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**THE APPROACH BY OUR COURTS TO THE APPORTIONMENT OF EXPENDITURE  
IN TERMS OF SECTION 11(a) READ WITH SECTION 23 (g) OF THE INCOME TAX  
ACT NO 58 OF 1962**

**BY**

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DECLARATION

I declare that:

THE APPORTIONMENT OF EXPENDITURE BY OUR COURTS IN TERMS OF SECTION 11(a) READ WITH SECTION 23(g) is my own work and that, all the sources I have used or quoted have been indicated and acknowledged by means of complete references.

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DUMISANI RICHARD NGUBANE

NOVEMBER 2004

## PREFACE

The primary aim of a dissertation is to try to discover information that could assist in solving a particular problem at hand. The object of this dissertation is to determine the approach by our courts to apportionment of expenditure in terms of section 11(a) read with section 23(g) of the Income Tax Act No 58 of 1962. A single expenditure incurred for more than one purpose poses a problem when deduction of such an expenditure, is sought by a taxpayer.

The problem that the courts have always encountered when dealing with the deductibility of expenditure incurred for a dual purpose, is that there is no provision in the Income Tax Act that directs what to do when faced with such a problem. The courts have always chosen apportionment of expenditure as a solution to the deductibility of expenditure incurred for more than one purpose, one such purpose being for tax purposes and the other being for non tax purposes.

Apportionment of expenditure is used as a device to allocate part of the expenditure, which was incurred to produce income, as taxable expenditure, and another part of that expenditure which was incurred to produce non-taxable income, as non-deductible expenditure.

This dissertation seeks to find out whether courts do take into consideration the provisions of the Income Tax Act applicable to the deduction of expenditure when called upon to make a decision on a particular case. The South African Revenue Services use apportionment of expenditure where it deems appropriate and the courts have never opposed it.

The Legislature, which is responsible for the enactment of the act, seems to be happy to lie low, and allow the courts to dominate in handling the disputes that arise as a result of expenditure incurred with a dual purpose. It has been suggested that whilst the Income Tax Act does not provide any direction in situations where the deductibility of dual purposes expenditure is in dispute, apportionment is implied in the terms of section 11(a) read with section 23(g) of the Income Tax Act no 58 of 1962.

The main aim of this research is to establish whether the path taken by the courts is the correct one in terms of section 11(a) and section 23(g) of the Income Tax Act no 58 of 1962. It is hoped that this work will be of assistance to both The South African Revenue Services and the taxpayers at large in terms of understanding that the courts are within the bounds of the Act.

## TABLE OF CONTENTS

ACKNOWLEDGEMENTS	II
DECLARATION	IV
DEDICATION	V
PREFACE	VI

### CHAPTER 1

1.1	EXECUTIVE SUMMARY	1
1.2	PROBLEM STATEMENT	2
1.3	RELEVANCE OF THE STUDY	5
1.4	OBJECTIVES OF THE STUDY	7

### CHAPTER 2

2.1	TYPES OF RESEARCH	8
2.2	LITERATURE REVIEW	8
2.2.1	INTRODUCTION	8
2.2.2	THE INCOME TAX ACT NO 58 OF 1962	9
2.2.3	GROSS INCOME	11
2.2.4	RESIDENCE AND SOURCE	11
2.2.5	DEFINITION OF A 'RESIDENT'	12
2.2.6	COURTS DECISIONS	12
2.2.7	ALLOWABLE DEDUCTIONS	13
2.2.8	EXPENDITURE AND 'LOSSES'	16
2.2.9	ACTUALLY INCURRED	18
2.2.10	INCURRED DURING THE YEAR OF ASSESSMENT	22
2.2.11	IN PRODUCTION OF INCOME	23
2.2.12	TEST OF INTENTION	31
2.2.13	NOT OF A CAPITAL NATURE	33
2.2.14	LAID OUT OR EXPENDED FOR THE PURPOSES OF TRADE	38
2.2.15	PRIVATE AND DOMESTIC EXPENDITURE	40
2.2.16	CESSATION OF TRADE	43
2.2.17	APPORTIONMENT OF EXPENDITURE	51

### CHAPTER 3

3.1	RESEARCH DESIGN	68
3.2	ANALYSIS OF CASES	69
3.2.1	CASE 1	69

3.2.1.1	SUMMARY OF FACTS	70
3.2.1.2	MATTERS OF DECISION	70
3.2.1.3	APPELLANT'S ARGUMENTS	70
3.2.1.4	RESPONDENT'S ARGUMENTS	70
3.2.1.5	JUDGEMENT	70
3.2.1.6	RETIO DECIDENDI	70
3.2.1.7	THE ATTITUDE OF THE COURTS TOWARDS APPORTIONME	70
3.2.2.1	CASE NO 2	72
3.2.2.2	INCOME TAX CASE NO 800,1954	72
3.2.2.3	SUMMARY OF FACTS	72
3.2.2.4	MATTERS OF DECISION	72
3.2.2.5	APPELLANT'S ARGUMENTS	73
3.2.2.6	RESPONDENT'S ARGUMENTS	73
3.2.2.7	JUDGEMENT	73
3.2.2.8	RATIO DECIDENDI	74
3.2.2.9	ATTITUDE OF COURT TOWARDS APPORTIONMENT	74
3.2.4	CASE NO 3	75
3.2.4.1	CIR v GUARDIAN ASSURANCE HOLDINGS (SA) LTD 38	75
3.2.4.2	SUMMARY OF FACTS	75
3.2.4.3	APPELLANT'S ARGUMENTS	75
3.2.4.4	RESPONDENT'S ARGUMENTS	77
3.2.4.5	MATTERS OF DECISION	77
3.2.4.6	JUDGEMENT	78
3.2.4.7	RATIO DECIDENDI	78
3.2.4.8	THE COURT'S ATTITUDE TOWARDS APPORTIONMENT	79
3.2.4.1	CASE NO 4	79
3.2.4.2	CIR v RAND SELECTIONS CORPORATION LTD	79
3.2.4.3	SUMMARY OF FACTS	79
3.2.4.4	APPELLANT'S ARGUMENTS	80
3.2.4.5	RESPONDENTS ARGUMENTS	80
3.2.4.6	MATTERS OF DECISION	81
3.2.4.7	JUDGEMENT	81
3.2.4.7	RATIO DECIDENDI	81
3.2.5.1	CASE NO 5	82
3.2.5.2	MALLALIEU v DRUMMOND (INSPECTOR OF TAXES) 1983	82
3.2.5.2	SUMMARY OF FACTS	82
3.2.5.3	APPELLANT'S ARGUMENTS	83
3.2.5.4	RESPONDENT'S ARGUMENTS	83
3.2.5.5	MATTERS OF DECISION	83
3.2.5.6	JUDGEMENT	83
3.2.5.7	RATI DECIDENDI	83
3.2.5.8	THE COURT'S ATTITUDE TOWARDS APPORTIONMENT OF EXPENDITURE	84

## CHAPTER 4

4.1	FINDINGS	85
4.2	THE PROVISIONS OF THE INCOME TAX ACT	87
4.2	METHOD OF APPORTIONMENT	90
4.3	ATTITUDE OF THE COURTS TOWARDS APPORTIONMENT	94

## CHAPTER 5

5.1	EXPENDITURE MUST BE INCURRED 'IN PRODUCTION OF INCOME'	100
5.2	APPORTIONMENT SANCTIONED BY THE INCOME TAX ACT	102
5.3	METHODS OF APPORTIONMENT	105

## CHAPTER 6

6.1	APPORTIONMENT OF EXPENDITURE TO BE USED AS A SOLUTION TO A PROBLEM	108
6.2	THE LEGISLATURE INVOLVEMENT	108
	BIBLIOGRAPHY	110



## THE APPROACH BY OUR COURTS TO THE APPORTIONMENT OF EXPENDITURE IN TERMS OF SECTION 11(a) READ WITH SECTION 23 (g) OF THE INCOME TAX ACT NO 58 OF 1962

### 1.1 Executive Summary

In the determination of the taxable income, a taxpayer is allowed to deduct from his income, expenditure, incurred from carrying on his business or trade, which is not of a capital nature, in terms of section 11(a) read with section 23(g) of the Income Tax Act No 58 of 1962. The so-called 'General deduction formula' comprise section 11(a), which sets out what may be deducted, (the positive test) and section 23(g) which stipulates what may not be deducted, (the negative test)(De Koker:1995). In order to establish whether the expenditure is deductible, the court has to look at the purpose of the act entailing the expenditure. If it is performed for the purpose of earning income, then the expenditure attendant upon it is deductible.

A single globular amount, which is laid out for more than one purpose, usually poses a problem to the courts, as to how such an amount should be regarded. Where the taxpayer incurs expenditure partly for revenue purposes and partly for capital purposes but wholly for trading purposes, then there can be apportionment under section 11(a) of the Income Tax Act so that, that part of expenditure that produced revenue can be allowed a deduction and the other part that was expended for capital purpose is not allowed a deduction (Guardian Assurance Holdings).

The Income Tax Act No 58 of 1962, contains no provisions for apportionment but the courts have held that apportionment of expenditure is implied from the terms of section 11(a), which permits only the deduction of such expenditure as is actually incurred in the production of income. Apportionment of expenditure is

also implied from the terms of section 23(g) of the Act, which permits deduction of expenditure to the extent to which it is expended for the purposes of trade. The courts regard apportionment of expenditure as a solution to a problem created, when a taxpayer has incurred a single expenditure for more than one purpose, one of which qualifies for deduction and the other of which does not. The courts apply apportionment of expenditure in a fair and reasonable manner, but take into account the provisions of the Income Tax Act, that relate to the deductibility of expenditure.

## 1.2 The problem statement

This study seeks to determine the approach by our courts to the deductibility of expenditure incurred with mixed motives. The deductibility of expenditure from income of a taxpayer is determined by the so-called 'The general deduction formula' which comprise section 11(a) read with section 23. Section 11(a) requires that for income to qualify for deduction, it must have been incurred in the production of income in the course of trade and is not of a capital nature. This means that any expenditure incurred for a profit producing asset is an expenditure of a capital nature and therefore not allowable as a deduction in terms of section 11(a).

Section 23 stipulates that the deduction of expenditure will only be allowed to the extent to which it was incurred for the purposes of trade. According to this section of the Act, any monies not expended for the purposes of trade, e.g., spending on private things, cannot qualify for deduction as was the case in *L v Commissioner of Taxes* (1992) 54 SATC 91 (ZHC).

In this case the taxpayer was a partner in a firm of legal practitioners in Zimbabwe. Her work involved a lot of reading and as a result her vision slowly deteriorated such that she ended up being almost blind. She decided to undergo surgery in South Africa. In connection with the operation she incurred

expenditure of R4200 on air tickets, medical treatment and hospital and drugs charges. She claimed these expenses as a deduction from her income, in terms of section 11(a) of the Act.

The court held, as was the case in *CIR v Genn & Co (Pty) Ltd* 1955 (3) SA 293 (A); 20 SATC 113, that the expenditure could not be regarded as so closely connected with the performance of the taxpayer's legal practice as to be part of the cost of performing it. The expenditure was domestic or private expenditure and as such was prohibited as a deduction in terms of the Act.

The Old version of section 23 was very restrictive in that it prohibited any deduction of expenditure that was not expended 'wholly and exclusively' for the purpose of trade. The new version is somewhat accommodative in that it recognizes the extent to which the expenditure was incurred for the purposes of trade.

Sometimes expenditure is incurred with mixed motives. A company might pay remuneration to its directors and only a portion of it might be considered by the Commissioner to have been laid out for the purposes of earning income. Expenditure may be laid out partly for the purposes of earning income in terms of the definition of the term 'income' in section 1 of the Income Tax Act and partly for the purposes of earning income exempt from tax in terms of section 10 of the Income Tax Act. A single expenditure may be incurred partly for the purposes of producing income and partly for the purposes of acquiring a fixed asset for the business.

The court in *ITC No 832, 1956*, held that the Income Tax Act does not provide any guidance with regards to the treatment of single indivisible amounts that are incurred for more than one purpose. In the absence of the statutory directive,

the courts have had to play their role of finding solutions to disputes regarding the deductibility of expenditure, incurred with mixed motives.

In *Bowden v Russel and Russel* (1965) 42 TC 301, as reported in *Pick 'n Pay Wholesaler* case, (Ch) Pennycuick L, held that it might often be difficult to determine whether the person incurring the expense has in mind two distinct purposes, or a single purpose which will or may not produce some secondary consequences. But once it is found that the person has a distinct purpose other than that of enabling him to carry on and earn profits in his trade or profession section 137(a) prohibits deduction of the expenses.

In *CIR v Nemojim (Pty) Ltd* 1983 (4) SA 935 (A), 45 SATC 241, Corbett JA as he then was, suggested that apportionment is a practical solution to what otherwise could be an intractable problem and in a situation where the only other answer, namely disallowance of the whole amount of expenditure or allowance of the whole thereof, would produce inequality or anomaly one way or the other. It is said that in making such an apportionment, the courts normally consider what would be fair and reasonable in all the circumstances of the case.

In ITC No 699 the court held that where an amount of money is expended for a dual purpose and one of those purposes would not qualify for expenditure for deduction from income for tax purposes, it would seem that no portion of the amount expended might be so deducted. The reason for this provision, it was suggested, was because it would open up very difficult inquiries if the amounts expended in this way had to be dissected, and would throw up the Commissioner of Inland Revenue and the Court, which has to deal with income tax matters, an almost impossible burden.

It would seem therefore that there is no single test that can be regarded as a touchstone for the deductibility of expenditure with mixed motives. The Income

Tax Act does not provide any solution to the same problem. However the court in ITC No 607,1945, concluded that the Income Tax Act itself contains no provision for such apportionment, but according to Income Tax Case No 832 1956, that may be regarded as implied from the terms of section 11(2)(a), which permit only the deduction of such expenditure as is actually incurred in the production of income and not of a capital nature.

The court in Income Tax Case No 800,1954, *supra*, suggested that a taxpayer was entitled to make apportionment if it is possible for him to do so and if neither the taxpayer nor the Commissioner can make any allocation, it is still open to the Court to make such allocation.

It is necessary, therefore, to investigate the approach by our courts to apportionment of expenditure, laid out for more than one purpose. The investigation will cover the extent to which the courts take the relevant sections of the Act into account, when deciding on these cases. The so-called 'General deduction formula' also be covered in the investigation to determine the extent the courts take it into account when deciding on these issues.

### 1.3 Relevance of the study

In *Commissioner for Inland Revenue v Rand Selections Ltd 1956*, the representative of the taxpayer company contended that the Act does not direct how apportionment of expenditure should be approached or tell us how to ascertain what portion of the expenditure may be deducted from 'income', or the whole of the expenditure is deductible from the 'income'. The absence of the Act that guides the contesting parties burdens the court with the job of finding solutions to all the disputes that concern the deductibility of expenditure, which is incurred for more than one purpose.

The study of the approach by our courts to apportionment of expenditure is long overdue. Not many people will agree that they know the criteria the court use when making decisions regarding the deductibility of a single expenditure incurred with more than one purpose.

The previous version of section 23(g) of the Act disallowed any claim for expenditure where the expenditure was not wholly or exclusively laid out for the purposes of trade. This is illustrated in the case, *ITC No 1385, 1984*, where the court disallowed the deduction on the grounds that the expenditure in question was at least part paid out to protect appellant's future home and that there could be no apportionment.

The court felt that it could not be said that the expenditure had been laid out wholly or exclusively for the purposes of trade because part of the expenditure was directed at the protection of the taxpayer's home. The new version of section 23(g) takes into account the extent to which the expenditure is incurred for the purposes of the taxpayer's trade.

This study will help taxpayers to understand how the courts approach apportionment of expenditure, and how these courts identify expenditure incurred with more than one purpose. The study will also help the taxpayers to understand that the applicable Act is important in deciding on the apportionment of expenditure case. The manner of handling these cases will highlight especially the applicability and the importance of case law as guide in making decisions on these cases. This study may serve as a catalyst in encouraging the legislature to take an active role, to provide guidelines to the courts, so that the approach by the courts in solving the problems of apportionment of expenditure, is uniform.

