Pty) Ltd* that expenditure is incurred "in the production of the income" if it is necessarily attached to the performance of the taxpayer's business operations to earn income and the expenditure is *bona fide* incurred for the purpose of carrying on the trading operations.

From these considerations, the court concluded that the fees for a statutorily prescribed procedure such as an audit had to have been incurred by the taxpayer because the audit fee was a part of the taxpayer's general overhead expenses, thus enabling it to carry on all of its activities, regardless of whether they involved the investment in subsidiaries, the lending of money interest-free to subsidiaries, or the lending of money at interest. It was further

concluded that the audit of financial records was clearly a function that is necessarily attached to the performance of the taxpayer's income earning operations. The court held that it would be fair and reasonable that only a portion (10%) of the audit fees claimed by the taxpayer company for each of the tax years in question should be allowed, as the dividends received did not represent "income" as defined, whereas interest did. With regard to the computer system professional fee, it was impossible to determine whether the professional fee could legitimately be deducted by the taxpayer company, given the inadequacy of the evidence provided by the taxpayer company. The deduction of the professional fee was disallowed in full.

Goldswain and Swart (2015) posed questions on how audit fees could be permitted as a deduction in terms of the narrow meaning ascribed by Watermeyer AJP in the *Port Elizabeth Electric Tramway* case to the "in the productions of the income" requirement. The authors stated (at 88) that: "Where is the close connection between the audit fees and the production of income? How can audit fees ever produce income, even indirectly?" According to Goldswain and Swart (2015), the decision in the *Mobile Telephone Networks Holdings (Pty) Ltd* case is of major importance, as it widened the scope of the test established by Watermeyer AJP in the *Port Elizabeth Electric Tramway* decision, available to taxpayers in claiming general business expenditure incurred as a deduction. The significance of this case is that fees for a statutorily prescribed procedure, such as audit fees, are incurred "in the production of the income" provided the procedure is a function that is necessarily attached to the performance of the taxpayer's income earning operations.

2.3. Concluding remarks on the case law on "in the production of the income"

The characteristic of the present section 11(a) of the Income Tax Act that the courts in the cases discussed above dealt with was the requirement that the expenditure or loss must be incurred "in the production of the income". The primary distinction in the judgments discussed is that they all involved different facts and the application of the requirement to the facts resulted in different decisions.

It is evident that two major interpretations were established by the courts in relation to the meaning of the words "in the production of the income", that is, in the *Lockie Bros Ltd* case and in the *Port Elizabeth Electric Tramway* case. Thus, deductions, in terms of the two

interpretations, are to be allowed for any expenditure or losses as incurred "in the production if the income":

- if actually incurred "in the course of and by reason of the ordinary operations undertaken for the purpose of conducting the business" (*Lockie Bros Ltd* case); and
- if (a) the act to which the expenditure is attached is performed in the production of income, and (b) if the expenditure is linked to it closely enough (*Port Elizabeth Electric Tramway* case) (Haupt:2015).

The latter of the two decisions is authoritative. Thus, the interpretation in the *Lockie Bros Ltd* was superseded by the *Port Elizabeth Electric Tramway* case.

The courts have on various occasions followed the principles relating to "in the production of the income", established by Watermeyer AJP in the *Port Elizabeth Electric Tramway* case. This decision has created a precedent for determining whether an expense or loss is incurred "in the production of the income" and has been cited with approval by the courts in several cases. It is evident that the courts supported the requirement of the close connection established in the *Port Elizabeth Electric Tramway* case. An example of this is the *Genn and Co (Pty) Ltd* case, where Schreiner JA confirmed and slightly modified the dual test in the *Port Elizabeth Electric Tramway* case and held (at 121) that the court must "assess the closeness of the connection between the expenditure and the income-earning operations, having regard both to the purpose of the expenditure and to what it actually effects". The Zimbabwean courts have also relied on the meaning ascribed by Watermeyer AJP, as shown in the *Rendle* case.

De Koker and Williams (Online) note the clarity provided by Watermeyer AJP on what the requirement encompasses, stating that for expenditure to rank as a deduction it must not only have been incurred for the purpose of earning "income" as defined but there must also be a sufficiently distinct and direct relationship or link between the expenditure incurred and the actual earning of the income. These authors, on the other hand, argue that the principles established by Watermeyer AJP are restrictive tests to "in the production of the income" and result in the disallowance of several business expenses that are necessarily incurred in the

carrying on the taxpayer's business, but fail to satisfy the requirement that their purpose should be to earn income.

Two cases in the Supreme Court Appeal, the *Warner Lambert SA (Pty) Ltd* case and the *Mobile Telephone Networks Holdings (Pty) Ltd* case, established that taxpayers now have a wider scope to claim general business expenditure that can be regarded as having been incurred "in the production of the income", such as social responsibility expenditure and fees for statutory procedures, where the strict application of the tests established in the *Port Elizabeth Electric Tramway* would have disallowed the expenditure.

2.4. Conclusion

This chapter explored the meaning of "in the production of the income" in determining the deductibility of expenditure and losses in terms of section 11(a) of the Income Tax Act. The South African courts have established that an expense or loss is regarded as having been incurred "in the production of the income" if the purpose of the act to which the expenditure is attached is to produce income, and it is sufficiently closely connected to the expenditure to be regarded as part of the cost of performing it. This test established by Watermeyer AJP in the *Port Elizabeth Electric Tramway* case has created precedent that has been followed by the courts on various occasions. The analysis reveals that where the purpose of the act entailing an expense or loss is not for the purposes of earning income, no further enquiry is made, and the expense or loss is therefore not incurred "in the production of the income". If the purpose of the act entailing the expense or loss is for the purpose of earning income but the expenditure or loss is not sufficiently closely connected to it then the expense or loss is not incurred "in the production of the income". The courts have held that whether income is generated in the present tax year or a future tax year should not affect the requirement if the expenditure or loss is incurred for the purpose of producing income.

Further principles were established in elaborating on the causality between expenditure incurred and the taxpayer's business operations. The fact that an expense or loss is incurred as a necessity, by chance or for the more efficient performance of the taxpayer's business operations does not affect the purpose of the expenditure. It has been held by the courts that it would be proper, natural or reasonable to regard these types of expenditure as part of the cost of performing the business operations, provided that they are closely connected with the

performance of the business operation. Related to the close connection test is the principle that expenditure is incurred "in the production of the income", if it is a necessary concomitant of the taxpayer's business operations. The courts have held that the act that necessitates the consequent liability should be a necessary concomitant of the taxpayer's trade and the liability should be incurred *bona fide* for the purpose of carrying on the taxpayer's business operations.

The remoteness of the connection between the taxpayer's trade and the expenditure cannot be ignored. It was held by the courts that, where remoteness exists, there is likely to be very little or no connection between the expenditure and the production of income and therefore the expense or loss would not have been incurred "in the production of the income". The courts have also established that expenditure incurred for a statutorily required procedure, such as an audit function, is regarded as having been incurred "in the production of the income", provided the procedure is a function that is necessarily attached to the performance of the taxpayer's income earning operations.

Having established the principles applied by the South African courts on what "in the production of the income" entails, chapter 3 analyses and compares the facts and judicial decisions in the cases dealing with "in the production of the income" in relation to the deductibility of losses due to embezzlement, fraud and theft, to establish why the court decisions differ in granting a deduction of the losses.

CHAPTER 3: CASE LAW ON THE DEDUCTIBILITY OF LOSSES DUE TO EMBEZZLEMENT, FRAUD AND THEFT

3.1. Introduction

The *Lockie Bros Ltd* case was the earliest case in which the South African courts provided clarity on the meaning of "in the production of the income". This case also created a precedent for disallowing the deduction of losses due to misappropriations by a manager of the taxpayer company. A taxpayer may not only incur a loss because of misappropriations made by his, her, or its staff, as in the *Lockie Bros Ltd* case. A loss can also result from embezzlement, fraud, or theft by third parties. Where such defalcations have occurred, the taxpayer may claim the resultant loss as a deduction. In addressing the second goal of the research, a case law analysis is undertaken in this chapter on the deductibility of losses due to embezzlement, fraud and theft, to establish whether the amounts are regarded as having been incurred "in the production of the income" in terms of section 11(a) of the Income Tax Act. An analysis of the judicial reasoning in the *Lockie Bros Ltd* case in disallowing the loss due to the manager's misappropriations is first undertaken. This is followed by an analysis and comparison of case law decided after the *Lockie Bros Ltd* case, to establish why the court decisions differ in granting or refusing a deduction of losses due to defalcations by different perpetrators. A brief comparative analysis is made of relevant Australian and Zimbabwean cases in which the foreign jurisdictions have dealt with losses due to misappropriation of funds entrusted to a person, unlawful and intentional misrepresentation which prejudiced others, and stolen money. Concluding remarks are made on the case law analysed to synthesise the principles established on the deductibility of losses due to embezzlement, fraud and theft. The chapter concludes by summarising findings relating to the circumstances under which a taxpayer can successfully deduct losses from defalcations as having been incurred "in the production of the income".

3.2. Analysis of case law on the deduction of losses due to embezzlement, fraud and theft

The analysis of case law on losses due to embezzlement, fraud and theft, involves an enquiry into whether losses resulting from the defalcations of senior employees or managers may be disallowed as a deduction, as was held in the *Lockie Bros Ltd* case. An enquiry is also undertaken on how the courts dealt with losses caused by different perpetrators, including

theft by persons other than the taxpayer's employee, that is, a third party. The enquiry also extends to question whether negligence on the part of the taxpayer in running his business, and which gives rise to the misappropriation, would be considered as a factor in determining the deductibility of the loss.

3.2.1. Defalcations by senior employees of the taxpayer

3.2.1.1. *Lockie Bros Ltd v Commissioner for Inland Revenue*

This case concerns the deduction of amounts that the manager of the taxpayer company misappropriated. The taxpayer claimed a deduction from income of money lost, on the grounds that the risk of embezzlement by its employees was a risk incidental to all businesses. The taxpayer contended that the embezzlement of funds by the manager was similar to common sources of loss in business, such as the taking of money from the till, stock pilferage, the negligent handling of goods or the negligent conduct of business. The taxpayer argued that it could only conduct its operations by using this manager, as he was entrusted with company funds for the purpose of the business. The court rejected the claim.

In dealing with the taxpayer's argument, Mason J distinguished between negligent handling of goods and embezzlement. He stated (at 152) that "the handling of the goods is a necessary incident of the business and negligence in that respect does not alter the nature of the transaction". He held that embezzlement "is not an operation undertaken for the purposes of the business" and thus, embezzlement cannot be equated to negligence. Mason J further illustrated the difference by distinguishing between negligence and crime in its relation to the liabilities in a master-servant relationship. He stated that the master of a servant is liable where the servant, through negligent driving while on his master's business, injures a person. The master is not liable if, however, the injury occurred as the result of an attempted murder. From this example, the first act is performed for the purpose of the servant's occupation, and the other is not.

Mason J cited a number of foreign cases that are authoritative with regard to negligence. The first case cited was *Strong and Co. of Romsey Ltd v Woodifield.* The court in this case held that a brewery owning an inn could not deduct a sum paid as compensation to a guest who had been injured by a falling chimney, because it had negligently not been repaired. Lord Loreburn considered that the loss was not incidental to the taxpayers' trade but fell upon the

taxpayers rather in their character as householders. It was concluded that it is not enough that the disbursement is made in the course of or arising out of, or is connected with the trade, but the disbursement must be made for the purpose of earning the taxpayers' income. In addition, reference was made to the case of *Inland Revenue Commissioner v Alexander von Glehn & Co Ltd*,1920, 2 K.B. 553. The court raised the question whether a penalty incurred by contravening the Customs (War Powers) Act, 1915, could be deducted as a loss or expense. The court assumed that the breach of the statute was the result of negligence and held that it was not a loss connected with the business, but a fine arising out of a breach of the law. Overall, the cases cited by Mason J indicate that there was nothing suggesting that negligence would result in the non-deductibility of the loss in question. His remarks, together with the examples given, indicate that negligence does not change the likelihood of refusing a deduction of a loss as incurred "in the production of the income". After referring to these cases, Mason J applied the test that losses are deductible if they are actually incurred in the course of and by reason of the ordinary operations undertaken for the purpose of conducting the business. He concluded that the embezzlement in the *Lockie Bros Ltd* case was not an operation undertaken for purposes of the taxpayer's business.

The principle established in the *Lockie Bros Ltd* case is that a loss due to defalcations by a person in the position of a manager is not incurred "in the production of the income" because these are not losses due to the ordinary operations undertaken for the purpose of conducting the taxpayer's business. It is submitted, with respect, that Mason J's decision did not clearly highlight the distinction between senior employees, junior employees or proprietors in granting a deduction for a loss due to their defalcations. The issue remains unclear whether losses by the defalcations of senior employees or managers remain disallowed as a deduction. SARS (2014) acknowledges the change in times since the decision of the *Lockie Bros Ltd* case was handed down. The revenue authority argues that the misappropriation of funds entrusted to a person in the position of senior manager is now seen to be common, and a resultant loss can no longer remain unacceptable for deduction in terms of section 11(a) of the Income Tax Act.

3.2.1.2. *Income Tax Case 1221*

The Zimbabwean courts dealt with losses due to defalcations by a senior employee of the taxpayer in *Income Tax Case 1221*, 36 SATC 233. In this case, the taxpayer company was a department store. The taxpayer had an employee who exercised sole authority over the secretarial and accountancy division. His duties were to keep the books of accounts, to supervise the office administration, to order office stationery and equipment, to pay staff salaries and to dismiss or engage junior office staff. When the taxpayer's managing director was on leave, the secretary/accountant performed the additional duties of attending to customers' complaints and dealing with requests for donations and advertising. He was also at times authorised to sign cheques on behalf of the taxpayer. He was considered a senior employee but did not acquire any proprietary interest, nor was he a director of the taxpayer company. This employee stole money from the taxpayer through the fraudulent withdrawal of moneys deposited by the taxpayer with its bank in a way that made it difficult to detect. The employee concealed the theft by the wrongful inclusion of the amount in the purchases made by the taxpayer. The taxpayer company sought to deduct the sum of the misappropriations made by the employee. The Commissioner of Taxes first allowed the amount as a deduction, but later added back the amount to the taxpayer's income. The issue that was before the court was whether the sum of money stolen from the taxpayer was a deductible loss in terms of the relevant provision of the Zimbabwean Income Tax Act.