#### 1.4 Research objectives

The objectives and the scope of this study are as follows:

To identify the reasons why courts opt for apportionment of expenditure

To determine whether the Income Tax Act does envisage apportionment of expenditure.

To identify methods of apportionment of expenditure.

To determine the attitude of the Courts towards apportionment of expenditure.

## CHAPTER 2

### Literature Review

#### 2.1 Types of research

Research can be classified into exploratory research, conclusive research and performance monitoring research. Conclusive research is designed to provide information for the evaluation of alternative course of action. Conclusive research can also be sub classified into descriptive research and causal research. Descriptive research is appropriate when the researcher wants to portray the characteristics of the marketing phenomena and determining the frequency of occurrence. Exploratory research is appropriate when the research objectives include;

- ❖ identifying problems and opportunities,
- ❖ Gaining perspective regarding the breadth of variables operating in the situation.

This research study will use the case study method, which is an analysis of events or conditions and their inter-relationship, with the aim of finding answers to the research problem. Five cases will be selected for thorough analysis. These cases will, according to the researcher, represent the majority of cases where 'apportionment of expenditure' is used as a solution to the problem of the deductibility of expenditure from income.

#### 2.2 Literature Review

##### 2.2.1 Introduction

Cooper and Emory: 1995, suggest that secondary data are already published data collected for the purposes other than the specific research needs at hand. Such data can be classified as internal or external. Internal data is available



within the organization, whereas external secondary data are provided by sources outside the organization. Secondary data rarely fulfill the requirements of a research project.

The central advantage of secondary data is the saving in cost and time in comparison with primary data sources. While secondary data may not completely satisfy all the requirements of a study, they may aid in the formulation of the decision problem, suggest methods and types of data for meeting the information needs, and serve as a source of comparative data by which data can be interpreted and evaluated. The advantages of secondary data relate to the extent that the data fit the information needs of the project and the accuracy of the data.

One of Adam Smith's basic maxims from his book (*The Wealth of Nations*; 1779) is that, "The subjects of every state ought to contribute towards the support of the Government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenues which they respectively enjoy under the protection of the state.

The expense of the Government to the individuals of a great nation is like an expense of management to the joint tenant of a great state, who are all obliged to contribute in proportion to their respective interests in the state". It may be correct to accept the relevance of the maxim to our tax system in that our tax system is based on the premise that those who are well to do carry a greater proportion of the burden of funding the state than the poor.

### 2.2.2 The Income Tax Act No 58 of 1962

South Africa has recently moved away from sourced based system of taxation to residence bases system of taxation. Our system of taxation is based on a

mixture of direct and indirect taxation. Income tax, in South Africa is levied in terms of a statute, which is called as the Income Tax Act No 58 of 1962, hereafter to be referred to as "The Act". Tax is levied on all persons who have taxable income.

Tax is an annual tax calculated by applying predetermined rates to the taxable income of a person. This was confirmed by Botha J.A. in *Caltex Oil (SA) Ltd v Secretary for Inland Revenue (SIR)* where he said that 'tax' is an annual event. The manner for determining taxable income in terms of The Act can be summarized as follows:

	Gross income (section1)	xxxxxx
Less	Exempt Income (section 10)	(xxxxx)
	Income	
Less	Deductions (Section 11-19 and 23)	(xxxxx)
Add	Taxable capital gains (section 26A)	xxxxxx
	<b>TAXABLE INCOME</b>	<b>xxxxxx</b>

Income is defined as follows:

"means that amount remaining of the gross income of any person for any year or period of assessment after deducting there from any amounts exempt from normal tax under Part 1 of chapter 22 of the Income Tax Act 58 of 1962"

Keith Huxham and Phillip Haupt, (2004) define taxable income as follows:

"..means the aggregate of –

- ❖ The amount remaining after deducting from the income of any person all amounts allowed under Part 1 of Chapter 11 of the Income Tax Act 58 of 1962 to be deducted from or set off against such income; and all income to be included or deemed to be included in the taxable income of any person in terms of this Act"

### 2.2.3 Gross Income

Silke (2001) regards the definition of 'gross income' in section 1 of the Income Tax Act as central to the whole of the Income Tax Act. Gross income is defined in section 1 of The Act as;

"In the case of any resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such resident; or

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

Beardle, J in *Local Investment Co v Commissioner of Taxes* (SR) 1958 (3) SA 34, defined 'gross income' as "all income receipts of the taxpayer". According to him 'Income' is defined as 'gross income less such amounts, which are exempt from income tax in terms of the Act.' It is on the 'taxable income' that tax is assessed.

### 2.2.4 Residence and source

South Africa has moved away from a source basis of taxation to residence basis of taxation since January 2001. The source basis of taxation subjects income of a taxpayer that is from a South African source whereas the residence basis of taxation subjects a taxpayer's income from any where in the world. However, source continues to be important for two reasons, namely;

- ❖ Persons who are not resident in South Africa are subject to tax on all income which are from a South African source, and; for a variety of reasons Double Tax treaties often use source of income as a basis for the provisions contained in the treaty. This means that the application of the provisions of a double tax treaty often requires the identification of the source of income.

### 2.2.5 Definition of 'Resident'

Resident is defined in the Income Tax Act as follows:

'resident' means any-

natural person who is ordinarily resident in the Republic; or

not at any time during the year of assessment ordinarily resident in the Republic, if such person was physically present in the Republic-

for a period or periods exceeding 91 days in aggregate during the relevant year of assessment, as well as for a period or periods exceeding 91 days in aggregate during each of the three years of assessment preceding such year of assessment; and for a period or periods exceeding 549 days in aggregate during such three preceding years of assessment:

Provided that, where a person who is resident in terms of this paragraph is physically outside the Republic for a continuous period of at least 330 full days immediately after the day on which such person ceases to be physically present in the Republic, such person shall be deemed not to have been resident from the day on which such person so ceased to be physically present in the Republic; or Person (other than a natural) which is incorporated, established or formed in the Republic or which has its place of effective management in the Republic (but excluding any international headquarter company)

### 2.2.6 Courts decisions

Where the sections of the Income Tax Act are not clear, it becomes necessary for the taxpayer and also The Receiver of Revenue Commissioner to approach the court to settle disputes. If a taxpayer is not satisfied with the assessment he can object to the assessment. If his objection is rejected by the Commissioner, he can appeal to an Appeal Board, then to the Income Tax Special Court, and thereafter to the Supreme Court. The judgements of our courts are important in that they interpret and clarify sections of the Act where there is uncertainty and as such they form part of our tax law.

### 2.2.7 Allowable deductions

In the process of determining the taxable income of a taxpayer, Practice Note No 31 Of 3<sup>rd</sup> October, 1994, suggests that to qualify as a deduction in terms of section 11(a) of the Income Tax Act no 58 of 1962, expenditure must be incurred in the carrying on of a 'trade' as defined in section 1 of The Act. The provisions of The Act no 58 of 1962 relating to deductions fall into two categories.

The first one is 'The general deduction formula' consisting of section 11(a) read with section 23(g), which lay down the general principles of deductibility. The second category consists of the various deductions, which are specifically authorized by the Act. According to Judge Corbett JA as he then was, in CIR v Pick 'n Pay Wholesalers 49 SATC 132 1987 (3) SA 453 (A), section 11(a) provides for the deduction of;

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

The current version of section 23(g) provides that

"No deductions shall in any case be made in respect of the following matters, namely:

Any moneys, claimed as a deduction from income derived from trade, to the extent to which such moneys were not laid out or expended wholly and exclusively for the purposes of trade."

The earlier version of section 23(g) provides:

"no deduction shall in any case be made in respect of the following matters, namely;

(g) Any moneys, claimed as a deduction from income derived from trade, which are not wholly or exclusively laid out or expended for the purposes of trade"  
(Silke:2001)

Silke: (2001) breaks down the general deduction formula into the following elements, namely;

The expenditure and losses

Must be actually incurred

During the year of assessment

In the production of income

They must not constitute expenditure and losses of a capital nature, and

If they are claimed, as a deduction against income derived from trade, they must, either in part or in full constitute moneys that are laid out or expended for the purposes of trade.

The court in *KBI v Van Der Walt* 1986 (4) SA 303 (T) laid down that section 11(a) and section 23(g) must be read together when one considers whether an amount is capable of deduction.

Expenditure under section 11 is deductible only if trade carried on. It is a precondition of the deductibility of all items in sub-paragraph (a) to (n) of section 11 that the taxpayer be carrying on trade. The term 'trade' is defined in section 1 and according to Notes on South African Income Tax 2003, 'Trade' includes every profession, trade, business, employment, calling, occupation or venture, including the letting of any property and the use of, or the grant of permission to use any patent, or trade mark, or any copyright, or any other property which is of a similar nature.

In *ITC 770* (1953 AD) 19 SATC 216 as reported in the *Burgess v CIR* case, Dowling J said, dealing with the definition of 'trade' in Act 31 of 1941, that it was obviously intended to embrace every profitable activity and it should be given the widest possible interpretation. In *CIR v Scott* 1928 AD 252, 3 SATC 253, Wessel JA who delivered the judgement of the appellate division of the Supreme Court

said that 'it was necessary to know whether the acts of the taxpayer in buying and selling those properties showed that he was carrying on the trade or business of a land jobber. Whether he was or was not carrying on such a business was an inference from facts.

The expenditure incurred that is referred to in section 11 of the Act may be claimed as a deduction only against income, as defined, derived from the carrying on of any trade. To establish whether a taxpayer is carrying on a trade is a question of law to be decided on the facts of each case. It would appear from the terms of section 11 that the Act contemplates the carrying on of more than one trade, and that deductions should be allowed from each trade as a unit by it self.

Where the allowable deductions in any particular trade exceed income, then, as regards to that particular trade, there is an assessed loss which, in terms of section 20(1)(b), may be set off against other income derived by the taxpayer. Whilst the Act contemplates the separate determination of a taxable income or assessed loss in respect of each trade carried on, these income or losses must be aggregated for the purposes of the determination of the taxable income as a single amount in the end.

Sometimes a taxpayer undertakes to carry on a business with no objective of making a profit, the court in ITC 615 (1946) 14 SATC 399, held that in appropriate circumstances the taxpayer would be regarded as carrying on a trade. The term 'trade', in spite of its wide meaning, does not embrace all activities that might produce income. In ITC 512 (1941) 12 SATC 246, the court held that a person who accumulated his savings and invest them in interest bearing securities or shares, held as assets of a capital nature does not derive the income from carrying on a trade.

However in ITC 770 (1953) 19 SATC 216, the court was of the opinion that the scale and the nature of the investment in securities or shares held as assets of a capital nature may be such as to amount to the carrying on of trade.

Trade implies an active occupation, something more than watching over existing investments that are not income producing and are not intended or expected to be so. The holding of investment does not imply a continuance of trade, even if it was acquired when trade was carried on.

Where a company makes loans to its shareholders or relatives of the shareholders and charge interest, the court in ITC 957(1960) 24 SATC 637, held that the interest received was not derived from the carrying on of trade.

In ITC 368 (1936) the word 'venture' was defined as " a transaction in which a person risks something with the object of making a profit.

In *Burgers v CIR* (1993 AD) the court was of the opinion that an investment, in the nature of a speculation, with the hope of a future profit, would not always have to be risky to constitute trade. It is obvious that trade, covers a wide spectrum of activities, but that there are certain activities which fall outside the scope of its definition. Of these the most common are investments made in dividend and interest bearing stock.

#### 2.2.8 Expenditure and 'losses'

The word 'loss' has been defined by courts and Keith Huxham et al (2003) regards expenditure and losses as cash outflows, to liabilities which may be settled in cash or otherwise. In *Joffe & Co (Pty) Ltd v CIR* 1946 AD 157, 13 SATC 354, the court considered that the word had several meanings and that it was not clear that they meant anything other than expenditure, but that possibly losses were expenditure of an involuntary nature. In SATC 360 case the court described the word 'loss' in relation to trading operations as sometimes used to



signify a deprivation suffered by the loser, usually an involuntary deprivation, whereas expenditure usually means a voluntary payment of money.

In *Port Elizabeth Electric Tramways Co Ltd v CIR* (1936 CPD) the court considered that the term 'losses' may refer to losses of floating capital employed in the trade which produces income. According to *COT v BSA Co Investment Ltd* 1966 (!) SA 530 (SRAD) case, the word 'loss' is confined to the actual expenditure or outgoing which the taxpayer seeks to deduct from his gross income. The Rhodesian Income Tax Appeals Special Court after review of a number of these cases, concluded that the word 'loss' meant an outgoing of some kind and not simply a diminution in the value of an asset (*ITC 1218(1974) 36 SATC 212*).

Sometimes it happens that a loss is sustained that does not involve any expenditure, for example, a bad debt. A bad debt may not be deducted under section 11(i) if its amount has not been included in income, as would be the position with a debt due to a money-lender. In *Plate Glass and Shutterprofe Industries Finance Co (Pty) Ltd v SIR* 1979 (3) SA 1124 (T) 41 SATC 103, a loss computed for accounting for accounting purposes by reference to the difference between the amount of a foreign obligation converted to rands at a rate of exchange prevailing at the year end and the amount of the obligation converted to the rands at the rate of exchange prevailing on some earlier date was accepted as being a 'loss' for the purposes of section 11(a).

It was suggested in *Caltex Oil (SA) Ltd v SIR* 1975 (!) SA 665 (A), 37 SATC 1 that the word 'expenditure' is not restricted to an outlay of cash but includes outlays of amounts in a form other than cash. If, for example, a merchant was required to pay for his goods by tendering land or shares in a company, the value of the land or shares would constitute expenditure in terms of section 11(a) and would be deductible. Where a merchant buys his goods from the

United States at a price fixed in dollars, the liability so contracted would be 'expenditure' and would have to be brought to account at its equivalent in South African currency.

#### 2.2.9 Actually incurred

In determining the taxable income of a person carrying on any trade in any year of assessment there is, in terms of section 11(a), deductible from such a person's income the expenditure actually incurred by him in the production of income during that year of assessment (*Caltex Oil (SA) Limited v SIR* 1975 (1) SA 665 (A). In *CIR v Delfos* 1933 AD 242, it was held that it is only at the end of that year of assessment that it is possible, and then it is imperative, to determine the amounts received or accrued on the one hand and the expenditure actually incurred on the other during the year of assessment.

According to ITC 542, 13 SATC 116, it was suggested that the expression 'expenditure actually incurred' in section 11(a) does not mean expenditure actually paid during the year of assessment, but means all expenditure for which a liability has been incurred during that year, whether the liability has been discharged during that year or not. This thus suggest that it is the tax year in which the liability for the expenditure is incurred, and not in the tax year in which it is actually paid, that the expenditure is actually incurred for the purposes of section 11(a) of the Income Tax Act.

Watermeyer AJP, in *Port Elizabeth Electric Tramways Company Ltd v Commissioner for Inland Revenue*, supra, said the words of the statute are 'actually incurred' and not 'necessarily incurred' The use of word 'actually' as contrasted with the word 'necessarily, according to him, may widen the field of deductible expenditure. An example would that of a man who conducts his business inefficiently or extravagantly, actually incurring expenses which another

man does not incur; such expenses therefore are not 'necessary' but they are actually incurred and therefore deductible.

Expenses actually incurred, does not mean they are actually paid. So long as the liability to pay them actually has been incurred they may be deductible. The court in the same case gave an example of a trader who may at the end of the income tax year owe money for stocks purchased in the course of the year or for services rendered to him. He has not paid such liability but they are deductible. The actual payment is therefore not essential for the deduction of expenditure: the Act merely requires that it must have been 'incurred'. In ITC 542 (1942) 13 SATC 116, the court gave the definition of the word 'incurred' as meaning either 'paid' or 'becoming liable for'.

In ITC 1117 1968 30 SATC 130, the court said it did not regard the presence of the qualifying word 'actually' in section 11(a) as adding anything to the plain and ordinary meaning of 'incurred', observing that 'expenditure is either incurred or is not incurred and if no legal liability for it arises it is not 'incurred'. This approach was, however criticized in the CIR v Golden Dumps (Pty) Ltd case supra, where the Judge said that this was contrary to the firmly established rule of statutory construction that a meaning must be given to every word.

According to Shorter Oxford English Dictionary, the adverb actually means 'in act or fact; really'. In an unreported decision an Australian decision suggest that it means 'ascertained', 'encountered' 'run into', fallen upon' and not merely, 'impending, threatened, or expected'. In other words, or so it would appear from the line of the court's reasoning, the liability under consideration must not be contingent.

The words 'actually incurred' rule out the deduction of provisions for expenditure or losses that are uncertain or may arise in the future or that are no more than

impending or expected. In ITC 169 (1930) 5 SATC 162, it was said that if there is no definite and absolute liability during the year of assessment to pay an amount, expenditure has not been 'actually incurred'

In *Nasionale Pers v KBI* 1986 (3) SA 549 (A), 48 SATC 55, the court said in relation to the words 'actually incurred' "Die vereiste dat die onkoste 'werklik angegaan' moet wees, het egter tot gevolge dat moontlike toekomstige uitgawes wat bloot as waarskynlik geag word nie ingevolge art 11 (a) aftrekbaar is nie. Alleen onkoste ten opsigte waarvan die belastingbetaler 'n volstreke en onvoorwaardelike aanspreekheid op die hals gehaal het, mag in die betroke belastingjaar afgetrek word".

In *Edgars Stores Ltd v Commissioner for Inland Revenue* 50 SATC 81, 1988 (3) SA 876 (A), it was said that our courts distinguish between;

Cases where the existence of the liability itself is conditional or subject to some contingency, and;

Cases where the existence of the liability itself is certain, but its amount is uncertain and cannot be accurately determined at the tax year-end.

Where the existence of the liability itself is dependent upon a future event, then the liability cannot be said to have been incurred. The fact of the liability must be absolute. *It must not be conditional or subject to contingency. All the events giving rise to the liability must have occurred.*

It is clear that only the expenditure in respect of which the taxpayer has incurred an unconditional legal obligation during the year of assessment in question may be deducted in terms of section 11(a) of the *Income Tax Act 58 of 1962* from income returned for that year. The obligation may be unconditional ab initio or, though initially conditional, may become unconditional by fulfillment of the condition during the year of assessment; in either case the relative expenditure

is deductible in that year. But if the obligation is initially incurred as a conditional one during a particular year of assessment and the condition is fulfilled only in the following year of assessment, it is deductible only in the latter year of assessment. This means that estimates of contingent liabilities are not expenditure 'actually incurred' as was said in *Pyott Ltd v CIR* 1945 AD 128, 13 SATC 121.

*Silke*: (1995) is of the opinion that the words 'actually incurred' do not mean that the expenditure must be due and payable at the end of the year of assessment. As long as there is a clear legal liability to pay at the end of the year, the expenditure is deductible even though actual payments may fall due only in a later year. This was the case in *ITC 674 (1949)* 16 SATC 235, where the taxpayer, in his financial statements for that particular tax year end, made provision for holiday pay due to his employees that was payable only in the month of December that followed the year of assessment.

It was found that in terms of the industrial agreement applying to the industry in which the taxpayer operated, there was an absolute liability to pay the holiday pay, for which a deduction was allowable even though payment was postponed. Where there is no absolute liability to pay, the courts have in the past disallowed deduction. This was the case in *KBI v Nasionale Pers Bpk* 1984 (\$) SA 551 ©, 46 SATC 83, where a company claimed deduction for the portion of annual bonuses it considered to be appropriate to the period ending on the last day of each year of assessment. Its employees could, however, at those dates make no claim for bonuses, becoming eligible for them some months later. The court disallowed the deduction on the grounds no liability existed at the relevant dates and that there was no expenditure actually incurred.

Where a taxpayer carries on a business, which has a number of branches, which together make up a single business, these branches are not different entities in

law. This means that any payment representing expenditure that one side of the business is supposed to have paid to the other cannot rank as allowable deduction from income since no expenditure will have been incurred as required by section 11(a) of the Act (ITC 103 (1927) 3 SATC 328). It is an established principle of income tax law that a man cannot lend to himself, trade with himself or make a profit out of himself.

#### 2.2.1 Incurred during the year of assessment

The courts have held that the claim, in terms of section 11(a), for the deduction of expenditure or loss must be made in the year of assessment when the expenditure or loss was 'actually incurred'. This means that the accounting principle of matching does not apply in the case of tax and that the expenditure must be claimed in the year in which it is incurred.

Deductible expenditure cannot be carried forward to a subsequent year or carried back to a previous year even though it may properly relate to the income of those particular years. The court in *Concentra (Pty) Ltd v CIR (1942) CPD*, refused a claim for deduction of expenditure on the grounds that the expenditure should have been claimed in the years in which it arose, and that, by failing to claim at the right time, the company had forfeited its right to claim a deduction in terms of section 11(a)

In this case the company had claimed as a deduction certain expenditure relating to the directors' expenses, which had arisen in earlier years. In *Caltex Oil (SA) Limited v SIR 37 SATC 1975 (!) SA 665 (A)*, the court reaffirmed the earlier courts' decisions that it is only at the end of the year of assessment that it is possible. And then it is imperative, to determine the amounts received or accrued on the one hand and the expenditure actually incurred on the other during the year of assessment.

The principle of the decision in this case is that the expenditure incurred during the year of assessment must be calculated and brought into account for the purposes of section 11(a) at the end of that year or at the date of the discharge of that liability within that year. In *Sub Nigel Ltd v CIR (1948) AD* the court ruled that the scheme of the Act shows that, as the taxpayer is assessed for income tax for a period of one year, no expenditure incurred in the year previous to the particular tax year can be deducted.

There are certain exceptions to this rule. Section 23H Of the Act, limits the deduction available for expenditure in certain circumstances and among the so-called special deductions described in chapter 8. If the expenditure is incurred in respect of services to be rendered, the deduction in a particular year of assessment is limited to the amount which bears to the total amount of the expenditure the same ratio as the number of months during which the services are rendered in that year bears to the total number of months during which the service will be rendered. The effect of section 22 of the Act is that the cost of goods or other assets bought for resale is deductible in the year of assessment in which the goods or assets are eventually sold.

#### 2.2.11 In the production of income

##### Definition of "in production of income"

In *Port Elizabeth Electric Tramways Company Ltd v CIR (1936 CPD)*, "in production of income" it was contended that any expenditure or losses, sought to be deducted from income, must have been incurred in the production of income. The income referred to is that as defined in section 1 of the Income Tax Act 58 of 1962, that is, the gross income less the exempt income. It follows that if the expenditure is incurred to produce income that fall outside 'gross income' as defined in section 1 of the same Act or produce income that is exempt from

tax in terms of section 10 of the Income Tax Act no 58 of 1962, all such amounts not being included in 'income' as defined, the expenditure is not deductible.

The element 'in production of income' requires a link between the act, giving rise to the expenditure and the earning of income.

The term 'in production of income' has been the subject of a number of court cases which have attempted to define its meaning. In *Port Elizabeth Electric Tramway Co Ltd v CIR (1936 CPD)*, the court was called upon to decide whether certain expenditure incurred by the company, as a result of an accident, was properly deductible, being 'expenditure in the production of income'. A vehicle belonging to the company had been involved in an accident, as a result of which the driver had been fatally injured.

The company was compelled to pay compensation and legal costs that was incurred when it contested the claim of the deceased representatives. The court held that whilst compensation paid, was incurred in the production of income, the legal costs incurred in resisting the claim were not. The court in the same case explained that gross income is not produced directly by either expenditure or losses. It is the results from work and labour or the use of capital in productive enterprise or loan of capital and it is produced in diverse ways.

Income is produced by a series of operations and transactions entered into for the purpose of manufacturing or acquiring products to be sold and thereafter selling it or by rendering services for which a payment is received. In the course of such operations and transactions, expenditure and losses may be incurred and these are the expenditure and losses referred to in the Act.

The court further pointed out that..." In order to determine whether expenditure and losses have been incurred in the production of income, one needs to enquire:



Whether the act, to which expenditure is attached, is performed in the production of income, and

*Whether the expenditure is linked to it closely enough."*

This means that, therefore, the act must be identified first and a decision made as to whether or not it was performed for the purpose of producing income, And, secondly, the expenditure sought to be deducted must be closely linked to the performance of the act identified.

Since the employment of the driver was necessary for carrying on the business of the company, and since the employment of the driver carried with it, as a necessary consequence, a potential liability to pay compensation if those drivers were injured in the course of their employment, the court considered that the compensation paid by the company had to be regarded as being so closely connected with the income-earning act from which the expenditure arose as to form part of the cost of performing it. The compensation was therefore allowed as a deduction.

All that had to be decided was whether the damages paid was closely linked to the employment of the driver as to as to be regarded as part of the cost of performing the income earning operation. The court held that the legal costs were expended in resisting a demand for compensation, and since this was not an operation entered into for the purpose of earning income, the legal costs were disallowed.

The court further suggested that where the act done is unlawful or negligent and the attendant expenses are caused by unlawfulness or possibly by negligence of the act, then it would not be deductible. However in *Joffe & Co (Pty) Ltd v CIR* 1946 AD 157, 13 SATC 354, the court held that damages which were paid out, were only deductible if they constitute expenditure not of a capital nature, and were incurred in the production of income in respect of which tax was levied. In

that case damages paid out did not pass the test of deductibility. The damages were paid out to discharge a debt or legal liability to the plumber's dependents, arising out of appellant's negligence in performing a trading operation.

On the question of the deductibility of expenses, the court further held that all expenses attached to the performance of a business operation genuinely 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 incurred for the more efficient performance of such operation provided there are so closely connected with it that they may be regarded as part of the cost of performing it.

It would seem that the above paragraph deals with three types of expenditures, namely;

- (i) Expenses which are necessary for the performance of the business
- (ii) Expenses which are attached to the performance of the business operations
- (iii) Expenses which are *bona fide* incurred for the more efficient performance of such business operations.

In CIR v Genn & Co (Pty) Ltd, 1955 (3) SA 293 (A), 20 SATC 113, the principle laid down in Port Elizabeth Electric Tramway Co case was cited with approval when Schreiner JA, who delivered the judgement of the appellate division, said:

"If I'm right in understanding the words 'they may be regarded' as connoting that it would be proper, natural or reasonable to regard the expenses as part of the cost of performing the operation, this passage seems to state the approach to such question correctly."

In Sub-Nigen Ltd v CIR 1948 (4) SA 580 (A), 15 SATC 381, the court authoritatively established that the words, 'incurred in the production of income'

do not mean that before a particular item of expenditure may be deducted it must be shown that it produced any income for the particular year of assessment. What was important was to establish whether expenditure had been incurred to produce income as defined in section 1 of the Act, in the current or future year of assessment.

In that case it was held that amounts paid by way of premiums on insurance policies against loss of profits and loss of standing charges occasioned by fire, were incurred in the production of income. The court further ruled that the fact that no income had actually been produced, was irrelevant and that the expenditure had been incurred for the purpose of producing income and was, therefore, deductible.

In *Commissioner for Inland Revenue v Allied Building Society* 25 SATC 343 1963 (4) SA 1 (A), the court argued that as the society's business was to borrow money it was also obliged to pay interest on those monies in order to continue to conduct its business. The payment of interest was thus, literally, necessary in order to earn income.

The court concluded that it was not concerned with whether a particular item of income produced any part of income, but with whether that item of expenditure was incurred for the purpose of earning income. Thus, according to the Court's reasoning the 'purposes' for which the expenditure was incurred is decisive in determining the deductibility of expenditure. If the expenditure is incurred for the purposes of earning income, then it is deductible.

In *Weinberg v CIR*, 14 SATC 210, where the taxpayer was a garage owner who undertook to let one of his customers park his car in his garage for a monthly fee. One day, an employee instead of taking the car to the garage, he drove it to his own home, and on his way back ran the car into a building, damaging the car

beyond recognition. The taxpayer was obliged to pay for the resultant damages and claimed these to be deductible expenditure. However, the court held that, when the employee drove the car into the building, he was not engaged in the rendering of any service in the normal course of business operations of his employ.

The act of damaging the car was not the inevitable or practically inevitable result of the contract, which the appellant had with the owner of the car and the expenditure was thus not incurred in the production of income. Therefore for the expenditure to qualify for deduction, according to this case decision, the act entailing expenditure must be an inevitable or practically inevitable result of the operations of the business.

In ITC 233, the taxpayer carried on a business of a stevedore. A man passing by was struck by an object, which fell out of the net whilst the taxpayer was loading the vessel, and died. The taxpayer was obliged to pay the dependents of the deceased damages. The court held that the payment of damages had to be regarded as incidental to the business such as stevedoring and therefore was deductible.

In CIR v Nemojim (Pty) Ltd 1983 (4) SA 935 (A), 45 SATC 241, the court clearly reiterated the fact that, to rank as a deduction, expenditure must not only have been incurred for the purpose of earning 'income' as defined, but there must be a sufficiently distinct and direct relationship or link between expenditure incurred and the actual earning of the income.

Corbett JA who delivered the judgement of the appellate Division said "It is correct ... that in order to determine in a particular case whether moneys outlaid by the taxpayer constitute expenditure incurred in the production of income,

important, sometimes overriding factors, are the purpose of the expenditure and what the expenditure actually effects.”

The requirement that there must be a sufficiently distinct and direct relationship or link between the expenditure incurred and the actual earning of income does not impose an investigation into the business efficacy of taxpayers.

In ITC 1600 (1995) 58 SATC 131, the taxpayer hired a computer equipment for use in one of his divisions. The fortunes of the business declined and the taxpayer had to cancel the lease agreement but had to pay a cancellation fee.

The court held that if the taxpayer had not disposed of the computer but replaced it with a cheaper and more efficient system, he would have been able to continue deducting the payments. It was further pointed out that the expenditure was made in good faith in the normal course of business and accordingly the taxpayer was entitled to the deduction claimed for the lease termination payments.

The expenditure is incurred in the production of income even if the taxpayer is not obliged to incur. This will be the case with voluntary expenditure incurred in order to induce an employee to enter and remain in the taxpayer’s service. In *Provider v COT* 1950 SR 161, 17 SATC 40, the taxpayer had initiated two schemes for the benefit of his employees.

One scheme was a service bonus and the other was a life assurance scheme. Under these schemes, which were non contributory, the taxpayer undertook to pay, firstly, a bonus on retirement to any employee who had been in the employ of the taxpayer for a certain period, and, secondly, a benefit to dependents of the employees who died whilst in the taxpayer’s service, both the bonus and benefit being linked to the length of service.

The taxpayer claimed a deduction for the payments, which he had made in terms of these schemes, on the grounds that they constituted 'expenditure actually incurred in the production of income'. The Commissioner allowed as a deduction the bonuses but not the benefits paid to dependents. Tredgold CJ, who delivered the judgement, held that for the payments to be allowable as deductions they must be shown, in terms of section 14(a) of the Income Tax Consolidation Act, 1948, to be 'expenditure actually incurred by the employer in the production of income'.

The court was of the opinion that the purpose of the taxpayer must have been to increase the productivity, to improve staff morale or loyalty, or to reduce staff turnover, all of which would impact on the production of income. Gratuity payments which does no more than reward past service, it would seem, not be 'incurred in the production of income' and would therefore not be deductible.

This was in fact the case in *W F Johnstone & Co Ltd v CIR 1951 (@) SA 283 (A)*, 17 SATC 235, where the company had paid four of its employees lump-sum gratuities and paid pension to one of them because they were too old to be members of the company's provident fund. These payments were on account of old age and honourable services. Judge Centlivres CJ as he then was, who gave the judgement felt that the real reason that influenced the directors to make the payments was in recognition of past services rendered to the company.