Whitaker P, who delivered the judgment, started by reaffirming (at 235) the principle emphasised in the *Rendle* case that:

> before fortuitous expenditure resulting from a mishap which has befallen the taxpayer can be deducted as expenditure incurred for the purposes of trade, the taxpayer must show that the risk of mishap which gave rise to the expenditure was inseparable from or a necessary incident of the carrying on of his particular business.

The learned President (at 236) referred to cases such as the *Rendle* case and *Income Tax Case 952,* 24 SATC 547, as authoritative in relation to the principle that "losses resulting from thefts by a managing director, a director or a manager in the position of a proprietor are not losses which can be regarded as connected with or arising out of trade". He also confirmed (at 235) that the case makes it clear that "thefts by subordinate employees may be regarded as

losses which are an incident of the taxpayer's trading activities". Whitaker P stated that the categorisation of the employees' positions was of no benefit but held that the essential question is whether the risk of embezzlement by the employee in exercising the authority was an incident of the carrying on of the taxpayer's trading activities.

The Commissioner argued that the taxpayer had not discharged the onus of proving that a risk existed. Whitaker P remarked that the court was entitled to take judicial notice of certain facts, namely, the necessity to employ a secretary/accountant in the taxpayer's business and that the embezzlement of funds by secretary/accountants from businesses in which they are employed is a familiar and recognisable hazard. It was concluded that keeping the bank account was a necessary incident of the taxpayer company's trading activities, and the loss incurred by the removal of funds from the taxpayer's bank account could be regarded as being part of the taxpayer's trading activities. The court held that the risk of embezzlement by the employee was a necessary incident of the carrying on of the taxpayer's business and that the losses incurred were sufficiently closely linked to the taxpayer's business operations as to be regarded as part of the cost of performing the business operations. Therefore, the loss was incurred in the production of the taxpayer's income and was deductible.

This case illustrates that a loss is held to have been incurred "in the production of the income" if the risk of embezzlement by an employee is a necessary incident in the carrying on of a business and the loss incurred is sufficiently closely linked to the performance of the business operations of the company as to be regarded as part of the cost of such performance. The act of embezzlement, fraud and theft should be a familiar and recognisable hazard of the taxpayer's business. The Zimbabwean court indicated that the question whether the defalcation was perpetrated by a senior employee was not relevant, but there is a need to enquire if the risk of embezzlement by the senior employee in exercising the authority was an incident of the carrying on of the taxpayer's trading activities.

3.2.1.3. *Income Tax Case 1383*

The South African Tax Court also dealt with the matter of losses due to defalcations by a senior employee in *Income Tax Case 1383*. The taxpayer was a commercial bank. It employed a secretary and staff manager in a fairly senior position at its head office. The senior employee had under his control his personal secretary, the staff clerk and the

receptionist. It was discovered that by systematic defalcations the secretary had stolen an amount of money from the taxpayer. He abused his authority to sign vouchers for the payment of salaries of members of the staff to perpetrate the thefts. He created false credit entries, withdrew the money and with the assistance of two collaborators, the corresponding debits were kept in suspense, floating between the head office and the branches of the bank. To a lesser extent, he stole money by making fictitious deposit entries into his own account and the accounts of two personal friends. The taxpayer claimed as a deduction the loss caused by its secretary's defalcations. The Secretary for Inland Revenue disallowed the deduction of the loss relying on the judgment of Mason J in the *Lockie Bros Ltd* case, contending that a loss as a result of theft by an employee is not deductible.

Hill AJ, who delivered the Court's judgment, argued that Mason J did not hold that loss due to theft by an employee in the course of handling operations of the employer's business is not deductible. In Hill AJ's view, embezzlement by a person in their capacity of a manager, as in the *Lockie Bros Ltd* case, can clearly not be reconciled with any operations undertaken for the purposes of the business. Hill AJ observed that there was no need for Mason J to enquire whether the risk of loss resulting from theft by a subordinate employee could be so closely connected with the conduct of the business of the employer as to be inseparable from it.

The learned judge referred to the test by Watermeyer AJP in the *Port Elizabeth Electric Tramway* case that expenditure must be linked to the conduct of a business. He also examined the judgment of Roper J in *Income Tax Case 815*, 20 SATC 487, where the taxpayer failed to prove that any part of the money stolen was trust money, and that it was therefore not necessary to consider the question of whether the *Lockie Bros Ltd* case could be distinguished. Hill AJ asserted that, if the taxpayer in *Income Tax Case 815* had discharged the onus of proving the trust moneys were stolen, the loss could have been deductible. The learned judge referred to the English case of *Curtis v J and G Oldfield*, 1925 (9) T.C 319, where it was held that if a subordinate employee, due to negligence or dishonesty, does not remit some of the receipts into the till or some bills are not collected, the resulting loss is connected with and arising out of the taxpayer's trade, and could be deducted. Hill AJ observed that Rowlatt J's *dictum* in *Curtis v J and G Oldfield* included subordinate employees and excluded persons in the position of a proprietor, such as a general manager, managing director or a manager with full powers to represent his or her employer. He held

that there is no logical basis for restricting the deduction to petty thefts of junior employees because such stealing happens frequently in the course of business operations. He further held that thefts by senior employees are certainly not rare occurrences, and the risk of such thefts is equally inseparable from or a necessary incident of the income-producing operations of a business. The learned judge mentioned that such thefts are usually well planned, difficult to detect and involve large amounts.

The court considered that it was necessary for a commercial bank to allow its employees to handle large sums of money in the ordinary course of its business, and the risk of theft was an ever-present factor in the administration of its business and must be regarded as inseparable from it. The decision by the court implies that the loss was incurred "in the production of the income" and therefore deductible. According to Goldswain and Swart (2015), the judgment in *Income Tax Case 1383* is a more reasoned approach that assists with the confusing issue of allowing a loss as a result of a misappropriation, theft or embezzlement by junior staff as deductible, but prohibiting the same deduction when the misappropriation is by a senior staff member. The principle established in *Income Tax Case 815* is that losses due to defalcations by senior employees is incurred "in the production of the income" if the risk of theft is an ever-present factor in operating the taxpayer's business and is regarded as inseparable from it.

3.2.2. Defalcations by junior employees of the taxpayer

3.2.2.1. *Income Tax Case 815*

The taxpayer in *Income Tax Case 815* was a partner in a firm of attorneys. The case before the South African Tax Court concerned a loss of trust moneys due to fraudulent misrepresentation and embezzlement by employees of the firm. The taxpayer was persuaded through false representation, to hand over trust funds belonging to their client by way of a mortgage loan to a party who was subsequently convicted of forgery, and from whom the moneys handed over could not be recovered. The taxpayer had to make good the loss of the client's trust moneys. The loss of the trust moneys included moneys advanced to the firm as a loan, and legal costs incurred in an attempt to recover the moneys advanced. He also incurred a loss due to the embezzlement, and the taxpayer sought to claim the losses as a deduction. The Commissioner disallowed the deduction of the losses contending that it was due to the taxpayer's own negligence. The issue before the court was whether the losses were allowable as a deduction.

The first issue addressed by the court was the deduction of the loss by the firm in respect of trust moneys. Based on the Commissioner's argument, Roper J, who delivered the Court's judgment, dealt with the issue of negligence. He examined the decision in the *Joffe and Co (Pty) Ltd* case and held that the court did not decide that losses incurred through the negligence of the taxpayer are not deductible from the taxpayer's income. He observed that the deduction of the loss was declined because there was no evidence that losses arising from negligence were necessary concomitants of the business carried on by the taxpayer. According to Goldswain and Swart (2015), this submission implies that the *Joffe and Co (Pty) Ltd* case is not a precedent for the principle that no expenditure arising as a result of negligence by a taxpayer is deductible as not being incurred "in the production of the income". Roper J stated that the result would have been entirely different if there was evidence that negligence was a necessary concomitant in the *Joffe and Co (Pty) Ltd* case. The learned judge also mentioned that negligence was referred to in the *obiter* remarks in the *Port Elizabeth Electric Tramway* case, that expenditure resulting from an act of negligence may not be deductible. He further considered the *dictum* on negligence in the *Lockie Bros Ltd* case. Roper J referred to Mason J's remarks on the distinction between negligent handling of goods and embezzlement. Roper J mentioned that the *dictum* suggested that losses due to negligence are not necessarily non-deductible.

Still on negligence, Roper J referred to the English case of *Strong and Co. of Romsey Ltd v Woodifield* and the decision by Lord Loreburn that losses can be deducted if they are incidentally connected to the taxpayer's trade, and that the nature of the trade must be considered, such as losses sustained by a railway company in compensating passengers for accidents in travelling. Roper J found no suggestion that compensation paid as a result of accidents is only deductible if there has been no negligence on the part of the railway company or its employees. He further held that negligence does not cause a loss to be non-deductible, whether the negligence is that of employees or of the taxpayer. Roper J (at 491) described negligence as "an element of inefficiency". The learned judge held that an inefficient taxpayer is taxed on the income actually earned and not on that which should have been earned if the taxpayer had been efficient. Roper J further stated that the deduction of a loss caused by negligence depends on the facts of the particular case, and on matters such as the nature and degree of the negligence and the character of the business.

After dealing with negligence, Roper J then referred to the provisions of the Income Tax Act, which authorises the allowable deductions now embodied in section 11(a). The learned judge mentioned that it was unnecessary for him to discuss the meaning and effect of the provisions because these had been exhaustively considered in several cases. Roper J confirmed the meaning of "in the production of the income" by Mason J in the *Lockie Bros Ltd* case and that of Watermeyer AJP in the *Port Elizabeth Electric Tramway* case. He mentioned that the article "the" in "the income" does not limit the deductible losses to those concerned with the production of income for the particular year in which the losses are incurred, as established in the *Sub-Nigel Ltd* case.

The learned judge concluded that when a liability or a loss is settled, it is immaterial to consider whether the taxpayer has carried out an act directed to the production of income. According to Roper J, the enquiry should be whether the taxpayer incurred the loss, or the liability that has caused the loss, in the course of operations directed to the production of income. He further held (at 493) that if the liability or loss is as a result of mischance or accident, a further question arises "whether the nature of the taxpayer's business is such that the risk of such a mishap can be said to be inseparable from, or a necessary incident of the carrying on of the business". The learned judge considered this test as the proper test to be applied in *Income Tax Case 815*.

In his reasoning, Roper J considered that a loss that is of rare occurrence does not necessarily mean that it is a risk of loss that is not a necessary incident of the business. The learned judge suggested that the risk of loss might be rare in a firm of attorneys because the members of that profession are trained to be thoroughly careful. The learned judge pointed out that attorneys may be victims of forgery in connection with mortgages, and the risk of being involved in a well-planned fraud is certainly a risk incidental to the practice of an attorney's profession. Roper J found that an attorney undertaking business with others is always subject to the risk that one of his or her partners may be involved in forgery, and so involve him or her in loss. Regarding the loss of the trust moneys in *Income Tax Case 815*, the court, *per* Roper J, concluded that the risk of loss was a necessary incident of the business of attorneys that was carried on by the taxpayer and his partners. It was further held that the loss of the trust moneys was therefore incurred in the course of an operation directed to the production of income and was allowable as a deduction because the business derived its income from the

investment of funds for its clients. It follows that losses of trust moneys are incurred "in the production of the income" if the risk of the loss is a necessary incident of the taxpayer's business operations.

Roper J further dealt with the losses due to embezzlement. The basis of the test of "in the production of the income" was different from the one applied to the loss of trust moneys. He referred to the *Lockie Bros Ltd* case, arguing that the reasons for Mason J's judgment did not indicate accurate grounds for holding against the taxpayer, except that the money thus lost was not an outgoing for the purpose of earning the taxpayer's income. According to the court in *Income Tax Case 815*, it was not possible to establish whether the funds stolen were trust moneys or funds belonging to the partnership, having been earned by the firm from services rendered to its clients. If the taxpayer had been able to establish that the moneys embezzled were trust moneys, it would have been necessary to enquire whether the *Lockie Bros Ltd* case could be distinguished on the grounds that in *Income Tax Case 815* the funds taken were trust funds, as the fact was not established. The taxpayer failed to discharge the onus that any sum of money that can be identified specifically as being trust money, was taken by the employees. The losses from the funds embezzled by the partnership's employee were not allowable as a deduction.

The significance of this case is that losses due to fraudulent misrepresentation are incurred "in the production of the income" if the loss was incurred in the course of operations directed at the production of income, and if the risk of the loss was a necessary incident of the taxpayer's business. The court also explained that negligence on the part of the taxpayer or an employee does not cause the deduction of a loss to be disallowed. Croome, Oguttu, Muller, Legwaila, Kolitz, Williams and Louw (2013) assert that the decision to disallow the loss due to embezzlement in *Income Tax Case 815* was incorrect. The authors stated that when reference is made to the decision of the court in the *Rendle* case, it is contended that the risk of the theft and embezzlement is incidental to the business conducted by the taxpayer.

3.2.2.2. *Commissioner of Taxes v Rendle*

The Zimbabwean High Court in *Commissioner of Taxes v Rendle* allowed the deduction of losses due to misappropriations by the clerks of the taxpayer, as indicated in the facts of the case in chapter 2. The grounds for allowing the deductions were that the reimbursement of

the moneys misappropriated was sufficiently closely connected with the business operations of the partnership, so as to be regarded as part of the cost of performing those operations. It was further held that the costs of the investigation and legal advice were inseparably related to the embezzlements and were thus deductible.

Beadle CJ who delivered the Court's judgment held that the fortuitous expenditure in the *Rendle* case was expenditure attached to the performance of the business operations by chance. In explaining that the chance of such expenditure incurred must be sufficiently closely connected with the taxpayer's business operations, he referred to the judgment of Watermeyer AJP in the *Port Elizabeth Electric Tramway* case. Beadle CJ observed that what was regarded as inseparable from the running of the tramway business was the potential liability or risk of a claim for damages arising. The learned Chief Justice gave several examples of cases that have direct authority to show that it is the risk of the expenditure being incurred that is the deciding factor. The first case he cited was the Australian case of *Charles Moore & Co. (W.A.) (Pty) Ltd, v Federal Commissioner of Taxation,* 1956, 6 A.I.T.R. 379, in which the court allowed the deduction of moneys robbed from a cashier when she was taking the firm's money to the bank. The court held that armed robbery of employees carrying money through the streets remains a risk arising as a result of the nature of the procedure of banking. Reference was also made to the New Zealand case of *Gold Band Services Ltd v Inland Revenue Commissioner* (*N.Z.*), 8 A.I.T.R. 193, in which the court held that the risk of the loss due to the robbery was inherent in the course of production of income.

Beadle CJ further cited the *Strong and Co. of Romsey Ltd* case, where Lord Loreburn L.C stated that losses could be deducted if they are really incidental to the taxpayer's trade, such as losses sustained by a railway company in compensating passengers for accidents while travelling. Beadle CJ suggested that the words "really incidental" in the illustration of the running of a railway business meant the risk of having to pay compensation to passengers. The learned Chief Justice also agreed with the views of Fieldsend P in *Income Tax Case 952*, and Davies P in *Income Tax Case 1030*, 26 SATC 59, that attention should be focused on the risk of the expenditure being incurred and not on the actual expenditure itself. In Beadle CJ's view, the words "reasonably incidental risk" by Fieldsend P in *Income Tax Case 952* originated in the judgment of Turner J in *Commissioner of Taxes v Webber*, 1956 N.Z.L.R. 552 (6 A.I.T.R. 291), and were adopted by Haslam J in the *Gold Band Services* case which he

used to simply mean "inherent in". Relying on these cases, Beadle CJ found that the risk of the expenditure being incurred is a deciding factor in the deductibility of expenditure and losses.

In the course of his judgment, Beadle CJ further examined how closely the risk must be connected with the performance of the business operation. He paraphrased (at 333) the words of Roper J in *Income Tax Case 815* that: "Before fortuitous expenditure can be deducted, the taxpayer must show that the risk of the mishap which gives rise to the expenditure happening, must be inseparable from or a necessary incident of the carrying on of the particular business."

According to Beadle CJ, this was a broad general test to be applied to the deductibility of fortuitous expenditure. He stated that the findings indicate that the risk in the *Rendle* case was a reasonably incidental risk of the taxpayer's business operations. He concluded that there was sufficient evidence that the risk of embezzlement in an accountant's business was such a familiar and recognisable hazard in that type of business as to be inseparable from it. From these considerations, the court, *per* Beadle CJ, held that the losses were incurred "in the production of the income". The learned Chief Justice argued that there was no logical argument that could prevent the application of the broad test to the theft by an employee as well as to theft by a third party. He contended (at 334) that "the risk of loss by theft of an employee may be just as great and in some cases greater than the risk of loss by theft of a third party". The learned Chief Justice stated that when an employee steals from his or her employer, he or she would not be acting in the execution of his or her duties; consequently, his or her position of theft would be similar to that of a third party.

Beadle CJ referred to Fieldsend P's view in *Income Tax Case 952,* when he compared the *Lockie Bros Ltd* case to the *dicta* by Rowlatt J in the English case of *Curtis v J and G Oldfield*. Beadle CJ (at 335) stated that "the risk of theft by a managing director can be regarded as inseparable from the carrying on of the business". The learned Chief Justice treated the perpetrator in the *Lockie Bros Ltd* case as a managing director whilst in reality he was a mere manager. He also mentioned that Roper J disallowed the deduction of a loss due to theft by an attorney's clerk from the attorney's own moneys because he felt bound by the *Lockie Bros Ltd* case. He suggested that the decision might have been different if the

attorney's clerk had stolen trust funds for which the attorney was responsible and not the attorney's money.

SARS (2014) notes that the "inseparable from" and "necessary incident of" tests in the *Rendle* case have the same substance as the "reasonably incidental risk" test used in *Income Tax Case 952*. Importantly, when carrying on a particular business, the taxpayer inevitably has to accept that the risk that embezzlement, fraud or theft could occur. Goldswain and Swart (2015) argue that the *Rendle* case is an example of an absurd conclusion because the taxpayer had not discharged the onus of proof that there was a sufficiently close connection to the firm's business operations and the misappropriation, thus the misappropriation of the taxpayer's own funds by the same clerks was not deductible. Although the decision in the *Rendle* case is only of persuasive authority, it did not establish that the misappropriation of trust funds by subordinate employees is always deductible and the misappropriation of the firm's own funds is never deductible (Goldswain: 2005). This will depend on the facts of a particular case. The court in the *Rendle* case, however, examined the closeness of the connection of the expenditure with the taxpayer's business operations in allowing the deduction.

3.2.2.3. *Income Tax Case 1242*

A conclusion similar to the one in *Income Tax Case 1221* by the Zimbabwean (Rhodesian) Special Court was arrived at by the South African Tax Court in *Income Tax Case 1242*, 37 SATC 306. The taxpayer was a company that carried on the business of a publisher. Most of its receipts and payments were made by way of cheques with small amounts of cash being handled by members of its staff. Two of its clerks committed a series of thefts of cash by taking some amounts from petty cash, misappropriations through the misuse of the company's order book, and by the misuse of its cheque book. A portion of the amounts stolen was recovered. The two employees disappeared, and the taxpayer company suffered some losses from the unrecovered amounts. The Secretary for Inland Revenue (now the Commissioner for the South African Revenue Service) disallowed the deduction of the losses because they were not incurred "in the production of the income". The question before the court was whether the taxpayer company could deduct from its income the losses of money stolen from it by the two clerks.

Watermeyer J, who delivered the judgment of the court, began by stating the provisions of section 11(a) of the Income Tax Act. He confirmed that the *Lockie Bros Ltd* case was precedent for the issue of losses by embezzlement of a taxpayer's own funds. The learned judge pointed out that since 1922 when the *Lockie Bros Ltd* case was handed down in the courts, the court merely followed the decision in the *Lockie Bros Ltd* case and disallowed the deduction of the losses. During the course of his judgment, Watermeyer J pointed out that it was important to determine the correct test as to whether a loss is incurred "in the production of the income" and apply it to the facts of a particular case. He highlighted that a decision in one case would not necessarily apply in another case. Watermeyer J acknowledged that the test by Beadle CJ in the *Rendle* case was the appropriate test to be applied to cases dealing with losses. The learned judge (at 309) emphasised the test stating that:

> 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.

After examining the manner in which the cash was handled in *Income Tax Case 1242*, it was established that it was necessary to employ clerks who handled a limited amount of cash, to draw cheques, and to place orders on behalf of the company that were of a routine nature. The court, *per* Watermeyer J, found that the thefts committed by the clerks were ever-present in a business such as the taxpayer's. It was concluded that the risk of a loss of this nature occurring is an ever-present one when subordinate employees are engaged to perform the duties entrusted to the two clerks. The court held that the taxpayer had shown that the risk of losses occurring was an inseparable or necessary ingredient of the carrying on of its business and that the losses in issue were, therefore, incurred "in the production of the income" within the meaning of section 11(a) of the Income Tax Act. It follows that, as a prerequisite to deductibility, a taxpayer must establish that the risk of the loss that he, she, or it seeks to deduct from income is inseparable from or a necessary ingredient of, the carrying on of the specific business.

On the question of distinguishing between ordinary employees and managers or managing directors, Watermeyer J agreed with the distinction made by Beadle CJ in the *Rendle* case

with the *Lockie Bros Ltd* case, on the grounds that a manager and not a subordinate employee committed the theft. Nonetheless, Watermeyer J (at 310) concluded that "each case must be decided on its own facts, and a decision in one case that a deduction is not permissible, does not mean that a deduction is never permissible".

3.2.3. Defalcations by proprietors or partners

3.2.3.1. *Income Tax Case 952*

The facts in *Income Tax Case 815* can be compared to the facts in *Income Tax Case 952,* in which the Zimbabwean Special Tax Court dealt with defalcations of trust funds by a partner. The taxpayer carried on a partnership business as an attorney. He discovered that his partner had made some misappropriations from the trust account of the firm's clients. The taxpayer was required to make good the deficit in the trust fund. He claimed the deficit as a deduction and the Commissioner of Taxes disallowed the deduction. Fieldsend P, who delivered the Court's judgment, began by stating the provision for allowable deductions in the Zimbabwean Income Tax Act. He stated that the underlying cause should be considered for the payment that the taxpayer made, and the immediate reasons for making the payment. The learned President found that the taxpayer's liability arose from the incidence of the partnership between himself and his partner, and from the fact that his partner acted in a way that imposed an obligation on the partnership, which became the taxpayer's legal liability to fulfil.

Fieldsend P stated that he had some difficulty in discerning any principle with regard to losses due to theft or embezzlement. He referred to the judgment of Mason J and De Waal J in the *Lockie Bros Ltd* case and he acknowledged the case as the leading case in this regard. He also referred to Roper J's decision in *Income Tax Case 815* that the loss suffered by an attorney's firm due to the embezzlement of funds, other than trust funds, by an employee, was not deductible. In addition, Fieldsend P considered the Australian case of *Charles Moore and Co (W.A) (Pty) Ltd.* In this case, two of the taxpayer's employees were held up and robbed of cash on their way to the bank with the day's takings. The Australian High Court allowed the sum lost as a deduction on the ground that the banking of cash takings was a necessary part of operations directed at earning of the total income for the year. It was also held that the loss by robbery was a risk inherent in the procedure adopted in banking the takings, so that the loss was, of its nature, connected with the operations that earned the

taxpayer's income. The court in this case referred to the Australian case of *Ash v Federal Commissioner of Taxation*, 1938 (61) CLR 263, where Rich J held that involuntary outgoings and unforeseen or unavoidable losses are deductible when they represent that kind of casualty, mischance or misfortune, which is a natural or recognised incident of a specific trade or business.

Fieldsend P further referred to the New Zealand Supreme Court case of *Gold Band Services Ltd*. In this case, the sole employee of a petrol service station was held up and robbed of part of the weekend takings. The court allowed the deduction of the loss because the risk of such an event was inherent in the course of the production of the taxpayer's income. Fieldsend P stated that it was difficult to reconcile the *Lockie Bros Ltd* case and *Income Tax Case 815* with the Australian and New Zealand cases referred to above. From the cases cited, the learned President concluded that it was essential to determine whether the dishonest removal of funds is a reasonably incidental risk to the production of the taxpayer's income, and, if so, the loss would have been suffered "in the production of the income".

The learned President compared his decision to the reasoning of Rowlatt J in the English case of *Curtis v J and G Oldfield Ltd*. The taxpayer in this case was the managing director and in charge of the whole business of the company. It was held that if a subordinate employee, due to negligence or dishonesty, does not remit some of the receipts into the accounts, the resulting loss is connected with and arising out of trade, and could be deducted. The English court found no evidence that the loss was connected with the taxpayer's trade. It found that the managing director made away with the income that had been paid over to the company, using the advantage of the position which he held. According to Fieldsend P, Rowlatt J's judgment appears to support the decision in the *Lockie Bros Ltd* case for disallowing the loss resulting from the manager's embezzlement. Fieldsend P stated that the revenues of most taxpayers' businesses are exposed to petty thefts of employees and leakages through negligence or dishonesty of ordinary employees. He also stated that a senior manager or managing director is not reasonably expected to make away with his or her employer's funds. If this occurs, the risk is not reasonably incidental to the taxpayer's trade. Relying on the *dicta* by Rich J in the *Ash* case, the court in *Income Tax Case 952* held that the defalcations of a partner in an attorney's firm were not a result of casualty, mischance or misfortune that is a natural and recognised incident of the business.

A distinction between the deductibility of a loss due to embezzlement by a manager and a non-managerial employee appears to have been suggested for the first time by Fieldsend P. He suggested that a distinction could be made between the embezzlement committed by an ordinary employee and managers or managing directors, the latter being in a position of authority. The taxpayer's appeal was disallowed because it was found that a partner is in a different position to an ordinary employee. It was further stated that the payment in this case was made by reason of the obligation upon the taxpayer arising from the fact that the partnership was obliged to repay the money paid to it by its clients. The taxpayer was liable for the obligation if the partnership or his partner could not meet it. Consequently, the defalcations were not expenditure incurred in the production of the taxpayer's income and could not be allowed as a deduction.

The case is of importance due to the fact that a loss due to defalcations by taxpayers' employees is incurred "in the production of the income" if the defalcation is a reasonably incidental risk to the production of the taxpayer's income. SARS (2014) points out that times have changed since *Income Tax Case 952* was heard in the courts and embezzlement, fraud and theft by senior managers have become prevalent. The revenue authority suggests factors that can be considered in weighing up whether the risk involved in the occurrence of the loss is inherent to a particular business. In the revenue authority's opinion, whether the act of embezzlement, fraud or theft can be regarded as inherent can depend on circumstances such as the nature of the taxpayer's business, who perpetrated or is suspected to have perpetrated the embezzlement, fraud or theft, the perpetrator's relationship to the taxpayer, and the method used to perpetrate the embezzlement, fraud or theft (SARS: 2014). SARS (2014) submits that taxpayers incurring expenditure and losses at the hands of senior managers will need to provide evidence that in their type of business the risk of senior managers embezzling, or stealing is an incidental risk of the business. It can be noted that what is relevant in one case and at one particular time, will not necessarily be relevant at another point in time. Each case must be considered on its own facts to determine the deductibility of the loss.