As such they did not form part of the ordinary operations undertaken by the company for the purpose of conducting its business; nor were they payments made for the purpose of earning income. Lastly they were not payments made wholly and exclusively for the purpose of the appellant's trade. And as such they were not deductible.

### 2.2.12 Test of intention

There are two inquiries that can be made when testing whether an amount is incurred in the production of income, namely;

What was the purpose of incurring the expenditure, that is, was it incurred for the purpose of earning income and if this requirement is satisfied,

Is the expenditure closely connected to the earning of the income?

Therefore, if the purpose is to earn non-income, that is, dividends, or, to preserve capital e.g. to prevent total extinction of the business from which the taxpayer's income was derived, then the inquiry closes and the expenditure is not deductible.

In *Natal Laeveld Boerdery Bk v Kommissaris van Binnelandse Inkomste*, 60 SATC 81, the taxpayer was unable to raise the purchase price of a farm as a result he borrowed an amount from a financial institution and registered a bond over the farm as security. The proceeds of the loan was used to pay the departing member. The question before the court was whether the interest paid by the taxpayer CC on the loan was deductible by it in terms of section 11(a) read with section 23(g) of the income Tax Act 58 of 1962.

The court held that where the deductibility of interest payable on a loan is in question, regard must be primarily be had to the purpose or purposes for which the money was loaned. The court held that the primary purpose of the loan was to buy out one member of the taxpayer CC and in so doing the remaining member became the sole member of the taxpayer. The court held further that the interest payment in issue was not deductible in terms of section 11(a) read with section 23(g) of the Act 58 of 1962.

In *CIR v African Greyhound racing Association (Pty) Ltd*, 13 SATC 259, 1945 TPD 344, the appellant company had sought to deduct expenditure amounting to \$1586 on legal representation before the commission appointed to enquire into

the question whether dog racing should be abolished or curtailed. The Commissioner refused to allow this as a deduction and the company approached the Supreme Court for a decision. The court held that the expenditure was not admissible as a deduction, inasmuch as it was not incurred for the production of income, but for the purpose of preventing the total or partial extinction of the business from which the appellant's income was derived.

In *CIR v Stellenbosch Farmers Winery*, 13 SATC 381, 1945 CPD 377, the taxpayer carried on a business of wine and spirits from the year 1935. The company introduced a product, which quickly took on the market, as a result of which the opposition tried to sell their wines under the company's label known as the 'Ship Sherry'. The company was able to obtain a judgement preventing these companies to use that label. However when Castle Wine and Brandy entered the market, it brought with it a sherry labeled 'Ship Sherry' and the company's sales declined.

In 1940 Castle Wine and Brandy made an attempt to register this label. Stellenbosch Farmers' Winery opposed the application on the grounds that the 'ship' device had become distinctive of its wines, and the use of the name as a trade mark by the applicant company would be calculated to deceive and lead to confusion. The Registrar of Patents decided to reject Castle Wine and Brandy's application and that led to the sales of Stellenbosch Farmers' Winery's 'sherry' increasing.

In its opposition to this application, Stellenbosch Farmers' Winery incurred legal expenses, which it decided to claim as a deduction in the determination of its taxable income for that tax year. The Commissioner having disallowed that expenditure, the respondent company appealed to the Special Income Tax Court against the assessments on the grounds that;

The expenditure was actually incurred in the production of income



The expenditure actually produced income in the year of assessment ended 30<sup>th</sup> June 1942 and in subsequent years; and

The expenditure was ordinary business expenditure and was not of a capital nature.

The Special court, allowed the respondent company's appeal, but the Commissioner, being dissatisfied with this decision, approached the Supreme court to overrule the Special Court's decision, submitting for the decision the following question of law: "On the facts found as admitted and proved and set out herein, was the expenditure incurred by the company, expenditure actually incurred in the production within the meaning of section 11 (2)(a) of the Act and not excluded from deduction on the ground that it was expenditure of a capital nature."

The court upheld the Commissioner's appeal on the grounds that the expenditure was incurred in seeking to nullify competition, which would have affected the company's business. *The court further held that the legal costs were sufficiently closely connected with the earning of the income as to be regarded as part of the cost of earning it and so admissible as a deduction. The court also decided that as the expenditure was not incurred in the protection of the company's label, but was for the purpose of meeting the threat to its business, which had proved to be of a recurrent nature, it was not of a capital nature and the taxpayer was entitled to claim it as a deduction.*

#### 2.2.13 'Not of a capital nature'

Section 11(a) stipulates that in order for expenditure or loss to be allowed as a deduction, it must not be of a capital nature. The Act does not define the expenditure or loss of a capital nature, and as Centlivres JA pointed out, in *Sub-Nigel Ltd v CIR 1948 (4) SA 580 (A), 15 SATC 381*, it is impossible to give a

definition of a non capital nature which will act as a touchstone in deciding all possible cases and it would be impracticable to attempt such a definition.

Marais J.A., in *Rand Mines (Mining & Services) Ltd v Commissioner for Inland Revenue* 1996, 59 SATC 85, pointed out that the distinction between expenditure of a capital nature and expenditure of an income nature is clear enough conceptually and so familiar that repetition is unnecessary. According to him the problem is to identify and then synthesize into a reasonably accurate and universally applicable yardstick the factors which are indicative of each of the two classes of expenditure.

The courts have identified useful indicia to which regard may be had, emphasizing that they are no more than that and that in each case close attention must be given to its particular facts. Viscount Radcliffe, in *Commissioner of Taxes v Ntchanga Consolidated Copper Mines* (1964) 1 All ER 208 (PC) at 212B, warned that any of the indicia identified by the Courts, taken singly, will always lead to the right conclusion.

The distinction drawn in *Commissioner for Inland Revenue v George Forest Timber Co.*, A.D. 516 at 526, and *New State Areas, Ltd v Commissioner for Inland Revenue*, 1946 A.D. 610 at 627, between capital and revenue expenditure is well recognized. In those cases it was said that money spent in creating or acquiring an income producing concern, a source of profit or a capital asset, is capital expenditure, whilst the cost incidental to the performance of the income producing operations is revenue expenditure.

In *New State Areas, Ltd v Commissioner for Inland Revenue*, supra, Watermeyer CJ, quoted with approval from *Port Elizabeth Electric Tramways Co v Commissioner for Inland Revenue*, supra, that in a literal sense expenditure and losses do not produce income. Income is produced by work or services or

activities or operations and as a rule expenditure is attendant upon the performance of such operations sometimes necessarily, sometimes not.

Expenditure may be incurred in the purchasing of manufacturing equipment, which he uses in the performance of his income earning operations. Both these forms of expenditure can be described as expenditure in the production of income and the latter is regarded as expenditure of a capital nature.

In this case the company was appealing against the decision of the Commissioner and the Income Tax Special Court, regarding the deductibility of expenditure.

The appellant company carried on business of gold mining.

In the year 1941 the local authority within whose area of jurisdiction the mine lay, required the company to install a system of water-borne sewerage and to link up with the authority's system. The company was obliged by the terms of Ordinance 17 of 1939 to comply with this requirement. The system installed consisted of sewers and connections upon the company's own property and sewers upon land outside the company's property linking up the system into the authority's own system. The system was installed at the cost of the local authority but the company was required to pay;

"A" basic charge

The court went on to describe the difference between floating or circulating capital and fixed capital. It was said that the capital employed in a business is frequently changing its form from money to goods and vice versa, and if this is done for the purpose of making a profit, then the capital employed is floating capital.

Expenditure of a capital nature, the deduction of which is prohibited under section 11(2), is expenditure of a fixed capital nature, not expenditure of a

floating capital nature, because expenditure which constitute the use of floating capital for the purpose of earning a profit, such as the purchase price of stock in trade in order to arrive at the taxable income derived by the taxpayer from that trade, must necessarily be deducted from the proceeds of the sale of stock in trade in order to arrive at the taxable income derived by the taxpayer from that trade.

The court in the case in Commissioner for Inland Revenue v George Forest Timber Co Ltd 1924, A.D. 516 felt that in the absence of any authoritative and comprehensive definition of capital expenditure it is important to know the characteristic quality of capital; that it is wealth employed in creating fresh wealth, invested to produce income.

It is common cause that proceeds of merchandise sold in the course of trade are included in the gross income of trade, because they are not receipts of a capital nature within the meaning of section 11(a) of the Act. At the same time, the cost of merchandise thus disposed of would be an expenditure not of a capital nature within the meaning of section 17(1)(a); and having been incurred in producing the income would be properly deducted under that clause.

The court further held that money spent in creating or acquiring an income producing concern must be capital expenditure. There is a great difference between *money spent in creating or acquiring a source of profit, and the money spent in working it*. The one is capital expenditure and the other is revenue expenditure. The reason is plain; in the one case it is spent to enable the concern to yield profits in the future, in the other it is spent in working the concern for the present production of profit.

These opinions have been expressed in a number of cases including Rhodesia Railways v Commissioner of Taxes (1925, A.D. 496.

In the ordinary cases it is not difficult to distinguish between capital expenditure and revenue expenditure, but there are many cases on the borderline, some of which, such as repairs and wear and tear of the means of production, are specifically provided for in section 11(2) of the Act.

Several tests for determining the difference between expenditure of an income nature and expenditure of a capital nature have also been suggested in the English cases. One such case where such a test was suggested was in *Vallambrosa Rubber Co v Farmer*, 1910 SC519 where it was said that a payment made once and for all is capital expenditure and a recurrent expenditure is revenue expenditure recognizes the form only and not the essential character of the transaction and is of little value to those cases where capital expenditure is given the appearance of revenue expenditure because it is paid in installments and where revenue expenditure is given the appearance of capital expenditure because it is commuted and paid in one lump-sum. The English courts do now recognize that they have to look at the true character of the transaction and not the form.

In *I.R.C. v Mallaby Deeley* (1938, A.E.R. 818 at page 823) the court held that the distinction to be drawn for the purposes of the Income Tax Acts between payments of an income character and payments of a capital nature is sometimes a very fine and rather artificial one. It depends upon the precise character of the transaction. If the amount to be paid is capital, the fact that that amount will be paid in installments will not change what is capital expenditure to be revenue expenditure.

The character of the expenditure to be made is determined by the nature of the transaction to be made and that the installment method used does not change the character of the transaction. But, where there is no obligation to pay an

amount of a capital nature, but an undertaking to pay annual sums, these annual payments will be considered to be revenue in nature for the purposes of the Income Tax Acts.

In *Vallambrosa Rubber Co v Farmer*, 1910 SC 519, the court expressed the opinion that capital expenditure is a thing that is going to be spent once and for all, and income expenditure is a thing that is going to recur every year. However Lord Dunedin emphasized that the criterion suggested was not, intended to be decisive in every case.

According to the court in *CIR v African oxygen, Ltd* 1963 (1) S.A. 681, money spent in creating or acquiring an income producing concern, a source of profit or a capital asset, is capital expenditure, while the cost incidental to the performance of the income earning operations is revenue expenditure.

#### 2.2.14 'Laid out or expended for the purpose of trade'

Section 23(g), the so called negative portion of the deduction formula, prohibits as a deduction 'any moneys, claimed as a deduction from income derived from trade, to the extent to which such moneys were not laid out or expended wholly or exclusively for the purposes of trade'. When deduction of expenditure from income is being determined, section 23(g) should be read together with section 11(a) of the Act.

Prior to its amendment in 1992, section 23(g) prohibited the deduction of expenditure, which was not laid out wholly and exclusively for the purposes of trade. The previous provision of section 23(g) was much more restrictive than the present version, in that, where expenditure was not wholly and exclusively laid out for the purposes of trade, the deduction was disallowed.

This problem was highlighted in an appeal court case in *Solaglas Finance Company (Pty) Ltd v CIR 1991 AD, 53 SATC 1*, in which the court held that a loss suffered as a result of a loan debt from a fellow subsidiary which went bad, was not deductible because, the loan had been made with mixed motives, namely, the carrying on of a money lending business (trade) and for the purpose of benefiting the group (non-trade).

The non-trade element was the reason for disallowance of the deduction because it meant that the expenditure was not wholly and exclusively laid out for the purposes of trade. According to the court in *Commissioner for Inland Revenue v Pick n' Pay Wholesalers (Pty) Ltd 49 SATC 132 1987 (3) SA 453 (A)*, section 23(g) as amended in 1992 reads as follows:

Section 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 on trade'.

In this case the court first concerned itself with the meaning of the words, 'moneys which are wholly or exclusively laid out for the purposes of trade' According to the court the answer to this question was provided by the analysis of similar words in the judgement of Romer LJ in *Bentleys, Stokes and Lowless v Beeson (1952) 33 TC 491 (CA)* at 503-4 where it was said that:

"The question whether the deduction of expenditure is allowable in terms of section 23(g) is a question of law, however the purpose of the taxpayer in incurring the expenditure is a question of fact (*SIR v Ineson 1980 (3) SA 852 (A)*, 42 SATC 125). In a United Kingdom case, the words 'expended for the purposes of trade' in section 23(g) was considered and the courts there interpreted them to mean 'for the purposes of enabling a person to carry on and

earn profits in the trade' (Strong & Co of Romsey Ltd v Woodfield (Surveyor of Taxes (1906) AC 448, 5 TC 215."

#### 2.2.15 Private and domestic expenditure

Section 23 prohibits the expenditure of the following:

(a) The cost incurred in the maintenance of any taxpayer, his family or establishment.

(b) Domestic and private expenses, including the rent of or cost of repairs of or expenses in connection with premises not occupied for the purposes of trade or of any dwelling house or domestic premises except in respect of such part as may be occupied for the purposes of trade.

Provided that:

- ❖ (a) Such part shall not be deemed to have been occupied for the purposes of trade, unless such part is specifically equipped for the purposes of the taxpayer's trade and regularly and exclusively used for such purposes; and
- ❖ No deduction shall in any event be granted where the taxpayer's trade constitute any employment or office unless;
  - His income from such employment or office is derived mainly from commission or other variable payments which are based on the taxpayer's work performance and his duties are mainly performed otherwise than in an office which is provided to him by his employment; or
  - His duties are mainly performed in such part"

Huxham and Haupt in Notes On Income Tax In South Africa (2004) explains that expenditure such as bond interest, repairs to domestic dwellings, domestic servants' wages and cost of running a private motor vehicle are all disallowed under these sub-sections. Subparagraph (a) of the proviso to section 23(b) does



make provision of expenditure incurred in respect of any portion of a private dwelling occupied exclusively and regularly for the purpose of trade.

A full-time salaried employee will not be permitted a deduction in respect of a home office, in terms of subparagraph (b) to the proviso to section 23(b), unless *his income is derived mainly from commission and his work is mainly performed otherwise than in office provided by his employer or his duties are mainly performed in his office*. It is submitted that if an employee also carries on some other trade he will still be entitled to a deduction if he uses his home office regularly and exclusively for the purposes of that trade.

In *L v Commissioner of Taxes* (1992) 54 SATC 91 (ZHC) a taxpayer developed cataracts in her eyes, which caused the deterioration of her eyesight resulting her undergoing surgery in South Africa. After the operation she was able to resume her duties. In connection with her medical treatment in South Africa, she incurred expenditure to the tune of \$4200, on air tickets, accommodation, the hire of car, medical treatment and hospital and drugs charges. She claimed these expenses as expenditure incurred for the purposes of her trade.

The court was of the view that the expenditure incurred by the taxpayer, could not be said to have been closely connected to the performance of a taxpayer's *legal practice, as to be regarded as part of the cost of performing it*. Judge Smith J, who presided over the court proceedings quoted from *Norman v Golder (Inspector of Taxes)* 1945, 1 All ER 352 (CA) at 354, where Lord Greene MR said, "It is quite impossible to argue that a doctor's bills represent money wholly and exclusively laid out for the purposes of trade, profession employment or vocation of the patient.