3.2.3.2. *Ash v Federal Commissioner of Taxation*

The facts and the court's decision in *Income Tax Case 952* can be compared to the Australian case of *Ash v Federal Commissioner of Taxation*. In this case, an attorney sought to deduct an

instalment paid under an agreement to make good misappropriation by his former partner of moneys belonging to clients of the firm. The fraudulent partner had required clients to make overpayments to him in respect of various expenditures, such as counsels' fees, payments under contracts of sale, and stamp duties. The court in the *Ash* case drew distinctions between the defalcations by a partner and those of an employee. Latham CJ (at 273 – 274) stated that: "purloinings by office boys and thefts by shop employees should, *prima facie*, be allowed as deductions. They may be shown to be incidental to, and perhaps inevitable in, the operations which produce income". On the other hand, Rich J (at 277) stated that: "The defalcations of a partner appear to me to stand in a different position from the petty larcenies of servants, and the leakages through carelessness or dishonesty to which the revenues of most profit-earning organisations are exposed". The court held that losses should be allowed as deductions when they represent that kind of casualty, mischance or misfortune that is a natural or recognised incident of a specific trade or business, the income of which is in question. Accordingly, the loss caused by the fraudulent partner did not represent the kind of casualty, mischance or misfortune that is a natural or recognised incident of a professional partnership. It was further held that the risk that partners would abuse their position and make fraudulent out of pocket expense claims, is not a natural or recognised incident of conducting business through a partnership. If applied to the South African case law, it follows that the loss as a result of the partner's defalcations is not incurred "in the production of the income" because it is not a recognised incident of conducting business or incidental to the taxpayer's business operations.

3.2.4. Defalcations by a third party

3.2.4.1. *Income Tax Case 1661*

The cases discussed above dealt with perpetrations by the taxpayers' employees. The South African Tax Court dealt with a case involving losses from theft, fraud and misappropriation of funds by a third party in *Income Tax Case 1661*, 61 SATC 353. The taxpayers were partners practising as dentists. They appointed a firm of auditors to perform accounting and certain management functions that included the right to make out and sign cheques on behalf of the partnership. Two signatures were required on every cheque and the firm of auditors agreed with the partnership that cheques would be signed as follows: a signature by one of the partners and one of the auditors, or a signature by one of the auditors and an employee of the auditors. An employee of the auditors and possibly one of the auditors stole money from

the taxpayers or falsified their signatures on cheques. In addition, on occasions, false statements were made that cheques were necessary for a certain purpose and these cheques were then made out for personal use by one of the auditors and/or the employee. The taxpayer claimed the amounts defrauded as a deduction. The Commissioner, in his determination of the taxpayers' liability for tax, disallowed the claim by the taxpayers that the theft, fraud or misappropriation was an inherent risk in the production of their income as dentists.

Kirk-Cohen J, who delivered the judgment of the court, first stated the requisites that the taxpayer had to prove as set out in the general deduction formula. He mentioned that although the auditor had a fiduciary relationship with the taxpayers, the auditor or accountant would remain at all times an independent contractor. It was common cause that in the case at hand there was no master/servant relationship. The learned judge recognised that South African case law has shown that a loss incurred through theft or embezzlement by an employee or officer of the taxpayer can be allowed as a deduction, each case dependant on its own facts. He stated (at 356) that "the officer referred to was an employee as defined under the common law". Kirk-Cohen J confirmed that the *Lockie Bros Ltd* case indicated that the court would recognise the deduction of theft by junior employees. He held that those responsible for the losses in *Income Tax Case 1661* were not the taxpayers' employees. He further remarked that the contract with the auditors was not a pre-requisite for the earning of income, and the theft by the independent contractor and its servant was not a pre-requisite for the production of income in terms of section 11(a) of the Income Tax Act.

Kirk-Cohen J concluded that the evidence established that the theft, fraud or misappropriation took place after the income was earned. The production of income was not concomitant with the theft, fraud or misappropriation, the one occurred after the other. The court found no evidence to support the submission by the taxpayers that the theft and the fraud by an independent contractor in this case was an inherent risk of the practice of dentistry. The court compared *Income Tax Case 1661* to an Australian case of *Levy v Federal Commissioner of Taxation*, 1960 (8) A.I.T.R 127. In this case, a manufacturing partnership employed a firm of accountants to write up its books. An employee of this firm of accountants, who was instructed to carry out the task, stole moneys from the partnership. The Commissioner made enquiries as to whether the accountant had become an employee of the partnership and it was

found that the clerk was at all times an employee of the firm of accountants. The court held that the defalcations would be an allowable deduction if they were a kind of misfortune that was a material or recognised incident of the partnership. It was further held that the facts as to the nature of the business, the position of employee and the method by which the employee effected his defalcations, were sufficient to make it clear that the deduction could not possibly be supported on that basis. Applying the reasoning in the case of *Levy*, the court in *Income Tax Case 1661* held that the losses were not deductible. It follows that the defalcations in issue would have had to be the kind of misfortune that was a material or recognised incident of the partnership, and the facts in this case were sufficient to make it clear that the deduction could not possibly be supported on that basis.

The significance of this case is that a third party perpetrated the theft. SARS (2014) points out that the outcome of the taxpayers may have been different if they had discharged the onus that the risk of the loss was inherent in the business. The revenue authority suggests examples of evidence that taxpayers in similar circumstances as in *Income Tax Case 1661* may present, namely appropriate crime or insurance statistics that support the case. This indicates that the courts regard theft by third parties to be "in the production of the income" if the taxpayer shows that there is an inherent risk of embezzlement, fraud or theft in the taxpayer's business.

3.2.4.2. *Charles Moore & Co. (W.A.) (Pty) Ltd v Federal Commissioner of Taxation*

The Australian High Court have also dealt with losses caused by third parties, that is by a person other than an employee of the taxpayer or a proprietor, in *Charles Moore & Co. (W.A.) (Pty) Ltd v Federal Commissioner of Taxation.* The taxpayer company conducted business as a department store. It was the practice every business morning for the cashier, accompanied by another employee, to take the previous day's takings to the bank some short distance away and pay them in to the credit of the taxpayer. On the morning of the incident, while on their way to the bank, the two unarmed employees were held up at gunpoint and robbed. The money they carried consisted of cheques and cash forming the trading receipts of the previous day. A bag containing the cheques was recovered but the bag containing cash was stolen and never recovered. The taxpayer was not insured against a loss of such a description. The taxpayer claimed the amount as a deduction from the assessable income in the return for the year in which the robbery occurred, but the Commissioner disallowed the claim.

From the judgment in the *Charles Moore and Co (W.A) (Pty) Ltd* case, referred to in *Income Tax Case 952* and the *Rendle* case, it should be evident that the conduct is a necessary part of the operations that are directed at producing the taxpayer's income. The occasion for the loss should be the course pursued in conducting the taxpayer's operations. The operation should be an essential part of the conduct of the taxpayer's business, a necessary or recognised incident or concomitant, and relevant as well as incidental to the production of income. In terms of the decision in the *Charles Moore and Co (W.A) (Pty) Ltd* case, armed robbery of employees carrying money to the banks is a familiar and recognised hazard, and the certainty that the loss is deductible is increased when insurance is involved. The court held (at 351) that the phrase "incidental and relevant" when used in relation to the deduction of losses does not refer to "the frequency, expectedness or likelihood of their occurrence or the antecedent risk of their being incurred, but to their nature or character". It was stated that consideration should be given to their connection with the operations that more directly gain or produce the assessable income.

Thus, losses due to armed robbery are incurred "in the production of the income" if the nature of the loss is closely connected to the operations that produce the taxpayer's income. This case shows that when a taxpayer suffers a loss as a result of a robbery, the loss incurred is held as "in the production of the income" if it arises in the course of carrying out a necessary or expedient part of the operations directed to the production of the income of a taxpayer's business.

According to FA News Report (in Institute of Certified Bookkeepers, South Africa, (2013: Online)), "...although three quarters of South African businesses have fallen victim to some form of commercial crime, only 20% of these incidents are reported to the police". It can be noted that from the South African cases discussed, no record of a police report was indicated in the facts and the reasoning of the judges. In terms of the Tax Administration Act, 28 of 2011 (referred to as the Tax Administration Act), the burden of proving that an amount is admissible as a deduction lies with the taxpayer. According to SARS (2014), in proving a fraud, the revenue authority requires from a taxpayer proof such as a police docket reference number, a charge sheet issued by a court and a detailed report, such as a forensic investigation by a qualified person. The taxpayer needs to be able to quantify the expenditure and loss incurred in the embezzlement, fraud and theft.

3.3. Summary of case law findings on losses due to embezzlement, fraud and theft

From the analysis of case law on losses due to embezzlement, fraud and theft, some comparisons of the facts and judicial reasoning can be made. There are some similarities and distinctions regarding the persons who perpetrated the embezzlement, fraud or theft, and how the acts were perpetrated. In *Income Tax Case 815* and *Income Tax Case 952,* the losses concerned trust funds from firms of attorneys. The distinguishing factor is that in *Income Tax Case 815*, the fraudulent misrepresentation and embezzlement was perpetrated by the junior employees of the firm of attorneys whilst in *Income Tax Case 952*, the defalcations were made by a partner in a firm of attorneys. In *Income Tax Case 815*, the court concluded that the risk of loss of trust funds held by the partnership for investment was a necessary incident of the partnership business of the attorneys. The repayment of moneys entrusted to the firm of attorneys, was allowed as a deduction as the taxpayer derived its income from the investment of funds for its clients. However, the losses from the funds embezzled by the partnership's employee were disallowed as a deduction because the taxpayer failed to discharge the onus that the funds embezzled by the employees could be identified specifically as being trust money. In *Income Tax Case 952*, the court held that the defalcations of a partner in an attorney's firm were not as a result of casualty, mischance or misfortune, which is a natural and recognised incident of the business. It was found that a partner is in a different position to an ordinary employee. The court, therefore, held that losses due to defalcations and the repayment were not expenditure incurred in the production of the taxpayer's income, and could not be allowed as a deduction.

In the *Rendle* case, two clerks in a chartered accounting partnership were responsible for the misappropriations. Similar perpetrators were found in *Income Tax Case 1242*, where two clerks of a publishing company embezzled the taxpayer's own funds. In both cases, the losses were held to have been incurred "in the production of the income". In the *Rendle* case, the court held in favour of the taxpayer because the expenditure incurred by the taxpayer's partnership in the reimbursement of the clients' misappropriated funds by the partnership's employee was sufficiently closely connected with the business operations of the partnership so as to be regarded as part of the cost of performing those operations. It was further held that the costs of the investigation and legal advice were inseparably related to the embezzlements and were allowable as deductions on the same grounds. The court in *Income Tax Case 1242* held that the taxpayer must establish that the risk of a loss, which he seeks to deduct from his

income, is inseparable from, or a necessary ingredient of, the carrying on of the particular business. The thefts committed were ordinary everyday thefts that occur from time to time in the business of a publishing company. The court held that the taxpayer had shown that the risk of the losses occurring was an inseparable or necessary ingredient of the carrying on of its business, and that the losses in issue were incurred, therefore, "in the production of the income".

An important factor considered in *Income Tax Case 815*, *Income Tax Case 952*, the *Rendle* case and *Income Tax Case 1242* is the type of funds misappropriated. Where the taxpayer's own funds are misappropriated by an employee or proprietor a loss is suffered by the taxpayer, but where trust funds are misappropriated, the payment of compensation made by the taxpayer is expenditure. The court in the *Joffe and Co (Pty) Ltd* case held that, in substance, there is no difference between expenditure and a loss, as expenditure is a voluntary payment whilst a loss is an involuntary deprivation (Goldswain: 2005). If the close connection test is applied to the expense or loss as having been incurred "in the production of the income", the expense or loss must have resulted from misappropriations attached to the business operation by chance, provided they are so closely connected with the operation that they may be regarded as part of the cost of performing it.

The secretary/accountant of a department store made the misappropriations in *Income Tax Case 1221*. Similarly, in *Income Tax Case 1383*, the secretary of a bank perpetrated the defalcations. The losses in both cases were allowed as a deduction. The court in *Income Tax Case 1221* held that losses due to theft by a managing director, a director or a manager in the position of a proprietor are not deductible. The court held that the risk of embezzlement by the employee was a necessary incident of the carrying on of the taxpayer's business, and that the losses incurred were sufficiently closely linked to the taxpayer's business operations so as to be regarded as part of the cost of performing the business operations. It follows that the loss incurred was in the production of the taxpayer's income and was deductible. In *Income Tax Case 1383*, it was emphasised that the deductibility of fortuitous losses and expenditure depends on the facts of the particular case. The court held that the loss was incurred "in the production of the income" because the risk of theft was inherent in and an inseparable element of the taxpayer's business as a bank, and that the loss was therefore deductible.

The common characteristic of *Income Tax Case 1221*, *Income Tax Case 1242* and *Income Tax Case 1383,* is that each of these three cases involved the taxpayer suffering losses as a result of thefts perpetrated of its banked funds by a subordinate employee. In the *Rendle* case and *Income Tax Case 1383*, theft by more senior employees and executives, excluding the proprietor, was held to have given rise to deductible losses. Regarding the decisions in the *Lockie Bros Ltd* case and the *Rendle* case, Croome *et al* (2013) stated that if a taxpayer suffers a loss as a result of theft or embezzlement, the loss should be deductible provided the loss is incidental to the business carried on by the taxpayer and that the acts giving rise to the loss are perpetrated by employees and not by the management of the business. It is important that the risk of theft be closely linked to the business operations conducted by the taxpayer.

Kruger *et al* (2012) assert that some absurd results can emerge from the deduction of losses incurred "in the production of the income". For example, where there has been an embezzlement in a business by an employee and the loss suffered by the taxpayer is as a result of theft by a lowly clerk, only then is it permissible as a deduction, such as in the *Rendle* case and in *Income Tax Case 1242,* or where a saleslady or similar type of employee is the thief. Where the theft has been perpetrated by a managing director it cannot be said that the risk of the loss is so closely connected to the business operations as to be regarded as necessarily incidental to the carrying on of that business as, for example, in the *Lockie Bros Ltd* case. However, De Koker and Williams (Online) assert that the decision to allow the deduction of losses due to theft by more senior employees and executives, excluding the proprietor, is correct, as deductibility is limited to the risk of loss, and this risk is not in any way linked to seniority of position.

The perpetrators in *Income Tax Case 1661* were different from other cases discussed. The taxpayer's auditors were those responsible for the losses. These were not the taxpayers' employees but third parties. The contract with the auditors was not a pre-requisite for the earning of the taxpayer's income, and theft by the independent contractor and the taxpayer's employee was not a pre-requisite for the production of income. There was no evidence to prove that the theft and fraud by an independent contractor in this case was an inherent risk of the practice of dentistry. It was held that the losses were not incurred "in the production of the income".