True it is that if you do not get yourself well and so incur expenses to doctors you cannot carry on your trade or profession, and if you do not carry on your

trade or profession you will not earn an income, and if you do not earn an income, the Revenue will not get any tax. The same thing applies to the food you eat and the clothes you wear. But expenses of that kind are not wholly and exclusively laid out for the purposes of trade, profession or vocation.

They are paid out in part for the advantage and benefit of the taxpayer as a living human being. Paragraph (b) of the rule equally would exclude doctor's bills, because they are, in my opinion, expenses of maintenance of the party, his family or a sum expended for the domestic or private purpose, distinct from the purpose of the trade or profession".

In *Commissioner for Inland Revenue v Hickson* (1960 (1) SA 746), the respondent had incurred a spinal injury and was only able to move with considerable difficulty. In 1955 he was asked by his company to visit Britain and America for a series of business meetings. As he could not travel unassisted, the company agreed to finance his wife who was going to look after him during that journey. In his income tax return for the tax year ended 30<sup>th</sup> June 1956, the respondent claimed deduction of his wife's expenses on the trip.

The Commissioner rejected the claim for deduction but in the Special Court, it was held that the expenditure was actually incurred in the production of income, that it was wholly and exclusively laid out for the purposes of trade and was not prohibited by the provisions of section 12 of the Income Tax Act which disallow expenditure on the 'maintenance of the taxpayer, his family or establishment' or on the 'domestic and private expenses' of the taxpayer.

The Commissioner appealed direct to the Appellate division of the Supreme Court. In its judgement, the court explained the reasoning behind section 11(2)(q) of the Act, which allows as a deduction 'in respect of any person suffering from any disability, and the sum of whose taxable income and

dividends, for the year of assessment in question does not exceed one thousand five hundred pounds, notwithstanding the provisions of paragraphs (a) and (b) of section 12, *so much of any expenditure, but not exceeding one hundred and fifty pounds, incurred by such a person during the year of assessment as the Commissioner is satisfied was necessarily incurred by him in consequence of such disability and for the purpose of carrying on of his trade and which is not such expenditure as is referred to in any of the other paragraphs of this subsection'*

The court's opinion with regards to this paragraph was that it merely permits, within limits, a deduction of expenses which would otherwise not be allowable because of the provisions of subsection (a) and (b) of section 12, i.e. either because they are incurred in maintaining the taxpayer or are of a domestic or private nature. The object of adding this paragraph to the other paragraphs in subsection (2) of section 11 was, probably, to afford a certain class of taxpayer some further and additional relief.

In conclusion the court felt that the expenses claimed by the respondent were not of the kind contemplated and prohibited by subsections (a) and (b) of section 12 of the Act. According to the court, 'maintenance of the taxpayer, his family or establishment' means feeding and clothing himself and his family, providing them with the necessities of life, and comforts, and, maintaining a certain standard of living, and keeping up his establishment. 'Domestic and private expenses' are, according the court, expenses pertaining to the household, and to the taxpayer's private life as opposed to his life as a trader.

#### 2.2.16 Cessation of trade

In ITC 729 (1951) 18 SATC 96, the taxpayer continued paying his employees pension long after the business stopped operating. The taxpayer sought to deduct these amounts paid as having been incurred for the purposed of trade.

The court held that, because the obligations were incurred for the purposes of trade, the actual expenditure satisfied the requirements of the provisions equivalent to section 23(g) and was therefore deductible from income derived from another trade. The court further held that it is not the requirement of section 23(g) that a particular trade in respect of which the expenditure has been laid out be in existence at the date the expenditure is incurred

In Income Tax Case No 1029, reference was made to the Australian case of *Amalgamated Zinc (De Bavay's) Ltd v Federal Commissioner of Taxes (1935) 54 C.L.R. 295*, as reported in ITC No 490. In that case it was decided that expenditure incurred by the taxpayer as a result of operation which it had ceased to carry on after it had so ceased to carry on the operations, could not be regarded as 'losses and outgoings incurred in gaining or producing assessable income'.

The court, however pointed out that, as the Australian legislation is different from ours, so would be our approach in South Africa due to the legislation that is different to Australians'. The court held that if the expenditure was deductible, by a taxpayer while he carried on business, the fact that he ceased to carry on that business did not render such expenditure non-deductible provided that it arose out of the taxpayer's activities prior to the cessation of his business operations.

Not wholly and exclusively laid out for the purposes of trade

In *Pick n' Pay Wholesalers (Pty) Ltd 49 SATC 132 1987 (3) SA 453 (A)* the court was trying to establish the status of the donation to Urban Foundation by the appellant company. Part of the donation was regarded by the Commissioner as being not wholly or exclusively laid out for the purposes of trade and as such no deduction was permissible.

The court had to examine the meaning of section 23(g), in particular the words 'moneys which are not wholly or exclusively laid out for the purposes of trade'.

Judge Nicholas AJA, who presided over the court proceedings, referred the case, 'Bentleys, Stokes and Lowless v Beeson (1952) 33 TC 491 (CA) at 503-4 and said:

"The relevant words... 'wholly and exclusively laid out or expended for the purposes of the profession' appear straight forward enough. It is conceded that the first adverb "wholly" is in reference to the quantum of the money expended and has no relevance to the present case.

The sole question is whether the expenditure in question was "exclusively" laid out for business purposes, that is: What was the motive or object in mind of the two individuals responsible for the activities in question? It is well established that the question is one of fact: and again, therefore, the problem seems simple enough. The difficulty, however, arises, as we think, from the nature of the activities in question. Entertainment involves inevitably the characteristic of hospitality: giving to charity or subscribing to a staff pension fund involves inevitably the object of benefaction: an undertaking to guarantee to a limited amount a national exhibition involves inevitably supporting that exhibition and the purposes for which it has been organized.

But the question in all such cases is: Was the entertainment, the charitable subscription, the guarantee, undertaken solely for the purposes of business, that is, solely with the object of promoting the business or its profit making capacity? It is, as we have said, a question of fact.

And it is quite clear that the purpose must be the sole purpose. The paragraph says so in clear terms. If the activity is undertaken with the object both of promoting the business and also with some other purpose, for example, with an object of indulging an independent wish of entertaining a friend or stranger or of supporting a charitable or benevolent object, then the paragraph is not satisfied though in mind of the actor the business motive may predominate. For the statute so prescribes. Per contra, if, in truth, the sole object is business

promotion, the expenditure is not disqualified because the nature of the activity necessarily involves some other result, or the attainment or furtherance of some other objective, since the latter result or objective is necessarily inherent in the act”

In this case the company had made a donation of R500,000 to Urban Foundation over a period of five years. According to the witnesses in the court the donation was to benefit Urban Foundation while at the same time promoting the appellant's business. The Commissioner had contended, in the Special Court, that

- ❖ The two amounts of R100,000 in issue were of a capital nature
- ❖ Neither was “wholly or exclusively laid out or expended for the purposes of trade”
- ❖ Alternatively and in any event, the R100,000 paid in 1979 tax year ‘did not constitute expenditure actually incurred in the production of income and/or was not wholly or exclusively laid out for purposes of trade.

The contention of behalf of Pick n’ Pay was that the donation was merely a vehicle which it used to ride to publicity and profits and that the benefit to the Urban Foundation was incidental. The court had to decide whether the expenditure was exclusively for the purpose of trade but produced incidental effect, or the secondary consequence, of benefit to Urban Foundation or whether it had the dual purpose of promoting trade and benefiting the Urban Foundation.

The court held that there existed a dual purpose, namely, a purpose to make a benefaction to the Urban Foundation and a purpose to promote the business of Pick n’ Pay by publicity which was to be obtained from the announcement of the benefaction. Section 23(g) at that time, disallowed expenditure which had been laid out for a dual purpose, one being a trading purpose and the other for non trading purpose and the expenditure on trade could not be separated and identified.

The words “wholly and exclusively laid out or expended for the purposes of the trade”, were considered by the House of Lords in *Mallalieu v Drummond (Inspector of Taxes)* (1983) 2 All ER 1095. In that case a female lawyer was claiming deduction from expenditure incurred by her in the replacement, cleaning and laundering of certain items of clothing, which she wore in court.

In considering the words of the tax provision, Lord Brightman said at 1099 e-f that they mean ‘expended to serve the purposes of the trade or for the purpose of enabling a person to carry on and earn profits in the trade. According to the court, the effect of the word ‘exclusively’ is to preclude a deduction if it appears that the expenditure was not only to serve the purposes of the trade, profession or vocation of the taxpayer but also to serve some other purposes. Such other purposes if found to exist, will usually be the private purpose of the taxpayer.

In *Solaglass Finance Company (Pty) Ltd v Commissioner For Inland Revenue* 53 SATC 1991 (2) SA 257 (A) the court had to determine circumstances where expenditure can be said to be affected by the provisions of section 23(g). The court suggested that the answer to that question could be found by analyzing the particular facts of the case, namely,

- ❖ By examining the nature of the activities carried on
- ❖ The nature of the expenditure, and,
- ❖ The closeness of the connection between the expenditure and the benefit derived there from by the group.

The appellant company was formed with the object of lending money to any person or company and to borrow such monies as it deemed fit. Any company in the group that wanted finance would approach the appellant, who in turn would provide the necessary funds by way of loans. The appellant’s sole business consisted of borrowing moneys and utilizing the moneys so acquired for making loans but only to companies in the group, to staff members and customers of

trading companies in the group. In submitting its income tax return for the tax year in question, the appellant sought to deduct losses sustained on loans which had become irrecoverable.

The appellant contended that it was conducting the business of a banker or money lender or a business 'sufficiently similar to and analogous with' such a business, and the losses were accordingly losses of floating or circulating capital and were thus deductible in terms of section 11(a) of the Act. The appellant further contended that because section 23(g) did not refer in terms to 'losses', as did section 11(a), the Legislature did not intend section 23(g) to apply to the deduction of 'losses' at all, and, since the appellant was clear claiming a deduction of 'losses' and nothing else, its claim could not be barred by section 23(g).

The appellant further contended that although it may have been brought into operation for the purpose of promoting the interest of the group, when it commenced, and thereafter continued its trading activities, it did so for the sole purpose of serving its own interest by earning profit, and not with the purpose of advancing the group's purpose.

The promotion of the Group interest was merely a motive of the appellant in carrying on its trade, and not a purpose of it. The appellant further submitted that the promotion of the group interest was merely the appellant's 'subjective intention' and not the 'objective purpose' of its trading activities and that the promotion of the group interest was not a 'purpose' of the appellant's trade, but merely an 'effect' of it, or a 'result'.

The respondent had contended that the appellant was not conducting the business of a banker or money-lender, it was merely carrying on an administrative business and its income was derived from managerial functions it performed in the course thereof.



Judge Friedman AJA listed various guidelines that have been laid down for the determination of the question whether a taxpayer can be said to be carrying on business on a money-lender or banker, namely;

- ❖ There must be an intention to lend to all and sundry provided they are, from his point of view, eligible.
- ❖ The lending must be done on a system or plan which discloses a degree of continuity in laying out and getting back the capital for further use and which involves a frequent turnover of the capital.
- ❖ The obtaining of security is a usual, though not essential, feature of a loan made in the course of a money lending business.
- ❖ The fact that money has on several occasions been lent at remunerative rates of interest, is not enough to show that the business of money lending is being carried on; there must be a certain degree of continuity and system about the transactions.
- ❖ The proportion of income from loans to the total income: the smallness of the proportions cannot, however, be decisive if the other essential elements of a money lending business exist.

The court held that

- ❖ The losses in question incurred by the appellant as a result of loans made by it in the course of its business becoming irrecoverable were disqualified from the deduction by reason of the provisions of section 23(g).
- ❖ The legislature did intend section 23(g) to apply to the deduction of 'losses'
- ❖ The wording of section 23(g) contains the requirement that any moneys sought to be deducted must be moneys
  - Which are laid out or expended and
  - Wholly and exclusively for the purposes of trade
- ❖ The requirements described above in no way touches upon the question whether moneys which are laid out or expended have been lost or not; that is immaterial for the purpose of the section, according to its wording.

- ❖ The monies which are laid out or expended are decreed in terms of section 23(g) not being deductible if they are not laid out or expended in the manner required: there being nothing in the section to support the argument that the prohibition did not apply when moneys which are laid out or expended happen to result in losses.
- ❖ Section 11(a) provides positively for what may be deducted and section 23(g) negatively for what may not, but there is no direct correlation between the one and the other.
- ❖ The inquiries under the two sections (i.e. ss 11(a) and 23(g)) are notionally and logically discrete; section 11(a) is concerned with the deduction of 'expenditure' qua expenditure and the deduction of 'losses' qua losses, while section 23(g) focuses on the deduction of 'moneys' qua moneys.
- ❖ For the deduction claimed by the appellant to pass the test of section 23(g), it must be shown that the amounts of the loans made by the appellant were wholly and exclusively laid out or expended for the purposes of trade.
- ❖ There are no hard and fast rules for deciding whether a taxpayer's expenditure falls within or outside the ambit of section 23(g); it being not possible to devise any precise universal test for determining whether expenditure comprises moneys 'exclusively laid out or expended for the purposes of trade; in general, one can say no more than that the issue is to be resolved by examining the particular facts of each individual case.
- ❖ That on the facts, the appellant's trading activities were geared to the achievement of a dual purpose: furthering the interests of the group's subsidiaries and thus of the Group itself; and making a profit for the appellant.
- ❖ The trading activities of the appellant are governed by the policy considerations dictated by the interests of the Group.
- ❖ In the context of section 23(g) what calls for determination is the relationship of that business *vis-a-vis* the promotion of the group interests, on the one hand, and the making of a profit, on the other.

- ❖ The connection between the expenditure in the form of loans and the benefit to the group is both direct and immediate; in these circumstances the benefit falls within the ambit of the word 'purpose' in section 23(g).
- ❖ The link between the appellant's activities and the furthering of the group's interests was sufficiently close, on the evidence, to cause the latter to fall within the ambit of the word 'purpose' as used in section 23(g)
- ❖ Section 23(g) precluded the claimed deductions.

#### 2.2.18 Apportionment of expenditure

It does happen sometimes that some items of expenditure are laid out with mixed motives. A taxpayer who carries on more than one trade may incur a lump-sum expenditure for the benefit of his different trades. A company might pay remuneration to its director and only a portion might be laid out for the purpose of earning income as defined in section 1 of the Act and partly for the purposes of earning exempt income. An expenditure may be incurred partly for the purposes of earning income and partly for acquiring a fixed asset for the business. Discrete amounts expended for different separately identifiable purposes do not require to be apportioned, and their eligibility for deduction can be judged on their merits.

In the case, *Secretary For Inland Revenue v Guardian Assurance Holdings (SA) Ltd* 38 SATC 111, 1976 (4) SA 522 (A), the company had deliberately influenced over subscription of shares in order to make extra interest by keeping excess application money in the bank for about a month. The interest earned amounted to R616 049, which the respondent reflected in its income tax return for the year ended 31<sup>st</sup> December 1968. The respondent claimed a deduction of R98 085, being expenditure incurred in earning the aforesaid interest of R616 085.

The Secretary refused to allow any portion of the said R98 085 as a deduction on the grounds that the expenditure was of a capital nature. The Secretary further submitted that the expenditure incurred was one indivisible, in the sense that

every bit of it was incurred for the purposes of raising capital, whereas only a portion of it was incurred for income purposes. Further the appellant contended that the operation and expenditure had two motives, one being the raising of capital and the other the earning of income, thus the expenditure could not be dissected and allocated to the different objects.