From the case law that dealt with losses due to misappropriations by employees, the principles established are that:

- expenditure arising from the repayment of trust funds misappropriated by employees of the trustee firm will be deductible, provided the link between the risk of misappropriation and the ordinary operations of the business is established (Goldswain *et al*: 2016); and
- deduction of the expenditure and loss depends on the facts of the particular case as held in *Income Tax Case 815* and *Income Tax Case 1242*.

Thus, it can be said that a loss due to embezzlement, fraudulent misrepresentation and theft by a taxpayer's employee is incurred "in the production of the income" if the risk of loss is a necessary incident of the taxpayer's business. In addition, in terms of section 102 of the Tax Administration Act, the onus is on the taxpayer to establish that the risk of loss is inseparable from or a necessary incident of the income producing operations of the business.

According to Goldswain *et al* (2016), persons in the positions of proprietors, including sole traders, partners, members of close corporations and shareholders, cannot steal from themselves. Consequently, losses or thefts by a proprietor from his or her own business are not incurred "in the production of the income" and are not admissible as a deduction in terms of section 11(a) of the Income Tax Act. Regarding a partnership, section 24H of the Income Tax Act provides that each partner is taxed on his or her proportionate share of the income of the partnership business. The partner will be allowed to deduct his or her portion of the deductions or allowances related to his or her proportionate share of income. The loss resulting from misappropriations by the partner concerned is not incurred "in the production of the income" as shown in *Income Tax Case 952*. This decision was supported in the Australian case of *Ash v Federal Commissioner of Taxation*. Thus, if the misappropriations are perpetrated by a proprietor or partner, the risk of loss is not a recognised incident of the taxpayer's business, and consequently the loss is not incurred "in the production of the income".

Mason J in the *Lockie Bros Ltd* case indicated that negligence would not result in the non-deductibility of the loss in question. His remarks indicate that negligence does not change the likelihood of refusing a deduction of a loss as incurred "in the production of the income".

Roper J in *Income Tax Case 815* held that negligence does not cause a loss to be non-deductible, whether the negligence is that of employees or of the taxpayer. Roper J further stated that the deduction of a loss caused by negligence depends upon the facts of the specific case, and upon matters such as the nature and degree of the negligence and the character of the business.

3.4. Conclusion

The aim of this chapter was to analyse case law dealing with the deduction of losses due to embezzlement, fraud and theft and to establish why court decisions differ in granting a deduction of the losses. This chapter involved an analysis of the requirement that losses due to embezzlement, fraud and theft must have been incurred "in the production of the income" to be deductible.

In the general test of determining if an expenditure or loss is incurred "in the production of the income", the courts have held that the expenditure or loss must be "closely connected" to the business operations. The major principle from the case law discussed in the present chapter is that a loss due to embezzlement, theft, or fraud is incurred "in the production of the income" if the risk of the mishap is inseparable from or is a necessary incident of the carrying on of a specific business. This principle was first enunciated in *Income Tax Case 815*. The need for the inherent risk of embezzlement, fraud, or theft to be present in the business has substantiated the need for a close connection between the loss and the taxpayer's business.

The court decisions analysed differed because different perpetrators misappropriated the taxpayer's funds, or trustee funds, unlawfully and intentionally made misrepresentations that prejudiced the taxpayer or stole money from the taxpayer. The distinction between embezzlement, fraud or theft by an ordinary employee, a senior employee and a proprietor, is necessary as the courts have shown that misappropriations by an ordinary employee are incurred "in the production of the income", whilst those by a senior employee or proprietor or partner are not. The courts have on several occasions generally held that theft committed by junior employees is an inherent risk of the taxpayer's business operations, but if a manager, managing director or owner embezzles funds, it is difficult for the taxpayer to prove that this act is an inherent risk of the business. Thus, a deduction of losses due to misappropriations by managers, managing directors or senior employees is granted as incurred "in the production

of the income" only if the taxpayer proves that in their type of business the risk of senior managers embezzling, or stealing is an incidental risk of the business.

The courts regard theft by third parties to be "in the production of the income" if the taxpayer shows that the theft is an inherent risk of the taxpayer's business. The Australian courts indicated that evidence should be provided by the taxpayer that the occasion of the loss was in the course pursued in conducting the taxpayer's operations. Importantly, the operation should be an essential part of the conduct of the taxpayer's business, a necessary or recognised incident, or concomitant of the production of the taxpayer's income. This can be applied to the South African test of "in the production of the income" for losses caused by persons other than the taxpayer's employees

According to the Institute of Certified Bookkeepers, South Africa (2013: Online), it is important for a taxpayer to have strong internal controls making it very difficult for fraud to occur, and to enable the expenditure and loss in question to be quantified. If a taxpayer's business has no internal physical or administrative controls in place, and the business is run in a negligent manner, the risk of misappropriations by employees increases. Such risk of misappropriation would be an inevitable concomitant of conducting the taxpayer's business (Goldswain: 2005). The courts have held that the fact that the taxpayer may conduct his business in a negligent or inefficient manner is not grounds, in itself, for disallowing expenditure or loss as not incurred "in the production of the income". Negligence would not increase the likelihood of the denial of an expense or loss being incurred "in the production of the income".

The following chapter, chapter 4, addresses the deductibility of expenditure on damages and compensation, particularly whether the expenditure can be regarded as having been incurred "in the production of the income" in terms of section 11(a) of the Income Tax Act.

CHAPTER 4: CASE LAW ON THE DEDUCTIBILITY OF DAMAGES AND COMPENSATION

4.1. Introduction

In chapter 2, an analysis of case law was undertaken, which provided clarity on what "in the production of income" means in terms of section 11(a) of the Income Tax Act. The courts in the *Port Elizabeth Electric Tramway* case and the *Joffe and Co (Pty) Ltd* case dealt with the meaning of "in the production of the income". The court in the two cases dealt mainly with the deduction of damages and compensation incurred by the taxpayers. The issue of concern that emerged from the *Port Elizabeth Electric Tramway* and the *Joffe and Co (Pty) Ltd* cases was as a result of the conflicting decisions reached by the courts on the deduction of damages and compensation, in relation to the requirement that an expense must be incurred "in the production of the income". In the *Port Elizabeth Electric Tramway* case, the court held that compensation paid under the Workman's Compensation Act was deductible, because it was regarded as being part of the cost of the tramway company's operations for the purpose of earning income. In contrast, the court held in the *Joffe and Co (Pty) Ltd* case, that damages were not incurred "in the production of the income" because it was not established that negligent construction was a necessary concomitant of the taxpayer's trading operations. Negligence was referred to in an *obiter* remark in the *Port Elizabeth Electric Tramway* case where it was stated that an expense attendant upon a negligent act is probably not deductible.

The differing decisions in the two cases are the basis of the aim of this chapter, which is to analyse and compare the facts and court decisions in case law relating to damages and compensation. The analysis is undertaken to establish why the court decisions differed in granting a deduction for expenditure on damages and compensation as having been incurred "in the production of the income". Relevant foreign cases that addressed the issue are briefly analysed for comparative purposes. Concluding remarks are made on the circumstances under which a taxpayer can successfully deduct damages and compensation as having been incurred "in the production of the income".

4.2. Analysis of case law on the deductibility of damages and compensation

The decision in the *Joffe and Co (Pty) Ltd* case appears to suggest that a business which is run in a negligent manner by the taxpayer or the taxpayer's employees increases the

possibility of a successful deduction of an expense for damages and compensation. In this context, it is necessary to enquire into the circumstances under which the courts would consider negligence as a factor for refusing the deduction of an expense for damages and compensation as having been incurred "in the production of the income". The cases in this chapter are discussed on the basis of successful and unsuccessful deductions of damages and compensation as having been incurred "in the production of the income", including cases decided after the *Port Elizabeth Electric Tramway* and *Joffe and Co (Pty) Ltd* cases.

4.2.1. Successful deductions of damages and compensation

4.2.1.1. *Income Tax Case 8*

One of the earliest South African cases that came before the court involving the deduction of damages and compensation was *Income Tax Case 8*, 1 SATC 57. The taxpayer carried on business as a tramway company. In the course of its business, the taxpayer company found it necessary to pay compensation for injuries to persons and properties resulting from collisions, accidents in connection with broken trolley wires, excavations made in the roadway, and accidents due to passengers alighting while the trams were still in motion. The company also incurred expenditure in obtaining legal advice in respect of those claims. The Commissioner disallowed the claim by the taxpayer to deduct these expenses in the calculation of the company's taxable income. The issue before the court was whether the compensation was deductible.

Ingram P, who delivered the Court's judgment, considered that in the carrying on of an undertaking of a tramway company, expenditure on compensation, up to a certain amount, is inevitable even where every precaution is taken to guard against accidents or negligence of the employees of the company. He stated that the loss was recurrent in undertaking tramway operations and had to be taken account of because it has a direct bearing on the income-earning capacity of the taxpayer. Ingram P referred to the meaning ascribed to "in the production of the income" by Mason J in the *Lockie Bros Ltd* case. The learned President remarked that when applying the requirement that expenses must be incurred "in the course of and by reason of the ordinary operations undertaken for the purpose of conducting the business", each case must be evaluated on its own merits. However, he pointed out that in certain instances, the dividing line between cases might be difficult to establish when applying Mason J's interpretation. The court held that the merit of *Income Tax Case 8* was

that payments made in compensation for injuries and the associated legal costs were normal current expenses incurred in the course of the ordinary operations carried on in the conduct of the taxpayer's business and were therefore incurred "in the production of the income". The expenditure was incidental and pursuant to the course of the operations which produced the taxpayer's income and it related to a necessary risk undertaken to earn the income. It was further held that fees paid to attorneys in connection with claims arising out of such damage were equally as inevitable as the actual damages and compensation to which it related and were also attributable to the ordinary operations of the company.

This case was heard before the *Port Elizabeth Electric Tramway* case, which had similar circumstances and similar business operations. The court allowed the deduction of the compensation applying the principle established in the *Lockie Bros Ltd* case, which was authoritative at the time. The test applied in *Income Tax Case 8* is that normal current expenses incurred in the course of the ordinary operations carried on in the conduct of the taxpayer's business are incurred "in the production of the income". Such expenditure must be incidental and pursuant to the course of the operations producing the taxpayer's income and should be as a result of a necessary risk undertaken to earn the income.

4.2.1.2. *Income Tax Case 49*

Income Tax Case 49, 2 SATC 122, is also an illustration of a successful deduction of damages incurred by the taxpayer. The taxpayer carried on the business of the sale of petrol lamps. Each lamp sold was subject to a guarantee. One of the lamps sold exploded causing injuries to the purchaser, who claimed damages for these injuries. The taxpayer incurred expenses for payment of the damages claimed in the lawsuit and the associated costs, which he claimed as a deduction. The Commissioner disallowed the claim. The issue before the court was whether the damages were allowable as a deduction. The court concluded that the expenditure was incurred in the course of the business of the taxpayer and it arose out of that business. The court held in favour of the taxpayer because the lamp in question had been sold in the course of the taxpayer's business and the taxpayer was held liable because he had given a guarantee in conjunction with the sale of the lamp. Thus, the damages were expenditure incurred "in the production of the income" and the court held that it was logical to allow the associated costs. According to Stiglingh, Koekemoer, Van Zyl, Wilcocks and De Swardt

(2015), it follows that the inherent risk of injuries in *Income Tax Case 49* were an inevitable concomitant of the taxpayer's trade and the resultant expenditure allowable as a deduction.

The court based its decision on the construction of "in the production of the income" by Mason J in the *Lockie Bros Ltd* case, which was authoritative at the time, as the case was heard before the dual test had been established in the *Port Elizabeth Electric Tramway* case. The significance of this case is that damages and costs of injuries resulting from an article sold under guarantee are incurred "in the production of the income" if they arise from the ordinary operations of the taxpayer's business.

4.2.1.3. *Income Tax Case 233*

Income Tax Case 233, 6 SATC 259, is another illustration of a situation in which the court allowed the deduction of damages and compensation paid as having been incurred "in the production of the income". The taxpayers carried on the business in partnership as stevedores. While unloading cargo from a vessel, an article fell out of the net and killed a passer-by. The heirs of the person killed claimed damages from the taxpayers. The taxpayers incurred legal expenses in consulting counsel for payment of the damages. The taxpayers claimed the cost of damages and legal expenses as a deduction. The Commissioner disallowed the deduction. The issue before the court was whether the damages were allowable as a deduction.

Nathan P, who delivered the Court's judgment, referred to the English case of *Strong and Co. of Romsey Ltd v Woodfield,* where it was held that consideration should be given to the nature of the trade and that losses could be deducted if they are connected with the trade, and if they are truly incidental to the trade or business. Relying on this decision, the court in *Income Tax Case 233* questioned whether the loss was incidental to the trade of stevedoring. It was held, *per* Nathan P that the damages must be regarded as incidental to the business of stevedoring because in the business of loading and unloading, it is a very likely and indeed almost foreseeable consequence and an inevitable consequence, that packages or other articles could fall out of the nets handled by stevedores and injure passers-by. The learned President further held that the enquiry whether the man in question was guilty of contributory negligence was a remote question of liability. Thus, negligence did not impact on the taxpayer's liability to pay for the damages. The court held in favour of the taxpayer because this was a legitimate

expense in connection with the earning of the taxpayer's income. The damages and costs were incurred "in the production of the income" and allowable as a deduction, applying the test that the expenditure should be connected with the taxpayer's trade, and if they are truly incidental to the trade or business.

4.2.1.4. *Port Elizabeth Electric Tramway v Commissioner for Inland Revenue*

The facts of the *Port Elizabeth Electric Tramway* case were stated in chapter 2. The significance of this case is the dual test to determine whether an expense or loss is incurred "in the production of the income". Watermeyer AJP (at 16) established that two questions need to be addressed, namely: (a) whether the act to which the expenditure is attached is performed in the production of income, and (b), whether the expenditure is linked to it closely enough". In answering the first question he held that the act entailing expenditure must be *bona fide* carried out for the purpose of carrying on the trade which earns the income. Regarding the second question, he held that all expenses attached to the performance of a business operation *bona fide* performed for the purpose of earning income must be so closely connected with it that they may be regarded as part of the cost of performing it.

Watermeyer AJP referred to the English case of *Strong and Co. of Romsey Ltd v Woodifield,* where it was suggested that compensation by a railway company is so closely connected with such operations as to form part of the cost of performing them as no amount of care could prevent compensation from arising. Reference was also made to the English case of *Smith v The Lion Brewery,* 1911, A.C. 150. The taxpayers were brewers who owned tied houses. They sought to deduct from their income an amount they had indirectly paid as their contribution towards a fund created by statute and contributions towards which were levied annually on tied houses. This was for the purpose of increasing their trade. The issue before the House of Lords was whether the amounts in question would be deductible. The court held that the purpose of the fund was to provide compensation to licensed houses whose licences were withdrawn and allowed the deduction. Watermeyer AJP compared the tied house to the workman in the *Port Elizabeth Electric Tramway* case. He mentioned that compensation was not payable in a lump sum by the employer of the tied house, but by way of an annual contribution towards a fund used for the purpose of compensating injured tied houses. The distinction was that the amount deducted in the *Smith v The Lion Brewery* case was an annual

contribution in the nature of an insurance premium, whereas in the *Port Elizabeth Electric Tramway* case compensation was paid as a lump sum and not as an annual premium.

He cited a further example in *Hancock v General Reversionary and Investment Co., Ltd,* 1919, I.K.B. 25, where it was held that the payment of a lump sum being the value of an annuity, to a servant on his retirement from service was a deductible expense. In comparison to this decision, Watermeyer AJP held that payments under the Workmen's Compensation Act in the *Port Elizabeth Electric Tramway* case were sometimes periodical payments, and were made in respect of incapacity by injury, whereas a pension as in the *Hancock* case was usually paid on account of incapacity by reason of age.

The taxpayer company in the *Port Elizabeth Electric Tramway* case had compensated the widow of a deceased driver for the injuries sustained by the driver in the course of his employment. Watermeyer AJP held that payments under the Workmen's Compensation Act in the *Port Elizabeth Electric Tramway* case were made in respect of incapacity by injury. The taxpayer's claim for deducting compensation paid was successful in the Cape Provincial Division based on the conclusion that payment of the compensation to drivers injured in undertaking their employment was inseparable from the taxpayer's business. Consequently, it was held that amounts paid as compensation under the Workmen's Compensation Act to the widow of the driver were incurred "in the production of the income", because they were regarded as part of the cost of the company's operations for the purpose of earning income. Thus, the compensation was deductible based on the dual test.

In his judgment, Watermeyer AJP made the *obiter* remark on negligence, stating (at 17) 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". Concerning unlawful acts, Watermeyer AJP stated that the expenses attendant to unlawful acts such as fines were not deductible. He concluded that no further enquiry was to be made on the question of unlawfulness of a business operation or negligence in carrying it out, because these did not arise in the *Port Elizabeth Electric Tramway* case.

According to Goldswain and Swart (2015), negligence was not an issue in the *Port Elizabeth Electric Tramway* case because compensation was paid for a claim brought in terms of the

Workmen's Compensation Act. Whether or not negligence played a part in the accident was not relevant to the decision and it was not necessary for Watermeyer AJP to discuss the deductibility or otherwise of expenditure incurred as a result of negligence. Commenting on the *obiter* remark on negligence by Watermeyer AJP, Williams (2009) is of the view that if the victim of the accident in the *Port Elizabeth Electric Tramway* case was a bystander and instituted action against the taxpayer for damages, any compensation payable by the taxpayer would not have been deductible because the act which entailed the expenditure would have been unlawful or negligent.

4.2.2. Unsuccessful deductions of damages and compensation

4.2.2.1. *Joffe and Co (Pty) Ltd v Commissioner for Inland Revenue*

Ten years after the *Port Elizabeth Electric Tramway* case, Watermeyer CJ as he later became, came to a different decision on the deduction of damages claimed by the taxpayer company as having been incurred "in the production of the income" in the *Joffe and Co (Pty) Ltd* case. The taxpayer company was an engineering firm. It was contracted for the steel reinforcement of a concrete hood on a certain building. A plumber working under the building was killed when the hood collapsed. The dependants of the deceased plumber sued the taxpayer for damages. The Court found that the taxpayer had been negligent by not taking proper precautions to prevent the reinforcing rods from becoming displaced while the hood was being constructed. This had weakened the structure and caused its collapse. The taxpayer was obliged to pay damages and costs. The taxpayer sought to deduct the damages awarded and the costs incurred. The Commissioner disallowed the deduction.

The question before the Appellate Division, *inter alia*, was whether the damages were deductible expenditure in terms of the present section 11(a) of the Income Tax Act. Watermeyer CJ, who delivered the Court judgment, first considered whether the damages were "actually incurred" "in the production of the income". Watermeyer CJ stated that the Australian case of *The Herald & Weekly Times, Limited v Federal Commissioner of Taxation*, 1932, HCA 56; 48 CLR 113 was relevant to the question on the deductibility of damages as incurred "in the production of the income" because the Australian statute is similar to the South African Income Tax Act. The taxpayers in this case were publishers of a newspaper. They claimed as a deduction from their income money paid out by way of compensation to satisfy certain claims against them for damages arising from the publication

of defamatory matter in their newspaper, and also money paid out as costs in connection with those claims. The majority of the court took the view that the publication of defamatory matter, and the consequent liability entailed thereby, were the inevitable, or "practically inevitable", concomitants of the newspaper business carried on by the taxpayer. Consequently, it was held that when such damages were paid, expenditure "in the production of the income" was incurred.

Watermeyer CJ emphasised that there was no suggestion in the Australian case that negligence and liability incurred thereby were the inevitable concomitants of a taxpayer's business but were involved in the *Joffe and Co (Pty) Ltd* case when the cantilever hood being constructed collapsed and killed a plumber. Thus, the question was whether the negligent construction and liability incurred thereby were the inevitable concomitants of the business of a reinforced concrete engineer. Consequently, Watermeyer CJ held that the *Joffe and Co (Pty) Ltd* case could not rely on the principle applied by the majority of the Court in the Australian case.

Watermeyer CJ held that damages paid by the taxpayer company did not pass the test that expenditure is deductible if it is necessarily attached to the performance of the operations which constitute the operation of the income-earning trade and is *bona fide* incurred for the purpose of carrying out trading operations. In the *Joffe and Co (Pty) Ltd* case, the court applied the test that expenditure on damages payable by a taxpayer as a result of negligence in carrying out trading activities is deductible in terms of section 11(a) of the Income Tax Act, if negligence is an inherent risk of that trade. It was found that damages were paid out to discharge a debt or legal liability owing to the plumber's dependants, arising out of taxpayer's negligence in performing a trading operation. The taxpayer's appeal was unsuccessful, and the court disallowed the deduction of these damages as it had not been established that negligent construction was a necessary concomitant of the taxpayer's trade, and the expenditure was not incurred for the purpose of earning income.

In terms of section 82 of the Income Tax Act (now replaced by section 102 of the Tax Administration Act), the taxpayer is required to provide prove that amounts expended are deductible. The taxpayer in the *Joffe and Co (Pty) Ltd* case failed to discharge the onus of proof placed upon it that negligent construction was an inevitable concomitant of its trade.

For this reason, the compensation paid to the plumber's dependants did not meet the requirement of the "in the production of the income" test.

Kruger *et al* (2012) are of the opinion that the court managed to distinguish between the *Port Elizabeth Electric Tramway* case and the *Joffe and Co (Pty) Ltd* case. The court came to a different decision because it found negligence in the *Joffe and Co (Pty) Ltd* case. According to Broomberg (in Hattingh *et al* (2015)), the person killed in the *Port Elizabeth Electric Tramway* case was an employee of the taxpayer company, while in the *Joffe and Co (Pty) Ltd* case, the victim was a third party. In the author's view, the legal basis for the obligation on the part of the taxpayers to pay compensation was different. This distinction justifies allowing the deduction in the *Port Elizabeth Electric Tramway* case but not in the *Joffe and Co (Pty) Ltd* case. Viewed from a business and economic perspective, Broomberg (in Hattingh *et al* (2015)) argues that the different outcomes are irrational. It indicates some misconception by the same judge on cases with similar economic consequences to the taxpayers. The compensation resulted from an accident that occurred while the taxpayer companies were carrying on their business operations. Kruger *et al* (2012) submit that if the meaning of "in the production of the income" in the *Lockie Bros Ltd* case had been applied, the taxpayers in both the *Port Elizabeth Electric Tramway case* and the *Joffe and Co (Pty) Ltd* case, would have been granted a deduction of both the damages and the legal expenses. Kruger *et al* conclude that the interpretation by Mason J in the *Lockie Bros Ltd* case that deductible expenditure is incurred "in the production of the income" if it is incurred "in the course of and by reason of the ordinary operations undertaken for the purpose of conducting the business of the taxpayer" could have been a wider and more useful decision.

According to Williams (2009), it is unpersuasive for the court to argue that human error or negligence is inevitable in all human activities. The author further points out that the issue should be whether a particular hazard is an inherent risk of the business of a concrete engineer, and not whether the particular taxpayer carried on business in a way that was likely to lead to accidents. From the *Joffe* decision it logically follows that irresponsible and reckless engineers would be entitled to deduct the damages paid by them arising from the course of their trading activities, whereas careful responsible engineers would be denied the deduction. Williams (2009) submits that the line of reasoning in the *Joffe and Co (Pty) Ltd* case that negligence is a factor in allowing the deduction of damages is an unusual

proposition. Mason J in the *Lockie Bros Ltd* case held that negligent handling of goods is different from embezzlement because handling of goods is a necessary incident of the business and negligence in that respect does not alter the nature of the transaction. In this regard, negligence is not a decisive factor impacting on the non-deductibility of expenditure as having been incurred "in the production of the income".

In his judgment, Roper J in *Income Tax Case 815,* analysed in chapter 3, examined the matter of negligence in relation to the requirement of "in the production of the income". The learned judge commented that the *Joffe and Co (Pty) Ltd* case does not hold that losses incurred through the negligence of the taxpayer are not deductible from the taxpayer's income, but that there was no evidence that losses arising from negligence were necessary concomitants of the taxpayer's business. Roper J, in *Income Tax Case 815,* concluded that negligence does not cause a loss to be non-deductible, whether the negligence is that of employees or of the taxpayer. The learned judge further remarked that the deduction of an expense or loss caused by negligence depends upon the facts of the specific case, and upon matters such as the nature and degree of the negligence and the character of the business. It follows that if there is evidence that the nature and degree of the negligence and the character of the business gave rise to the compensation, expenditure or losses arising from negligence would be deductible.

De Koker and Williams (Online) give a number of examples in which SARS allows the deduction of expenditure incurred as a result of negligence of the taxpayer or his employees, if the operations carried on by the taxpayer are of a nature that necessarily lead to accidents. These include the deduction of losses sustained by accountants and auditors in having to pay compensation or damages to clients for negligent work performed, whether the negligence was their own or that of their employees, deduction of damages paid by hairdressers to customers who suffer from burns and electric shock, and the deduction of compensation paid by a laundry for damage to or loss of articles entrusted to its care. According to De Koker and Williams (Online), SARS would probably not allow damages owing to negligence where a trader's bacon-slicer cuts off the hand of a customer, since such negligence is not an inevitable concomitant of the operation of the taxpayer's trade. Goldswain and Swart (2015:82) suggest that taxpayers could place before the court some possible evidence that negligence that caused the damages was an inevitable concomitant of the taxpayer's business, such as:

> valid statistics of the number of workmen who have been killed on building sites over a period of 20 years due to negligence, could go a long way towards discharging the onus of proof provisions by showing that negligent acts by employees is an occurrence that is expected and that even if strict precautionary measures are undertaken to prevent such accidents happening, it is still an inherent risk of doing business in the construction industry.

Thus, the test established in the *Joffe and Co (Pty) Ltd* case is that expenditure on damages payable by a taxpayer as a result of negligence in performing a trading operation is incurred "in the production of the income" if the negligence is an inherent risk, or a necessary concomitant of that trade, and that the consequent liability which the negligence entailed was incurred *bona fide* for the purpose of carrying on the trading operations of the taxpayer.

4.2.2.2. *Weinberg v Commissioner for Inland Revenue*

The case of *Weinberg v Commissioner for Inland Revenue,* 1946 CPD 429, 14 SATC 210, illustrates a situation where the taxpayer failed to secure the deduction of damages based on the decision in the *Port Elizabeth Electric Tramway* case. The taxpayer was a proprietor who carried on the business of a motor garage. He also derived income from rentals, salary and interest. He entered into an agreement with a customer to garage, dust and polish the customer's car. The customer was allowed to pick up one of the taxpayer's employees at the garage so that the employee could drive the car to the garage from the customer's home. On one occasion, one of the taxpayer's drivers took the customer's car out of the garage and drove it to his own home. On his way back, the driver had an accident and the car was badly damaged. As a consequence of the accident, an action was brought against the taxpayer by the customer to recover the value of the damaged car, as the taxpayer had breached the contract for safekeeping of the customer's car. The taxpayer was obliged to pay the damages with costs. The taxpayer sought to claim as a deduction the damages and costs connected with the action. The Commissioner disallowed the deduction of these costs. The issue before the court was whether the claim for damages was expenditure incurred "in the production of the income" and allowable as a deduction.

Newton Thompson J, who delivered the Court's judgment, began by stating the sections that govern the deductibility of expenditure and losses now embodied in the present section 11(a) of the Income Tax Act. He acknowledged that the meaning of the elements of the section was considered in the leading case of *Port Elizabeth Electric Tramway*. The learned judge (at

215) referred to the two questions ascribed to the phrase "in the production of the income" by Watermeyer AJP (at 16) in the *Port Elizabeth Electric Tramway* case, namely "(a) whether the act to which the expenditure is attached is performed in the production of income, and (b) whether the expenditure is linked to it closely enough". Newton Thompson J first dealt with the question whether the act to which the expenditure is attached was performed "in the production of the income". To apply this requirement, the learned judge (at 215) took account of the nature of the taxpayer's business in that to produce income, the garage proprietor had to garage the customer's car, dust the car every night, polish it once a month, and allow the customer to pick up one of the taxpayer's employees at the garage so that said employee could drive and deliver the car from the customer's house to the garage.