The appellant further cast doubt as to whether, for the purposes of income tax, there could be any apportionment on any basis of expenditure incurred, the reason being that, inasmuch as the expenditure in question was incurred for a dual purpose, there was a 'capital element' in every item of the expenditure incurred, which meant that the expenditure was of a capital nature and therefore not deductible under section 11(a) of the Act. The other contention was that of section 23(g) of the Act, which requires that expenditure, in order to qualify for deduction, must be 'wholly or exclusively laid out or expended for the purposes of trade'

Apportionment is possible and applicable where a single, indivisible expenditure has been laid out for more than a single purpose. In *Local Investment Co v Commissioner of Taxes (SR)*, 1958 (3) SA 34 case, it was held that in a business where expenses can readily and accurately be appropriated to 'income' and non-taxable amounts the application of the section 23 does not present any difficulty. However, in many, if not most, businesses, there are bound to be expenses of a general character, which cannot be accurately appropriated either to 'income' or to non-income amounts.

The proper way, according to the court, to deal with such expenses, is to make a fair and reasonable apportionment of these expenses as between 'income' and non-taxable amounts. The fact that the Act does not make any special provision for apportionment in such a case is no argument for holding that either 'all' or 'none' of the general expenses may be deducted. In the absence of a specific

direction from the Act, apportionment seems to be the only proper way to deal with such expenses.

According to the court in ITC No 1589 1993, the objective, when applying apportionment, is to reach a solution which is fair and reasonable in the circumstances of the particular case and if the taxpayer is not satisfied with apportionment made by the Commissioner of Taxes, the onus is on the taxpayer to establish that apportionment is not fair and reasonable.

Judge Corbett JA, in *Commissioner for Inland Revenue v Nemojim (Pty) Ltd* 45 SATC 241, 1983 (4) SA 935 (A), defined apportionment as a device which has previously been resorted to where expenditure in a globular sum has been incurred by a taxpayer for two purposes, one of which qualifies for deduction and the other does not. He further suggested that apportionment is a practical solution to what otherwise could be an intractable problem and in a situation where the only other answers, viz disallowance of the whole amount of expenditure or allowance of the whole thereof, would produce an inequity or anomaly one way or the other.

In making such an apportionment the court considers what would be fair and reasonable in all circumstances. In *Tuck v Commissioner For Inland Revenue* 50 SATC 98, 1988 (3) SA 819 (A), the court defined apportionment as a sensible and practical solution to the problem which arises when a taxpayer receives a single receipt and the quid pro quo contains two or more separate elements, one or more of which would characterize it as capital.

The court then suggested that a taxpayer is entitled to make an apportionment, if it is possible for him to do so. It is also competent for the Commissioner to make such apportionment, either himself or in consultation with the taxpayer, if he has the necessary data to enable him to do so. If neither the taxpayer, nor

the Commissioner has made any allocation, it is still open to the court to do so if the necessary evidence is available to enable the court to make such allocation.

The court thereupon laid down the principle of law with regards to apportionment of expenditure as follows: that where a lump-sum expenditure is sought to be deducted from one's taxable income, that sum must have been wholly or exclusively expended for the purposes of trade. If portion of such lump-sum was so laid out and portion was not and if it is not possible to allocate each portion to its appropriate purpose, then no portion of the lump-sum can be deducted.

But if the lump-sum can be dissected and that portion expended for the purposes of trade can be identified, such portion may be deducted. This is *plainly the effect of the decisions*. There is nothing in the section prohibiting such allocation and, it is in accordance with common sense. The allocation can be made in various ways, namely, on a time basis, or perhaps (in a proper case where the facts justify it) on a piece-work basis.

The question of how apportionment should be made was also raised in *Local Investment Co v C.O.T. (SR) 1958 (3) SA 34*, where the Commissioner to exclude a portion of the general expenses as being expended in the production of non taxable expenses. The court, citing *Gunn's Commonwealth Income Tax Law and Practice*, 4<sup>th</sup> ed., p. 375, held that it is a question of fact, depending upon the particular circumstances of each case, and the question of fact being to make a fair apportionment to each object of the company's actual expenditure, where items are not themselves referable to one object or the other.

The court, however declined to lay down the general rules as to how apportionment must be made, other than that it must be fair and reasonable, having regard to all the circumstances of the case. The court gave an example

of one case where an apportionment based on the proportion which the different types of income bear to the total income, might be proper, as was done in *Rand Selections Corporation's* case.

In another case, however, such an apportionment might be grossly unfair: for example, in the case where bulk of the expenditure was clearly devoted exclusively to operations intended to earn income, but which unfortunately in fact earned very little income, with the result that in the particular year of assessment the company earned very little 'income' but from the operation which incurred little expense earned relatively large taxable amounts.

In such a case to apportion the bulk of the expenses to the non taxable amounts would be unfair. In another case a fair method of apportionment might be to take the proportion, which the capital invested in the operations earning the non-taxable amount bears to the total capital invested, as was done in ITC No 832 of 1956.

Section 23(g) of the previous version, have had the effect of preventing apportionment of expenditure not wholly or exclusively incurred for the purposes of trade. This was confirmed in ITC 699, where the appellant had undertaken a trip abroad to open a diamond brokerage business, and in the process incurred expenses. In normal circumstances he would have expected that the Commissioner would allow expenses incurred in the operation of his business together with traveling expenses abroad to open the brokerage business.

The difficulty confronting the appellant, according to the court, was that the Act did not allow the deduction from income of expenditure that was not wholly or exclusively incurred for the purposes of earning that income. The appellant's evidence showed that he went overseas to open his diamond brokerage business and he also gave evidence that his other intention was to open an export/ import

business. The court held that where some of the money is expended for a dual purpose and one of those purposes would not qualify the expenditure for deduction from income for tax purposes, it seems that no portion of the amount expended may be so deducted.

No doubt the reason for this provision, according to the court, is because it would open up very difficult inquiries if amounts expended in this way had to be dissected, and would throw the Commissioner for Inland Revenue and the Court, which has to deal with income tax matters, an almost impossible burden. The simple provision is, therefore, made that the expenditure must be wholly and exclusively incurred in the production of the income, which is under consideration.

Price J, President of Transvaal Income Tax Special Court, in ITC No 800, quoted Case No 4309 1947, where the court held that a sum paid initially as allocated to diverse purposes may be treated in its original divisions. Where it is expended for mixed purposes and in unallocated quantities, the words of the section forbid its dissection or deduction of any part thereof from income. The court however had some reservations about this suggestion because of the fact that section 12(g) does not forbid the dissection of a lump-sum of expenditure proportionately into sums each allocated to different items of income if this can be done.

The court has in the past made such allocations in various cases. Section 12(g) provides that 'any moneys claimed as a deduction from income derived from trade which are not wholly or exclusively laid out or expended for the purposes of trade' may not be deducted from income. There is nothing said in this section about dissection. The court made an illustration, where assuming definite sums can be allocated as representing the cost to the appellant company of the technical services rendered to it by the "I" company such sums would properly rank for deduction.



But as regards any expenditure represented by the contribution by the appellant company to the "I" company towards the cost of its research work, such latter cost would be inadmissible as being too remotely connected with the production of the appellant company's income: further as being of a capital nature; as also as not having been wholly and exclusively laid out in the appellant company's trade.

In an unreported Case No 4863, 1950, at page 5, the court held that, where expenditure was incurred by a taxpayer, in order to acquire an asset, that expenditure was of a capital nature, as the expenditure was incurred for the purposes of acquiring an income producing machine. The court cited ITC 703, 1950, which was reported in 17 SATC 208, where a salary of \$1014 paid by way of shares to a firm of technical engineers, for a particular tax year was apportioned to capital expenditure and expenditure to earn income.

The court relied upon the test laid down in New State Areas case, 1946 AD 610 at 627 (13 SATC 400) where it was said that the true nature of each transaction should be looked into and that this was in each case a matter of fact. The true nature of the transaction, the Court concluded, was not only the establishment of the factory but the provision of technical advice for its successful operation over a period of ten years. The firm was engaged for approximately eleven months in establishing a factory and for approximately one month in operating the factory for profit. The court apportioned \$910 to capital expenditure and \$104 to expenditure deductible from income.

Cases Nos 4545, (1949) and No 4749,(1950), establish the proposition that where a lump-sum is expended in respect of different items of expenditure, some categories whereof would be deductible from income and some of which would not be deductible, and the amounts falling into these different categories cannot be identified, nothing at all can be deducted from the taxable income.

In the ordinary course of events, where income is derived more or less uniformly during the whole course of the year, no question arises as to the right to deduct expenditure in payment expenses for business purposes, or expenditure in payment of interest on monies borrowed for investment in the business.

There are cases where deduction of expenditure become an issue, namely

- ❖ Where such payments are antecedent to the production of any income;
- ❖ Where a period intervenes due to some external cause during which no income is produced;
- ❖ Where, owing to the business ceasing to function or becoming unprofitable, no further income is derived;
- ❖ Or where the expenditure overlaps the tax year, being partly attributable to a prior year or to a succeeding year.

The case, Income Tax Case No 130 (4 SATC 130), interest was paid on monies borrowed and constituted preliminary expenditure prior to the earning of income, the asset not having reached the income producing stage. The court disallowed the deduction.

Expenditure incurred prior to the commencement of the business of the taxpayer is not allowable, and this was conformed in the case of ITC No 607 1945, where the taxpayer was seeking deduction for expenditure incurred during the period where no income was received. In that case, the court was confronted by the taxpayer who demanded deduction on expenditure incurred on rates and on interest on loan, the portion of which was used to finance building expenses. The Commissioner's ground for disallowing deductions were that prior to the date of the completion of the building no income was receivable.

The other contention was that the expenditure on rates, though paid on a lump-sum during the tax year, should be disallowed in respect of the period during which no income was received or receivable. With regards to interest, until

money borrowed was actually utilized either in payment of the cost of the building or as regards the portion thereof till it was re-lent to the principal shareholder, the interest on such money lying idle could not be regarded as expended in the production of income.

Normally, there would be no problem, where income is derived more or less uniformly during the whole course of the year, and no question arises as to right to deduct expenditure in payment of expenses on assets used for business purposes, or expenditure in payment of interest on monies borrowed for investment in the business. However, problems do arise in cases;

- ❖ Where such payments are antecedent to the production of income, as illustrated in the case, 'Income Tax Cases No 130 (4 SATC 130) where interest was paid on monies borrowed and constituted preliminary expenditure prior to the earning of income, the asset not having reached the income producing stage. The deduction of expenditure incurred, was refused by the court in that case.
- ❖ Where a period intervenes due to some external cause during which no income is produced. This can be illustrated by the case, Income Tax Cases No 318 (8 SATC 174) where a break of six months in the earning of income occurred through rebuilding operations. The court upheld the Commissioner's decision to disallow the expenditure on rates during the period of unproductiveness.
- ❖ Where, owing to the business ceasing to function or becoming unprofitable, no further income is derived, as was the case in the cases, Income Tax Case No 1 (1 SATC 48) and Income Tax Case No 19 (1 SATC 130).
- ❖ Where expenditure overlaps the tax year, being partly attributable to a prior year or to a succeeding year as was illustrated in the case 'Income Tax Case No 73 (3 SATC 64). The court in this case held that where an appellant became the owner of certain premises from the 1<sup>st</sup> April, 1925,

and as owner he became liable to pay rates levied for the twelve months ended the 31<sup>st</sup> December, 1925, payment of which fell due in April in each year, the Commissioner was correct in apportioning the expenditure on rates, to the period of the tax year, that is a quarter, during which the appellant has derived income from the property.

As regards an insurance premium, paid to cover the period of twelve months, the court held that, though the payment was a lump-sum, it must bear a distinct relation to the profit earned and that as the profit was earned in the three months' period, the cover as far as the expenditure was concerned, must be limited to three months.

The same system of apportionment over particular years was approved by Russell C.J. in *Building Contractor v Commissioner of Taxes* (1941, *SRLR*, 12 SA Tax Cases 182). In this case a building was erected in order to derive a rental income. While it is not rent producing or regarded as a lettable proposition, we cannot not state that the interest, which is paid on the mortgage, in respect of the property, is an amount which is incurred in the production of income. When it does reach a stage of earning revenue from rent, or has become a lettable proposition, then it is possible to set that interest off.

In this case the court held that, "The underlying principles laid down by these decisions is that the expenditure, the deduction of which is claimed, must be *linked to the income that is earned; and where it is possible to apportion the expenditure to the income so earned such apportionment must be made; and that the expenditure which cannot be so linked and apportioned must be disallowed. Further, that where the expenditure overlaps the tax year a similar apportionment must take place.*

It is true that the Act itself contains no provisions for such apportionments, but it may be regarded as to be implied from the terms of section 11(2)(a), which

permits only the deduction of such expenditure as actually incurred in the production of the income. The court is of the opinion that, in view of the above decisions and rulings laid down by more than one President of the high court previously, the maxim *stare decisis* should be applied and that the right of the Commissioner to make an apportionment in suitable cases should be upheld”.

Time based apportionment was also used by the court in *Borstlap v Sekretaris van Binnelandse Inkomste*, 1981 (4) SA 836, where the taxpayer had claimed a deduction of expenditure in the form of interest on the bond, insurance premiums and municipal rates on property, incurred for the whole year. The court, in regard to the deductibility of expenditure claimed by the appellant held that, “ The items disallowed by the Commissioner were disallowed because for a proportionate period in respect of which the expenditure was incurred, the building was in the course of erection and was not an asset which could be used to let and to produce income, and that the expenditure, therefore, was of a preliminary or capital nature.

It seems to me clear that until the asset becomes an asset capable of producing income, any expenditure upon it is of a preliminary nature and it is not deductible, because the rates and interest were not laid out exclusively or at all, in point of fact, for the purposes of trade. If a taxpayer has no asset with which he can trade, then he cannot be trading. That seems to me to be simple, logical statement, and it seems to me that it is the simple logical statement, which determines the issue in this case.

During the period in respect of which the rates and interest were disallowed the taxpayer had no assets with which he could trade and he was not trading, and if he was not trading the expenditure was not incurred in the production of income. The expenditure was incurred in the creation or equipment of an asset, which was intended to be used at a later stage, for the purposes of earning

income. It was initial or preliminary expenditure designed to extend the scope of the business or to improve its earning capacity. It was money spent in an attempt to create a source or to acquire an advantage for the benefit of the business which was later to be undertaken”.

The court in this case was of the view that the expenditure incurred by the taxpayer had a dual motive, the first being to obtain income by letting and the second motive was the acquisition and retention of a capital asset for future development, with the latter being the main objective. The court conceded that the Act does not provide any direction with regards apportionment of expenditure in cases where the taxpayer has paid a global amount in respect of items which are partially within and partially without the ambit of the general deduction formula of the Act. In practice such a division is sometimes permitted and recognized by the courts when it can be shown that particular items are closely associated with the production of income, the overall criterion being what is fair and reasonable on the particular facts.

The court then rejected the suggestion by the appellant to divide the amount of expenditure on a time basis since that would be incorrect to take into account the full interest on the bond and associated insurance premiums over the five months of the tax year during which the property was let because such interest and premiums had been paid with dual objectives of (a) obtaining of income by letting and (b) the acquisition and retention of a capital asset for future development.

Apportionment was also used in *CIR v Nemojim (Pty) Ltd* 1983 (4) SA (A), 45 SATC 241, because the court had concluded that the expenditure incurred by Nemojim in the acquisition of shares had a dual purpose, viz the receipt of moneys on resale which would constitute income in Nemojim’s hands and the

receipt of a dividend after the declaration thereof, which would constitute exempt income in Nemojim's hands.

The facts of the case was that Nemojim laid out moneys expended on the acquisition of the shares in various dormant companies in question, with a dual purpose. The one purpose was to receive dividends from the companies and these dividends were exempt from income in Nemojim's hands. The other purpose was to receive the proceeds of the shares on resale and these proceeds were income in Nemojim's hands.