The learned judge concluded that before the taxpayer could succeed in his claim he had to establish that his driver's act in damaging the car was an inevitable or practically inevitable result of the contract which the taxpayer had entered into with the customer, or of the business carried on by the taxpayer. The court did not find anything which would justify that conclusion. Newton Thompson J, found that when the driver had the accident he was not engaged in rendering to the customer, on behalf of the taxpayer, any of the three services. The court held against the taxpayer's claim to deduct the damages paid. The expenditure on damages was attached to an act that was not part of the taxpayer's business operations. It was held that the damages were not expenditure incurred "in the production of the income". The court found it unnecessary to enquire into the second requirement of the dual test, whether the expenditure was linked sufficiently closely to the act, because it had concluded that the act to which the expenditure was attached was not performed "in the production of the income".

According to Roper J in *Income Tax Case 815*, although the decision in the *Weinberg* case was based partly upon the test established in the *Joffe and Co (Pty) Ltd* case, that the taxpayer had to establish that his driver's act in damaging the car was an inevitable or practically inevitable result of the business carried on by the taxpayer, the judgment did not deal with the subject of negligence. The Commissioner in *Income Tax Case 815* had referred to the *Weinberg* case in support of his contention for disallowing a loss due to the taxpayer's own negligence. Roper J argued that the court in the *Weinberg* case did not discuss the question whether the risk of an employee taking a customer's car for his own pleasure was or was not a risk necessarily incidental to the trade. He mentioned that the *Weinberg* case was of no

assistance to the issue of negligence. Roper J concluded that negligence in itself affords no reason why an expense or loss caused by negligence should be held to be non-deductible. Therefore, the court in the *Weinberg* case merely disallowed the deduction of the damages based on the test that the act to which the expenditure is attached should be performed "in the production of the income".

4.2.2.3. *Income Tax Case No 1058*

The South African Tax Court also dealt with the deduction of damages paid in *Income Tax Case 1058*, 26 SATC 305. The taxpayer was a private company carrying on a manufacturing business. The taxpayer company and the South African Railways were involved in an action that arose out of a collision between a motor-car driven by the claimant and a railway trailer parked on a public road running past the factory of the taxpayer company. The South African Railways, acting in the ordinary course of its duties as carriers, delivered a load of raw materials to the taxpayer. Following normal procedure, the truck driver detached the trailer on which the goods were loaded and left it parked on the side of the road opposite the taxpayer's factory. During the course of the day employees of the taxpayer off-loaded the goods. As the trailer was blocking the entrance to the factory, the taxpayer's employees moved it in order to give easier access to the premises, and left it standing partly on the tarred portion of the road. That night, a motorist, the claimant, who was driving along that road, collided with the rear end of the trailer, which was unlighted. The motorist took action against the taxpayer and the South African Railways, seeking compensation for damages sustained as a result of the collision. The taxpayer and the South African Railways were obliged to pay for the damages as a result of the accident. The taxpayer sought to deduct half the amount of damages, half the amount of the claimant's costs, and their attorney's costs. The Secretary for Inland Revenue declined to allow the deduction claimed.

Hiemstra P delivered the judgment of the Court on the taxpayer's appeal. He stated the relevant sections of the Income Tax Act for allowable deductions. The learned President enquired whether the damages were deductible expenditure. He acknowledged the rule for deductible expenditure in the *Port Elizabeth Electric Tramway* case that an expense is deductible if it is attached to the performance of a business operation *bona fide* performed for the purpose of earning income, provided it is so closely connected with it that it may be regarded as part of the cost of performing it. The learned President remarked that the rule was

approved by the Appellate Division (now the Supreme Court of Appeal) in the *Genn and Co (Pty) Ltd* case. He also confirmed that Roper J in *Income Tax Case 815* quoted the test with approval that there must exist a closeness of the link between the expenditure and the production of the income.

Hiemstra P distinguished between the victim in the *Port Elizabeth Electric Tramway* case and *Income Tax Case 1058*. He found that the motorist in *Income Tax Case 1058* was in a quite different position to the tram-driver in the *Port Elizabeth Electric Tramway* case. The employment of drivers was necessary for carrying on the business of the tramway company, and the employment of drivers carried with it, as a necessary consequence, a potential liability to pay compensation if such drivers were injured in the course of their employment. Without payment of compensation upon injury of a driver, the tramway company would not get drivers. The motorist in *Income Tax Case 1058* was a third party who happened to drive past the taxpayer's factory at night. He was not essential to the taxpayer's trade. According to Hiemstra P, the damages paid as a result of the placing of the trailer at a spot dangerous to traffic could not be regarded as being part of the cost of performing the business operations of the company.

According to Goldswain and Swart (2015), the decision that a third party who happened to drive past the taxpayer's factory at night was not essential to the taxpayer's trade and did not, therefore, produce income was an absurd result. The authors submit that Hiemstra P took a backward step and erred when he held that compensation paid as a result of a negligent or perhaps stupid act on the part of the taxpayer, was not allowable as a deduction. Relying on the test established in the *Port Elizabeth Electric Tramway* case, the court held that the damages were not deductible because they were neither part of the cost of performing the business operations of the company, nor incurred in the course of such operations, nor a necessary consequence of the trade.

4.2.2.4. *Commissioner of Taxes v Cathcart*

The Zimbabwean (Rhodesian) Appellate Division also dealt with the deduction of damages in *Commissioner of Taxes v Cathcart*, 1965 (1) SA 507 (SRAD), 27 SATC 1. The taxpayer practised as an architect in partnership with other architects. The taxpayer designed a building and undertook to render the usual services as architect to one company. At the time the

taxpayer was engaged by the company, he gave a guarantee that the building would be waterproof. In the practice of an architect it is unusual for such a guarantee to be given, but it was given by the taxpayer in respect of his services as an architect because the company required the guarantee as a condition of the taxpayer's employment as architect. The company complained of leaks in the basement of the building designed and supervised by the taxpayer and claimed damages. The company sued the taxpayer and one of his partners for damages alleged to have been suffered in breach of a guarantee given by the taxpayer that the building in question would be waterproof. The taxpayer initially resisted the action, but it settled out of court on legal advice, and the taxpayer and his partner agreed to pay the company an amount in respect of damages and costs. The taxpayer sold his interest and share in the then existing partnership and retired from practice, being retained by a new firm as a consultant at a fixed fee per annum. The taxpayer sought to deduct the amount paid for the damages and costs. The Commissioner of Taxes disallowed the deduction, arguing that the expenditure was not a payment for the purpose of earning income, because the liability to pay did not arise from the giving of the guarantee in the first place, but only from the subsequent breach of it. The Commissioner also submitted that the expenditure was not necessarily attached to the performance of operations that constitute the carrying on of the income-earning trade. The issue was whether damages claimed on later developments of defects on services offered by the taxpayer were deductible expenditure.

Lewes AJA, who delivered the judgment of the Court, argued that the submission by the Commissioner placed too restrictive an interpretation of the test formulated by Watermeyer CJ in the *Joffe and Co (Pty) Ltd* case. The learned judge submitted that an enquiry should be made into the reason for the guarantee. He found that the guarantee was given in order to secure the work which earned the taxpayer's income, and that the guarantee carried with it the inherent risk that the income to be earned might be diminished by the cost of fulfilling the guarantee. He added that it was a risk or contingent liability on which the taxpayer had deliberately bargained in order to secure the contract and so to derive income.

Lewes AJA referred to the meaning given to designed and fortuitous expenditure by Beadle CJ in the *Rendle* case. Lewes AJA qualified the contingent liability or risk under the two heads of expenditure. He stated that the contingent liability or risk was designed if it was deliberately and *bona fide* undertaken by the taxpayer for the purpose of earning the income.

The expenditure would be fortuitous, and a misfortune of the taxpayer, when payment was actually made. In the *Cathcart* case, it was made through the risk of the guarantee having been fulfilled.

Beadle CJ in the *Rendle* case took the approach that expenditure is incurred "in the production of the income", if the "chance" of such expenditure being incurred is sufficiently closely connected with the business operation and not whether the actual expenditure itself is sufficiently closely connected. Regarding this approach, Lewes AJA commented that if the risk of incurring the expenditure is deliberately undertaken by contract in order to earn the taxpayer's income then, when that risk is fulfilled, and the expenditure is incurred, it is so closely connected with the performance of the business operation that it would be proper, natural or reasonable to regard it as part of the cost of performing the operation.

The court held that the giving of a guarantee to secure employment as an architect, though not usual, could be regarded as an undertaking for the purpose of earning income derived from the employment and any expenditure incurred in the implementation of that guarantee would be expenditure incurred in the production of that income. It was further held that the expenditure admissible as a deduction would be that for which the taxpayer was legally liable under the guarantee and would not include amounts paid to avoid legal proceedings for which no legal liability had been established.

Lewes AJA further stated that the taxpayer was required to show that the damages paid were in pursuance of a liability to pay. If payment is made to avoid the embarrassment or expense of litigation, the sum paid cannot be regarded as a payment made "in the production of the income". The taxpayer failed to discharge the onus that the terms of the guarantee given by him included the liability for consequential damages arising from defects of the building. The court held that the absence of the evidence resulted in the damages not being a part of the cost of performing the business operations of the taxpayer. Thus, the damages paid were disallowed as a deduction based on the test established in the *Port Elizabeth Electric Tramway* and the *Genn and Co (Pty) Ltd* cases that expenditure is incurred "in the production of the income" if it is so closely connected with the performance of the business operation that it would be proper, natural or reasonable to regard it as part of the cost of performing the operation.

4.2.2.5. *Strong and Co. of Romsey Ltd v Woodifield*

The well-known English case of *Strong and Co. of Romsey Ltd v Woodifield* has influenced decisions of the South African courts in determining whether expenditure or a loss is incurred "in the production of the income". The facts of the case are important as the case involved the claim of damages as a deduction. The taxpayer was a brewery owning an inn operated by a manager as part of the company's business. A customer sleeping in the inn was injured by the fall of a chimney that occurred owing to the negligence of the company's employees. The customer recovered damages for his injury with costs, which the taxpayer company sought to deduct from its income.

The reasons for the decision were not altogether harmonious. The court held that the taxpayer was not entitled to deduct the claim for damages since the loss was not one connected with or arising out of the taxpayer's trade. Importantly, there was no suggestion that expenditure or losses are non-deductible simply because they are due to the negligence of the taxpayer or his, her or its employees. Lord James doubted the correctness of such a decision in view of the fact that in the *Strong and Co. of Romsey Ltd* case the accident occurred to a guest of the house who would not have been injured unless the business of an innkeeper was being carried on, and when it was in the course of carrying out a portion of the business that the customer was injured there.

Lord Loreburn gave an illustration of losses suffered by a railway company in compensating passengers for accidents while travelling. He held that losses are deductible if they are incidental to the taxpayer's trade. He gave another example where a man kept a grocer's shop for which a house was necessary. One of the window shutters fell upon and injured a man walking in the street. In such a case, the loss arising to the grocer ought not to be deducted. He argued that no formula is so precise and comprehensive as to solve at sight all the cases that may arise. He held that in the *Strong and Co. of Romsey Ltd* case the loss suffered by the taxpayers was not really incidental to their trade as innkeepers and fell upon them in their character not of traders, but of householders.

The distinction between the cases discussed in this section on the deductibility of damages and compensation and the *Strong and Co. of Romsey Ltd* case, lies in the degree of connection between the trade or business carried on by the taxpayer and the cause of the

liability for damages. This English case shows that claims for damages and compensation should be an ordinary incident of the business conducted by the taxpayer to be regarded as having been incurred "in the production of the income".

4.3. Summary of case law findings on the deductibility of damages and compensation

The case law analysis has shown that the cases relating to damages and compensation that were heard before the dual test of "in the production of the income" was established in the *Port Elizabeth Electric Tramway* case, applied the meaning of "in the production of the income" construed by Mason J in the *Lockie Bros Ltd* case, which was authoritative at the time. Some similarities and distinctions can be identified in the cases discussed, based on the nature of the taxpayer's businesses and the cause of the payment for damages and compensation.

Income Tax Case 8 and the *Port Elizabeth Electric Tramway* case had similar circumstances and the same type of business operations of tramcars. Income Tax Case 8 was decided before the *Port Elizabeth Electric Tramway* case. The court in *Income Tax Case 8* allowed the deduction of both the compensation and the legal costs, applying the principle established in the *Lockie Bros Ltd* case. The taxpayer's claim was successful because the payments made in compensation for injuries and the associated legal costs were normal current expenses incurred in the course of the ordinary operations carried on in the conduct of the company's business and were therefore admissible as deductions. In the *Port Elizabeth Electric Tramway Company Ltd*, the court reached its decision based on two questions ascribed to "in the production of income", namely (a) whether the act to which the expenditure is attached is performed in the production of income, and (b) whether the expenditure is linked to it closely enough. The court held that the amount paid as compensation under the Workmen's Compensation Act to the driver's widow were regarded as being part of the cost of performing the company's operations for the purpose of earning income, and thus deductible. Negligence was not found in *Income Tax Case 8* and the *Port Elizabeth Electric Tramway* cases but was referred to in *obiter* remarks of the judgment for the deduction of compensation paid by the taxpayers operating tram cars business.

The court came to a different decision in the *Joffe and Co (Pty) Ltd* case. The taxpayer failed to secure a deduction for damages in the *Joffe and Co (Pty) Ltd* case because it did not

discharge the onus of proving that negligent construction was a necessary concomitant of the trading operations of a reinforced concrete engineer. It is submitted that the taxpayer did not provide evidence that the methods used by the taxpayer in construction were prone to causing accidents. Thus, the damages paid in respect of the accident were not incurred "in the production of the income". Williams (2009) asserts that damages or compensation payable by a taxpayer as a result of negligence in carrying out trading activities will be deductible in terms of section 11(a) of the Income Tax Act, if the negligence is an inherent risk of that trade. It is important to take account of Roper J's remark in *Income Tax Case 815,* that each case involving negligence is considered on the merits of its own facts.