Nemojim included the proceeds of the sale of shares in its gross income, and claimed a deduction for the purchase price of the shares. The deduction of expenditure from income can only be effected if the expenditure passes the dual test of qualifying for deduction in terms of section 11(a) and, at the same time, of not being excluded by section 23(f). The court was of the opinion that the expenditure did not wholly pass either test. Because one of the purposes of the expenditure was to earn income in the form of dividends and this purpose was achieved, *the expenditure was not wholly incurred in the production of income and was partly an expense incurred in respect of an amount received which did not constitute income.* The main point of contention before the court in this case, was whether having regard to all the circumstances, the connection between the expenditure incurred in the purchase of the shares and the receipt *of the dividends was sufficiently close to justify the conclusions that the expenditure was incurred partly in the production of dividends.*

The court held that in a case such as this expenditure incurred in the acquisition of shares relating to companies where dividend stripping occurred should be *apportioned in accordance with a formula. The apportionment had to be made of the expenditure in issue between that incurred by N in acquiring exempt income from the dividend stripping and that incurred by N in acquiring the income*

derived from the sale of the dividend-stripped shares; and that such apportionment should be made in accordance with a special formula.

The formula to be applied was an adaptation of one proposed in the CIR v Rand Selections Corporation Ltd 1956 (3) SA 124 (AD), and is as follows:

$$A = (B + C) \times \frac{D}{D + E}$$

Where

- A = deductible expenses
- B = general expenses relating to share-dealing
- C = total cost of acquisition of shares in companies subject to Dividend stripping in tax year
- D = total proceeds of the sale of such shares
- E = total dividends received in respect of such shares.

The court accepted the apportionment of expenditure, based on the proportions of relative investment, in Income Tax Case No 832, 1956. In this case the appellant company ran a business, as a finance company. During the year of assessment in question, the Commissioner disallowed that proportion of expenses, which the income expected to be received by way of dividends bore to the income received from interest on loan. Though no income had been received or accrued in the year in respect of dividends, the Commissioner reassessed the amount on the basis of the proportion, which the relative investments bore to each other.

It is common cause that the Act makes no provision for the apportionment of expenses, which cannot be specifically identified with particular items. In terms of section 11(2) (a) of the Act read with section 78, the appellant company must show that any amount which it claims to deduct under section 11(2)(a) was actually incurred in the production of income. In respect of the company, the dividend on shares was of course never income in terms of the Act and therefore



moneys expended in earning dividends could not be deducted in terms of the applicable Act.

With regards to its activities, it seemed impossible to say what activity or what portion of activities is actually devoted to earning interest from a loan investment and what is earned from other activities of the company through its directors. It seemed impossible for the company to show, any portion of its revenue was actually expended in the production of income by way of interest. According to ITC 607, 14 SATC 366, it has been recognized that where a taxpayer such as the company has revenue from more than one source, one such source justifying deductions because the revenue is taxable and another such source not justifying deductions because the revenue is not taxable, even if particular items of revenue cannot be identified with one or other source of revenue, an attempt can be made to apportion.

In *Commissioner for Revenue v Rand Selections Corporation, Ltd.*, 1956 (3) SA 124 it was contended on behalf of the appellant company that, as the Act itself does not direct an apportionment of expenditure, or tell us how to ascertain what portion of the expenditure may be deducted from the "income", the whole of the expenditure is deductible from the "income". In that case the Court held that the proper method of apportioning expenditure in that case was to adopt the formula employing the proportion which income from one source bore to the revenue received by dividend from the other source. The Court, however, was not laying down a principle that a particular formula had to be employed. What it decided was that a fair method of apportionment had to be adopted for each case.

The court held, dismissing the appeal that it was clear that some reduction had to be made in the expenditure, which was deductible and that the basis adopted by the Commissioner for determining the deductible proportion was fair and proper. A 50/50 basis of apportionment was suggestion by the appellant in *Tuck v Commissioner for Inland Revenue*, 50 SATC 98, 1988 (3) SA 819 (A), and was also approved by the Court. In this case the appellant, in 1981 tax year, received

his first initial annual installment of 668 shares, which were worth R14 251. In his income tax return the taxpayer suggested that one half of this amount was remuneration for services rendered and the other half was a compensation for complying with the trade restraint. The taxpayer included in his return R7125 as income, claiming that the other half to be of a capital nature.

During the 1982 tax year he again included another installment received from his contingent award account, advancing the same reasons as the previous year. The Commissioner rejected the demand for a deduction and instead issued additional assessment upon the appellant for the 1981 tax year. In the Special Court it was held that the whole of the sums in issue were of a capital nature. The Appeal Court took notice of the fact that both elements are important factors in the quid pro quo, which the employee provides in return for receiving the shares.

If the employee does not provide the requisite service he does not qualify for an award; if he fails to comply with the restraint, he forfeits the award. The aim of the Plan was to provide incentive to improve service. The company also held trade restraint condition very highly such that any violations led to forfeiture of all rights to the shares credited to contingent award account.

The court was of the view that, despite the absence of statutory authorization, the court has in the past approved of the principle of apportionment in dealing with the deductibility of expenditure which was partly of a capital nature and partly not. (Secretary for Inland Revenue v Guardian Assurance Holdings (SA) Ltd 1976 (4) SA 522 (A) at 533E – 34A).

The court felt that apportionment provides a sensible and practical solution to the problem which arises when a taxpayer receives a single receipt and the quid pro quo contains two or more separate elements, one or more of which characterize

it as capital. In the absence of any other acceptable basis of apportionment, the court held that a 50/50 basis of apportionment would be fair and reasonable.

## Chapter 3

### Data analysis and Interpretation

#### 3.1 Research design

A research design, according to Cooper & Emory (Supra), is a blueprint, for collection, measurement, and analysis of data. It is imperative to have a research design that will explain how the research intends approaching the study. The research design specifies the type of information to be collected, the source of data, and the data collecting procedures. However, there is no research standard to guide the researcher, since different types of designs can accomplish the same results. There are two main types of research designs, namely exploratory and conclusive research design.

This study is going to use a case study method of research and will use existing information from books, journals, case law, and newspapers to find answers to the problem at hand. The researcher is of the opinion that the sources of information mentioned will provide enough information to be able to understand the problem being studied. The case study method involves an extensive investigation of the situations, which are relevant to the problem situation. The aim is to select several target income tax cases, which are considered relevant to the topic.

These cases will be subjected to intensive analysis with the aim of identifying relevant variables, indicate the relationship among variable in order to identify the nature of the problem. The purpose is to obtain a comprehensive description of the cases and to formulate a better understanding of the variable operating.

The advantage of using the case study method is that, according to the researcher, it is appropriate for the topic being dealt with, less expensive than

other research methodologies and can be accomplished in a shorter time than other conventional research methodologies.

There will be fifteen income tax cases selected for analysis. All the cases chosen will be dealing with the topic of the research study being undertaken. The criteria for choosing these cases will be based on the judgement and experience of the researcher. The researcher will choose those cases, which, according to his experience, will contribute to the answering of the research question at hand.

These cases will be analyzed according to the following headings, namely;

- ❖ Case title
- ❖ Summary of facts
- ❖ Matters of decision
- ❖ Appellant's arguments
- ❖ Respondent's arguments
- ❖ Judgement
- ❖ Ratio decidendi
- ❖ The attitude of the court towards apportionment

## 3.2 Analysis of Cases

### 3.2.1 Case 1

Case title; Local Investment Co v Commissioner of Taxes (S.R.) 1958(3) S.A.34

#### 3.2.1.1. Summary of facts

The appellant company was trading as an investment company and from its business operations derived income amounting to £11,941 during the tax year in question. From the total income, £2037 was amount exempt from tax in terms of the Federal Income Tax Act, No 16 of 1954, whereas £9,904 constituted the income of the company liable for taxation. The company expended an amount of £2,459, £20 of which was wholly and exclusively expended in connection with non-taxable receipts of £2037.

The company sought to deduct from its income, during the tax year in question, the whole of its general expenses other than the £20, which had been genuinely expended for non-trade purposes. The Commissioner contended that some portion of the general expenses must be regarded as expenses incurred in respect of the non taxable receipts and that the only method of determining the amount to be excluded was by apportionment of the general expenses. The Commissioner accordingly apportioned the general expenses in the ratio that the receipts of non-taxable amounts bore to the receipts of taxable amounts and assessed the company accordingly.

#### 3.2.1.2 Matters of decision

- ❖ The court had to decide whether the Commissioner was entitled to apportion as between the non-taxable amounts and 'income'
- ❖ How is the apportionment to be made?

#### 3.2.1.3 Appellant's arguments

The appellant seeks to deduct from his income the full expenditure of £2459 less £20, which the appellant concedes was expenditure which was wholly and exclusively incurred in the production of non-taxable amounts. The Commissioner rejected the appeal and confirmed the assessment.

#### 3.2.1.4 Respondent's arguments

The Commissioner of Taxes disallowed the deduction of expenditure incurred but instead apportioned the total expenditure to the non-taxable amounts and 'income' and only allowed as a deduction from 'income' an amount which bears the same proportion to the total expenditure as the 'income' bears to the 'gross income'. This amount is £413.

#### 3.2.1.5 Judgement

- ❖ The court held that while the proportion of expenditure applicable to the non –taxable receipts had been incurred for the purposes of the company's trade, it had to be excluded from deductions allowed in the determination of the company's taxable income, in terms of section 23(f) of the *Income Tax Act*;

### 3.2.1.5 Judgement

- ❖ The court held that while the proportion of expenditure applicable to the non-taxable receipts had been incurred for the purposes of the company's trade, it had to be excluded from deductions allowed in the determination of the company's taxable income, in terms of section 23(f) of the Income Tax Act;
- ❖ That in the absence of proof as to the allocation of expenditure the Commissioner was entitled to apportion the general expenses as between the taxable and non-taxable receipts;
- ❖ That the appellant had failed to establish that the Commissioner's apportionment had not been fair and reasonable, having regard to all the circumstances of the case.

### 3.2.1.6 Ratio Decidendi

In terms of section 23(f) of the Act, any portion of the expenditure, which is wholly and exclusively incurred in the production of non-income amount, is not allowed as a deduction. The general expenses could not be readily and accurately appropriated to 'income' and non-taxable amounts. According to the court, the only proper way, to deal with such expenses was to make a reasonable apportionment of these expenses as between 'income' and non-income amounts.

### 3.2.1.7 The attitude of the Court towards apportionment

The court looked at the applicable Act to ensure that it is properly taken into account. In this instance the court looked into the applicability of the so called 'The deduction formula' and identified expenditure that was incurred for the purposes of earning income. In the same expenditure another amount was identified as being expended for non-income purposes and according to the court in Income Tax Case No 832, 1956, was expended for non-income purposes and as such was debarred from deduction.

Then the court used apportionment as a device to separate the two expenditure amounts into their appropriate categories, e.g. expenditure that can be properly

### 3.2.2.1 Case No 2

### 3.2.2.2 Income Tax Case No 800,1954

### 3.2.2.3 Summary of facts

The company was operating in South West Africa with its main objects as to exploit mineral claims and was also entitled under its memorandum to carry on the business of investors and financiers and to lend, invest and put out at interest, its money.

The company spent some money in the exploitation of the company's mineral claims but quickly stopped due to financial reasons. Thereafter the company decided to invest its cash in return for interest, as a result of which an interest amounting to £637 was earned. In its submission of its income tax returns, the company showed an amount of £637 as income for the year of assessment in question.

The income returns also reflected expenditure on administration and secretarial charges, directors' fees, mining options and rights written off and claims licenses amounting to £2497. An expenditure amounting to £1148, which was included in the amount of £2497, was incurred during the period January 1952, when the company first invested its funds, to 30<sup>th</sup> June 1952.

The Commissioner for Inland Revenue allowed as a deduction from interest received, the sum of £32 being an amount calculated as 5% of the sum of £637, representing an estimate of the expenses incurred in the production of such interest.

### 3.2.2.4 Matters of decision

The court had to decide whether to allow as a deduction monies received for the whole year or for the period between February and June 1952, during which the appellant was investing its money on interest bearing business. The court had to



determine whether the overhead expenses of carrying on the business of the appellant were wholly and exclusively laid out or expended for the purposes of trade in making investments.

#### **3.2.2.5 Appellant's arguments**

The appellant company claimed as a deduction an amount totaling £1148, against income of £637. As regards to the rest of the expenditure, the appellant's representative conceded that it had been correctly disallowed as it was incurred during a period when the company was not engaged in earning the income of £637.

#### **3.2.2.6 Respondent's arguments**

The Commissioner contended that;

- ❖ The expenditure of £1148 was not incurred in the production of income
- ❖ It was capital expenditure, and
- ❖ It is not deductible under section 12(g) of the Act in that it was not wholly or exclusively laid out for the purposes of trade, and that in the present case only such portion of the expenditure, if any, as was incurred in the production of the interest on the loans made by the company and which was not of a capital nature is allowable, and that only if it can be separated from the rest of the expenditure.

#### **3.2.2.7 Judgement**

- ❖ The court held that expenses incurred by the appellant during the active period, from February to June inclusive, be separated from the expenses incurred during the whole year and apportioning these expenses on the basis of time.
- ❖ The court also decided that an amount of £571, as recommended by the appellant, be allowed as a deduction from expenditure as an amount expended during the active period, in order to earn £637 income.

### 3.2.2.8 Ratio decidendi

- ❖ The expenditure of £571 was incurred during the active period in order to earn income of £637 and according to the case Income Tax Case No 73, 1926, the expenditure has to bear a direct relationship to the income produced or earned.
- ❖ The expenditure had to be dissected between the amount incurred during the active period and the amount that was incurred during the period outside the active period.

### 3.2.2.9 The attitude of the court towards apportionment

The court had to look at the time during which the business was being carried on. The loan that produced interest was made during the so-called active period; that is, between the months of February and July of the same tax year. The expenditure incurred during the active period that had to be taken into account when determining the deductibility of expenditure in terms of section 11(a) of the Act.

In this case the expenditure in question was expended for the whole year, whereas the business operations to produce interest was only during the active period. The court therefore held that the expenditure had to be apportioned according to the period during which the operations for the production of income were carried on and the period outside the active period during which no production of income took place.

The trade requirement of section 23(g) was also not fulfilled, in that outside the active period there was no trading, therefore no deduction was allowable. It would seem therefore that the court took its cue from the 'deduction formula' to be able to solve this case.

### 3.2.4 Case no 3

#### 3.2.4.1 Commissioner for Inland Revenue v Guardian Assurance Holdings (SA) Ltd 38 SATC 111, 1976 (4) SA 522 (A)

#### 3.2.4.2 Summary of facts:

The respondent company issued six million shares by public issue. In so doing the company hoped that the issue would be over subscribed affording the company an opportunity to earn extra income, between the closing date for applications and the date when excess application moneys were refunded. The company anticipated that a substantial profit would be made by way of interest on subscribed moneys.

As it turned out, shares were oversubscribed and the company made substantial profits from interest on short term investment of subscription money prior to refund of excess applications. In the process of earning these profits, expenses were incurred. The company in its income tax return sought to deduct these expenses as being incurred in the production of the interest earned. The Secretary having refused the deduction, the respondent approached the Special Court, which held that the expenses sought were genuine expenses 'incurred with the express purpose of making a profit and that this profit was decidedly sought for and worked for and was the result of a planned effort'.

The Special Court also express the view that the respondent had two dominant motives in incurring the total expenses, namely the raising of capital and the making of a profit by way of interest, that apportionment of expenses between those two objectives was permissible in principle; and that section 23(g) of the Act did not debar the expenditure in issue from deduction.

#### 3.2.4.3. Appellant's arguments

- The Secretary submitted that, although income had been earned, all the expenditure incurred was of a capital nature because the total expenditure incurred was one and indivisible, more especially since every applicant

was allotted at least 25 shares; that there was thus a capital element in every item of expenditure incurred; and that, on the analogy of section 23(g) of the Act, it would be anomalous to allow a deduction under section 11(a) where expenditure is incurred partly for income purposes and partly for capital purposes.