The South African Tax Court in *Income Tax Case 49* dealt with the deduction of damages involving a guarantee attached to the products sold by the taxpayer. The court held in favour of the taxpayer that the damages were expenditure incurred "in the production of the income" because the lamp in question had been sold in the course of the taxpayer's business, and the taxpayer was held liable because he had given a guarantee in connection with the sale of the lamp. Similarly, the Zimbabwean court in the *Cathcart* case also dealt with the deduction of damages for a contract to which a guarantee was attached. The test applied was that the giving of a guarantee in order to secure employment as an architect could be regarded as an undertaking for the purpose of earning the income derived from the employment and the damages incurred in the implementation of that guarantee were expenditure incurred in the production of that income. The damages were, however, disallowed because the taxpayer failed to give evidence that the terms of the guarantee included a liability for consequential damages arising from the defects of the building.

The court in *Income Tax Case 233* also held in favour of the taxpayer because the damages were a legitimate expense in connection with the earning of the taxpayers' income, thus incurred "in the production of the income". The court took the view that it was considered that in the business of a stevedore of loading and unloading it is indeed an almost foreseeable consequence, if not an inevitable consequence, that packages or other articles could fall out of the nets handled by stevedores and injure passers-by.

The Cape Provincial Division in the *Weinberg* case held against the taxpayer's claim to deduct the damages. The taxpayer's claim was unsuccessful because the damages were paid

as a result of an accident that occurred while the driver was not engaged in rendering services to the customer on behalf of the taxpayer. It is this act to which the expense of damages was attached. The damages were therefore not incurred "in the production of the income".

According to Haupt (2015:124), from the principles established in the *Port Elizabeth Electric Tramway* case, the *Rendle* case, and the *Joffe and Co (Pty) Ltd* case:

(1) an expense is incurred "in the production of the income" if
- it is incurred for the purpose of income (*Port Elizabeth Electric Tramway* case); or
- the *risk* of the expense being incurred is an inevitable or necessary concomitant of the taxpayer's business operations (*Rendle's* case).

(2) An expense brought about by the negligence of the taxpayer or its employees would only be deductible if it could be shown that the *risk* or *chance* of such an expense being incurred was closely linked to (an inevitable concomitant of or necessary concomitant of) the income earning operations of the taxpayer (*Joffe and Co (Pty) Ltd* case).

As emphasised, it is clear that two principles arise from the *Port Elizabeth Electric Tramway* and the *Joffe & Co (Pty) Ltd* cases, namely

- the act to which the payment of damages and compensation is attached must be undertaken by the taxpayer for the purpose of producing income and the payment of damages and compensation should be closely linked to that act; and
- the taxpayer must be able to show that the risk of his having to make the payment of the damages and compensation is a necessary concomitant of the taxpayer's trading operations (Kruger *et al*: 2012).

4.4. Conclusion

The aim of this chapter was to analyse case law dealing with the deductibility of damages and compensation, to establish why the court decisions differ in granting a deduction of the damages and compensation. This chapter provided an exposition of the tests applied by the courts in respect of the deduction of expenditure on damages and compensation as having been incurred "in the production of the income", and an analysis of the relationships between the principles formulated by the courts.

To enquire into the tests established and applied by the courts on the deduction of damages and compensation in relation to the requirement of "in the production of the income", examples were drawn from various case decisions illustrating why the courts allowed or disallowed the deduction of damages and compensation and highlighting the application of the tests to the facts of each case. From the analysis, the dominant test that has been applied to the deduction of damages and compensation, is that expenditure is incurred "in the production of the income" if the expense is attached to the performance of a business operation *bona fide* performed for the purpose of earning income, provided it is so closely connected with it that it may be regarded as part of the cost of performing it.

The courts in the *Port Elizabeth Electric Tramway* and the *Joffe and Co (Pty) Ltd* cases, reached different decisions on the deduction of damages and compensation, mainly because negligence was not found in the *Port Elizabeth Electric Tramway* case whilst the taxpayer in the *Joffe and Co (Pty) Ltd* cases did not discharge the onus of proving that negligent construction was a necessary concomitant of it trading operations. The chapter also sought to enquire into the circumstances in which the courts considered negligence as a factor for refusing the deduction of damages and compensation as having been incurred "in the production of the income".

The case law analysis indicated that where taxpayers are involved in the types of business operations where accidents or mishaps are likely to occur, either by their own fault or their employees, in consequence of which they are required to pay damages and compensation to the victim, the expenditure is regarded as being incurred "in the production of the income", even if that expenditure has some degree of negligence attached to it. The deduction is successful provided the taxpayers can discharge the onus of proof placed upon them that negligence was a necessary concomitant of their trading operations. The court disallowed the deduction of the damages where the taxpayer failed to discharge such onus. It was found that the *Joffe and Co (Pty) Ltd* case did not create a precedent that automatically disallows expenditure claimed as a deduction arising as a result of negligence. It therefore follows that expenditure on damages and compensation resulting from negligence is incurred "in the production of the income" if the taxpayer discharges the onus of proof in terms of section 102 of the Tax Administration Act. Roper J in *Income Tax Case 815* concluded that each case involving negligence is considered on the merits of its own facts.

In the next chapter, chapter five, conclusions are discussed on the research findings in relation to the research goals as addressed in chapters two, three and four.

CHAPTER 5: CONCLUSION

5.1. Introduction

The main goal of the research was to analyse the judicial decisions dealing with "in the production of the income" in granting a deduction for income tax purposes in terms of section 11(a) of the Income Tax Act. In particular the focus was on case law dealing with embezzlement, fraud and theft, and damages and compensation, to establish why the courts grant or disallow deduction of expenditure and losses. To achieve the main goal of the research, each chapter addressed a specific sub-goal as set out in the introductory chapter of the thesis. These sub-goals are restated as follows:

i. to explore what the requirement "in the production of the income" encompasses in determining the deductibility of expenditure and losses;
ii. to analyse and compare the facts and court decisions in the cases dealing with "in the production of the income" in relation to embezzlement, fraud and theft, and damages and compensation, to establish why the court decisions differ in granting a deduction of expenditure and losses; and
iii. to conclude on the circumstances under which a taxpayer can successfully deduct an expense or loss as having been incurred "in the production of the income".

A summary is provided in this final chapter on the findings in chapters 2, 3 and 4.

5.2. Summary of conclusions

To answer the research question, the following chapter findings are summarised. The Income Tax Act does not define the meaning of the requirement than an expense should be incurred "in the production of the income" as provided in section 11(a) of the Income Tax Act, in order to claim the deduction of the expense. Chapter 2 sought to obtain clarity on the meaning of "in the production of the income" through an analysis of case law dealing with the requirement. The analysis indicated that the authoritative test in relation to the meaning of "in the production of the income" was established by Watermeyer AJP in the *Port Elizabeth Electric Tramway* case. The dual test requires firstly that the act entailing the expenditure must be performed for the purpose of earning income; and secondly, that the expense attached to the performance of a business operation *bona fide* performed for the purpose of

earning income must be so closely connected with it, that it may be regarded as part of the cost of performing it. This dual test has been quoted with approval in several cases and upheld in the Supreme Court of Appeal in the *Genn and Co (Pty) Ltd* case. The Zimbabwean courts have also applied the test in several cases, including the *Rendle* case.

This clearly establishes that to qualify as a deduction, expenditure must have been incurred for the purpose of earning income. It is not necessary to show that it has produced income in the tax year in which it is incurred, as was held in the *Sub-Nigel Ltd* case. The income may have been earned in an earlier year, or earned in a future year, or no income at all may be earned. The expenditure or loss is deductible as long as it has been made for the purpose of earning such income. There also must be a sufficiently distinct and direct relationship or link between the expenditure or loss incurred and the earning of income. Thus, the requirement "in the production of the income" entails determining whether the purpose of the expenditure is to produce income and, if so, whether the expenditure is so closely connected with the income that it may be regarded as part of the cost of performing it (Goldswain *et al*: 2016).

The problem with the dual test highlighted by tax authors such as Kruger *et al* (2012) and De Koker and Williams (Online) is that it is far too narrow and restrictive a test and many expenses, although necessarily incurred in the performance of a taxpayer's business operations, fail to satisfy the requirement that they are incurred for the purpose of earning the income, and hence do not qualify as allowable deductions. In contrast to the dual test established by Watermeyer AJP, the earliest interpretation of the phrase by Mason J in the *Lockie Bros Ltd* case held that expenditure and losses are incurred "in the production of the income" if actually incurred in the course of and by reason of the ordinary operations undertaken for the purpose of conducting the business. Kruger and Scholtz (2012) have postulated that this is a far wider interpretation. Nonetheless, this interpretation has been superseded by the dual test which has now been referred to as the standard and authoritative test to "in the production of the income" in several cases.

The narrow and restrictive application of the dual test has been resolved by the recent Supreme Court of Appeal cases of *Warner Lambert SA (Pty) Ltd* and *Mobile Telephone Network Holdings (Pty) Ltd*. The courts' decisions in these cases have widened the scope of expenditure that can be regarded as having been incurred "in the production of the income"

namely, social responsibility expenditure and expenditure in undertaking a statutory function such as an audit. In addition to the close connection test by Watermeyer AJP in the *Port Elizabeth Electric Tramway* case, it was established in the *Warner Lambert SA (Pty) Ltd* case that further enquiry has to be made on the remoteness of the connection between the taxpayer's trade and the expenditure. If the particular expenditure in question is remote from the taxpayer's trade very little or no connection will exist between the expenditure and the production of income. The expenditure would not be incurred "in the production of the income". The decision in the *Mobile Telephone Network Holdings (Pty) Ltd* case implies that statutorily prescribed procedures should be necessarily attached to the performance of the taxpayer's income earning operations in order to be regarded as having been incurred "in the production of the income".

The aim of chapter 3 was to establish the tests proposed by the courts in relation to the deduction of losses suffered by a taxpayer as a result of misappropriations by an employee, and fraud or theft by a third party and to determine why court decisions differed in granting a deduction of such losses as having been incurred "in the production of the income" in terms of section 11(a) of the Income Tax Act. The dominant test established and applied by the South African courts was that a loss due to embezzlement, fraud or theft is incurred "in the production of the income" if the risk of the mishap is inseparable from or is a necessary incident of the carrying on of the taxpayer's business operations. This substantiated the close connection test to "in the production of the income" established by Watermeyer AJP in the *Port Elizabeth Electric Tramway* case.

An analysis and comparison of facts and court decisions in case law involving different perpetrators of the crimes were undertaken. There was a need to distinguish between embezzlement, fraud or theft perpetrated by an ordinary employee, a senior employee in the position of manager or managing director, and the proprietor of a business or partner in a partnership. The findings from case law were that misappropriations by an ordinary employee are incurred "in the production of the income", whilst those by a senior employee, proprietor or partner are not. It was shown by the courts that theft by a junior employee is an inherent risk of the taxpayer's business operations, whereas theft by a senior employee or proprietor is not. It is suggested by SARS, however, that theft by employees in senior positions is now common in today's business operations and disallowing the loss arising from such act would

be unfair to the taxpayer. In order for the loss to be deductible, the taxpayer must prove that the risk of the act leading to misappropriation by senior employees is an incidental risk of the business.

Concerning theft by third parties, the same test was applied by the courts in that there needs to be an inherent risk of embezzlement, fraud or theft in the taxpayer's business. It was found that the business operation during which the theft occurred should be an important part of the taxpayer's business, and a necessary concomitant of the production of the taxpayer's income. The Institute of Certified Bookkeepers in South Africa (2013: Online) have remarked that the absence of internal controls can cause a business to be run in a negligent manner. Nonetheless, the courts held that negligence does not increase the likelihood of disallowing a loss due to defalcations as not having been incurred "in the production of the income".

In chapter 4, case law dealing with the deduction of expenditure on damages and compensation in relation to "in the production of the income" was analysed. The chapter aimed to establish why court decisions differed in granting a deduction of expenditure on damages. It also aimed to determine whether negligence was a factor for denying the deduction of an expense or loss as having been incurred "in the production of the income". The analysis of case law dealing with damages and compensation revealed that damages and compensation paid by a taxpayer are deductible in terms of section 11(a) of the Income Tax Act, if the expense is attached to the performance of a business operation *bona fide* performed for the purpose of earning income, provided that such expense is so closely connected with the business operation as to be regarded as part of the cost of performing it. There must be a very close connection between the trade or business carried on by the taxpayer and the cause of the liability for damages.

The analysis indicated that the deduction of damages and compensation owing to negligence during the course of earning income does not automatically result in disallowing the expenditure as a deduction. Some tax authors such as Williams (2009), however, argue that taking negligence into account when determining the deductibility of damages and compensation seems to suggest that taxpayers who conduct their business operations irresponsibly or inefficiently are in an advantageous position in claiming damages and compensation, compared to those who are more careful.

Overall, the differences in the South African court decisions in granting the deduction of losses due to embezzlement, fraud and theft, damages and compensation as having been incurred "in the production of the income" in terms of section 11(a) of the Income Tax Act, were mainly a result of the following: different facts or circumstances of the case, the application of different tests by the court in determining whether a particular expense or loss was incurred "in the production of the income", and the failure by taxpayers to discharge the onus resting upon them to show that the expense or loss was incurred "in the production of the income". It is evident that the facts of each case are extremely important and each case must be decided on its own circumstances and merits.

In conclusion, the circumstances under which a taxpayer can successfully deduct an expense or loss as having been incurred "in the production of the income" is subject to the satisfaction of a number of principles that have been applied by the courts in determining whether or not expenditure or a loss is incurred "in the production of income". The most authoritative principles adopted by the South African courts in determining whether an expense or loss is incurred "in the production of the income" in terms of section 11(a) of the Income Tax Act, are the two questions in the dual test established in the *Port Elizabeth Electric Tramway* case. In particular, the South African judiciary have focused on the purpose with which the taxpayer incurred the expenditure, and ascertaining whether or not a requisite nexus (necessary link) or connection existed between the expenditure or loss and the taxpayer's income-producing trade activities. It implies that a taxpayer can successfully deduct an expenditure or loss as having been incurred "in the production of the income" if both requirements of the dual test are met.

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