- ❖ That even if permissible in principle, apportionment was precluded on the facts since the dominant purpose of the whole operation was to raise capital, the making of profit being ancillary or incidental thereto; and that all the expenditure incurred by respondent was, therefore, of a capital nature.
- That, even if apportionment were to be applied, there is no sensible or clear basis upon which it could be applied, other than arbitrarily, which would be contrary to the intention of the Act.
- The Secretary further contended that ordinarily and naturally expenditure incurred by a company in raising capital by an issue of shares, whether by way of private placing or by way of a public issue, constituted expenditure of a capital nature.
- That although the possibility of deriving interest from the short term investment of excess application monies may have been an incentive for the decision to raise R9000000 capital by way of a public issue, nevertheless all the expenditure of R226 755, referred to in paragraph 3(9)(a), constituted expenditure of a capital nature in that
  1. The said expenditure was related to and was wholly or dominantly incurred for the purpose of raising the said capital and
    - ❖ That no part of such expenditure related to or was incurred for the purpose of earning interest and that such interest as was received, viz, R616 049, represented income to which no expenditure was attached and which was derived merely as a collateral advantage to the method of raising capital adopted.

- ❖ That the appellant's claim as presented for the first time in its return of income that portion of the expenditure had been laid out for the purposes of making a profit in respect of interest was an afterthought.

#### 3.2.4.4. Respondent's arguments

- The respondent submitted that while the object of offering shares to the public was to raise capital, the object could have been achieved by private placing at limited or basic costs of a capital nature.
- That the respondent decided to adopt a method of public issue, at a greater expense than that involved in a private placing, took the deliberate decision to incur additional expense involve in a public issue, whatever the amount might be, in order to make a profit, being the difference between the amount of interest that might be earned on the temporary investment of excess application monies and the said additional expenses;
- That in the circumstances the said additional expenses, was, in terms of section 11(a) of the Act, expenditure incurred in the production of income and not of a capital nature, in that it was incurred in the separate venture, distinct from the main operation of raising capital, entered into for the purposes of making profit;
- That the said additional expenditure was wholly and exclusively laid out for the purposes of trade within the meaning of section 23(g) of the Act.
- That the amount of the said expenditure was determinable on the basis of proper apportionment or allocation of the total expenditure incurred and the court should grant an order referring the matter back to the Secretary for re-assessment accordingly.

#### 3.2.4.5. Matters of Decision

Whether the issuing of shares was for the purposes of raising capital of making a profit?

Was the expenditure in question directed at the raising of capital or in order to produce profit as claimed by the respondent?

If the expenditure was made with the purpose of a mixed motives, was apportionment possible?

Whether apportionment was permissible regardless of the applicability of section 23(g)

#### 3.2.4.6. Judgement

The court held;

- ❖ That the whole of the expenditure should not be regarded as of a capital nature and that there existed no objection in principle to an apportionment; nor would apportionment be inconsistent with section 23(g) of the Act.
- ❖ The raising of capital could not be said to be the dominant purpose. That two objectives, i.e. the raising of capital and the earning of income had been pursued. And that expenditure incurred in excess of what would have been expended in raising R9 million by private placing must be regarded as incurred in the production of income.
- ❖ The expenditure in excess of that required to raise R9 million capital by a private placing had been incurred with the express object of producing income, and it would be contrary to the basic principles of the Act not to permit an apportionment.
- ❖ That there is no basis for believing that apportionment would be arbitrary; and it suffice to say that prima facie the apportionment suggested by the respondent was sensible and clear and that, in any event, other methods of achieving a logical and fair apportionment may exist.

#### 3.2.4.7 Ratio Decidendi

The expenditure was incurred for a dual purpose, namely for raising capital and for earning income. Therefore it was possible to allocate or apportion expenditure incurred for raising capital, which was not deductible in terms of

section 11(a) of the Act, and expenditure incurred in the production of interest, which is deductible in terms of the same Act.

#### **3.2.4.8 The Court's attitude towards apportionment**

The court was of the opinion that it would be contrary to the basic principles of the Act not to permit of an apportionment. The court's view was that the expenditure was laid out to raise capital and to make a profit; two distinct motives. Therefore the expenditure was incurred in order to raise capital, which was a capital expenditure and is not deductible in terms of section 11(a) of the Act. The same expenditure was incurred in order to earn income from the short-term interest, and was fully deductible in terms of section 11(a) of the Act. Both the raising of capital and the producing profit was made for the purposes of the appellant's trade, in terms of section 23(g) of the Act, and was thus not barred from deduction.

#### **3.2.5.1 Case No 4**

**3.2.5.2 Commissioner for Inland Revenue v Rand Selections Corporation Ltd, 1956 (3) SA 124; 220 SATC 390**

#### **3.2.5.3 Summary of Facts**

The respondent company carried on business of share dealing and investments in shares. The company spent £367859 in acquiring additional shares in the L Company. The L Company was liquidated and paid the respondent £336434 for its shares.

The Commissioner, in the determination of the respondent's taxable income regarded the amount of £212311 paid by the liquidators to the respondent as constituting the return to the company and the amount of £124123 as a liquidation dividend.

The Commissioner excluded the expenses incurred by the company in respect of the portion of the amount received from the liquidators as dividends. This meant that the Commissioner had allowed an amount of £212311 as admissible expenditure with regards to the issue price of the shares and disallowed the balance of the expenditure amounting to £155549 as having been incurred in respect of the liquidation dividend received from profits earned by the liquidated company.

The Special Court dismissed the appeal by the respondent but in the Transvaal Provincial Division of the Supreme Court, the appeal by the respondent was upheld. The Court held that the company was entitled to deduct the full amount paid by it for the shares as an item of expenditure incurred in its business of share dealing and excluded the amount received as a dividend from profits from the gross income derived from that business. The Commissioner appealed against this decision.

#### **3.2.5.4 Appellants Arguments**

The Commissioner sought to exclude the expenses incurred by the company in respect of that portion of the amount received from the liquidation.

The Commissioner also disallowed the deduction of the expenditure in respect of an amount of £155 549 as having been incurred in respect of the liquidation dividend received from profits earned by the liquidated company.

#### **3.2.5.5 Respondent's arguments**

The respondent contended that the amount of £155 549 was a loss suffered on its dealings with Lace shares.

The respondent company also submitted that it was entitled to deduct the full amount paid by it for the shares as an item of expenditure incurred in its business of share dealing.



### 3.2.5.6 Matters of decision

Should the expenditure on an amount of income received, which also included a portion of dividend, be allowed as a deduction?

How should apportionment of expenditure be determined?

### 3.2.5.7 Judgement

The court held;

That the expenditure incurred by the company in the production of the total sum received, the portion of that sum consisted of dividends and therefore a portion of the expenditure incurred towards the production thereof is not allowable as a deduction in the determination of the company's taxable income.

That the amount allocated to the production of dividends could not be fixed arbitrarily, but should be determined by the proportion which the dividends bore to the total amount produced by the expenditure.

The court further suggested the method of apportionment in the form of the following formula, namely:

$$\begin{array}{l} X \text{ multiplied by } y \\ y \text{ plus } z \\ \text{i.e. } \quad \quad \quad \text{£}367859 \times \frac{212311}{336434} \end{array}$$

The resulting figure from this formula would represent the amount of the expenditure, which is deductible under section 11(2)(a)

### 3.2.5.7 Ratio decidendi

As dividends are not regarded as income in terms of the definition of the term "income" in section 1 of The Act, expenditure incurred in the production thereof is not allowable as deduction in terms of section 11(a) of the Act.

The respondent company was trading as a share dealer, and as such any income from shares sales is income in terms of section 11(a) of the Income Tax Act.

#### The attitude of the Court towards apportionment

- ❖ The court was of the opinion that it is important to understand that sections 11(2)(a) and 12(f) read together sanction apportionment of expenditure. Section 11(2)(a) allows the deduction of expenditure incurred in the production of income, whereas section 12(f) disallows expenditure which is not wholly and exclusively laid out for the purposes of trade. The court, however, suggested that such an apportionment would be based on the fact that the Legislature has split the liquidation dividends into two components parts.
- ❖ The court suggested that a portion of the expenditure attributable to the 'income' can be deducted under section 11 (2)(a), and the income exempt from tax, i.e. dividend, would not be allowed a deduction. This is because section 11(2)(a) precludes the deduction of expenditure which has been laid out for the production of exempt income.

#### 32.6.1 Case No 5

##### 3.2.6.2 *Mallalieu v Drummond (Inspector of Taxes) 1983*

##### 3.2.6.2 Summary of Facts

The taxpayer was practicing as a lawyer. During the year in question she had spent about £564 on the replacement, cleaning and laundering her clothing, which she used as uniform for her professional work. She sought to deduct that sum in the determination of her taxable income as being expenses wholly or exclusively expended in the production of her income. The Inspector of Taxes disallowed that expenditure as a deduction on the grounds that the expenditure had a dual motive, the professional one of enabling her to earn profits in her profession and the private one of enabling her to be properly clothed while engaged in her professional activity.

#### **3.2.6.3 Appellant's arguments**

The appellant taxpayer sought to deduct expenditure incurred on the replacement, cleaning and laundering of certain items of clothing which she wore in court, as being wholly and exclusively expended for the purposes of her profession, within section 31(a) of the Income and Corporation Taxes Act 1970.

#### **3.2.6.3 Respondent's arguments**

The Commissioner submitted that the appellant had two objects in making the expenditure, to serve the purpose of her business and to serve her own purpose by enabling her properly to be clothed.

#### **3.2.6.4 Matters of decision**

Whether the expenditure in question had been wholly and exclusively expended for the purposes of the taxpayer's profession.

#### **3.2.6.5 Judgement**

The court held that, as the barrister needed clothes to travel to work and clothes to wear at work, it is true that one object, though not a conscious motive, was the provision of the clothing that she needed as a human being. Thus the court felt that the expenditure was incurred for mixed motives, one for her profession, which was deductible in terms of section 11(a) of the Act, and one for private purpose, which was non deductible in terms of section 23(g), which precludes the deduction of expenditure incurred for non trade purposes.

#### **3.2.6.6 Ratio Decidendi**

The expenditure was incurred for mixed motives, one was incurred to produce income, and the other one was incurred for private purpose, the deduction of which is precluded by the terms of section 23(g) of the Act.

The expenditure was incurred for mixed motives, one was incurred to produce income, and the other one was incurred for private purpose, the deduction of which is precluded by the terms of section 23(g) of the Act.

#### 3.2.5.8 The court's attitude towards apportionment of expenditure

The taxpayer's main concern was the deduction of expenditure incurred in the production of income, but the Commissioner refused to allow the deduction of expenditure, because the expenditure was not 'wholly and exclusively' incurred for the purposes of trade in terms of section 23(g) of the Act. The Commissioner submitted that the expenditure was intended for another purpose, a private purpose, which was debarred from deduction by the terms of section 23(g) of the Act. This meant that the expenditure was incurred for two purposes; one was a business purpose and the other a private purpose.

If the taxpayer incurred the expenditure for the purposes of trade and partly for capital purposes, there can be apportionment under section 11(a) as was confirmed in 'Secretary for Inland Revenue v Guardian Assurance Holdings (SA) Ltd 1976 (4) SA 522 (A), 38 SATC 111. If the taxpayer has incurred expenditure for two purposes, one of them a 'trading' purpose and the other not, then it seems that an apportionment will be made either under section 11(a) or under section 23(g). It is evident that whenever the applicability of apportionment is being determined, the courts will always ensure that the expenditure does comply with the provisions of the 'The general deduction formula'

## Chapter 4

### Research Findings

#### 4.1 Findings

The reasons the courts resort to apportionment of expenditure

The court in I.T.C. No 800 laid down the principle of law with regards to apportionment of expenditure as follows; "Where a lump-sum expenditure is sought to be deducted from one's taxable income, that sum must have been wholly or exclusively expended for the purposes of trade. If portion of such lump-sum was so laid out and portion was not and if it is not possible to allocate each portion to its appropriate purpose, then no portion of such lump-sum can be deducted.

But if the lump-sum can be dissected and that portion expended for the purposes of trade can be identified, such portion may be deducted."

The court in this case decided that expenses should be apportioned to those incurred during the period when the loan was earning interest from the period when no such interest was being earned. This was the principle of matching expenditure with income earned.

The court in Local Investment Co v C.O.T. (S.R.) supra, explained the reasons that lead to apportionment of expenditure, as being that many businesses are bound to have expenses of a general nature, which cannot be accurately appropriated to 'income' and non income amounts. The only proper way, the court suggested, to deal with such expenses is to make a fair and reasonable apportionment of these expense as between 'income' and non-taxable amounts, as the case may be.

It is clear from cases such as *A.G.M., Ltd v Commissioner of Taxes*, that where a taxpayer engages in activities which are productive of both 'income' as defined in the Act and the amounts which are not 'income' as so defined, it is proper to apportion such items of general expenditure incurred by the taxpayer as cannot be directly connected with any particular amount received by the taxpayer, between the taxpayer's productive and non productive activities, and to allow as a deduction only that proportion of such general expenditure as can be fairly and reasonably be said to appertain to the activities of the taxpayer which are productive of income.

This was the case in the case, *Mallalieu v Dummond*, supra, where a taxpayer practicing as a barrister was claiming a deduction on the expenditure she incurred on replacement, cleaning and laundering of certain items of clothing which she wore in court, the court held that the expenditure was laid out with mixed motives, one for 'income' and the other for private purpose, which was debarred from deduction in terms of section 23(g) of the Act. For this reason the court sanction apportionment of that expenditure such that the 'income' portion should be allowed a deduction and the non-trade income denied deduction for reasons aforementioned.

The other case analyzed was *Secretary for Inland Revenue v Guardian Assurance Holdings Ltd 1976*, where the appellant company was claiming deduction on *profit made on short term interest made on excess applications*. The Commissioner was resisting the claim on the grounds that the expenditure was of a capital nature and not deductible.

The court concluded that the expenditure had elements of capital and also income and as such an apportionment of expenditure was appropriate in the *circumstance*. The court in *Local Investment Co v C.O.T*, supra, supported the

view that, though the Act does not sanction apportionment, is no argument for holding that either 'all' or 'none' of the general expenses may be deducted.

#### 4.2 The provisions of the Income Tax Act with regards to apportionment of expenditure

In *C.I.R. v Rand Selections Corporation Ltd*, the court had to decide whether the company under section 11(2)(a) read with section 12(f) of the Income Tax Act 58 of 1962, was entitled to deduct the whole amount of £367,859, which was an amount paid for shares, or only a portion thereof.

The court held that under section 11(2)(a) expenditure actually incurred in the production of 'income' might be deducted while the effect of section 12(f) was that expenditure in the production of the 'dividend' might not be deducted. The amount of £367859 was incurred in order to get liquidation shares. The liquidation shares dividends consisted of 'income' and 'dividends' and according to the court, in terms of sections 11(2)(a) and 12(f) read together, there was a need to apportion expenditure accordingly.

The court then suggested a formula according to which apportionment could be effected. What the court did was to analyze the purpose of expenditure and allocated the amounts, which were incurred for different purposes, namely, 'income' and 'non income' purposes, in terms of the Act.

The court in Income Tax Case No 1524, 1990, when considering the applicability of apportionment, that for any portion of the expenditure to be deductible, it must pass the deductibility test as set out in sections 11(a) and 23(g) of the Act 58 of 1962. The prohibition in section 23(g) was overruled in *CIR v Rand Selection Corporation Ltd* 1956 (3) SA 124 (A), where the court approved apportionment of expenditure claimed under section 11(a) in an earlier case involving a taxpayer that incurred expenditure in earning an amount comprised

both of income and exempt income, and again in *SIR v Guardian Assurance Holding (SA) Ltd*, where a taxpayer incurred expenditure partly of a capital nature and partly of a revenue nature.

The court in *Mallalieu v Drummond*, *supra*, had to decide whether the barrister when she bought her professional clothes, she had two motives in mind, one being to acquire clothing for business purpose and the other one, a private purpose, being the provision of clothing as a human being. In terms of the deduction formula, expenditure incurred for business purpose is deductible in terms of section 11(a) of the Act.

Expenditure incurred for a taxpayer's private purpose is not deductible in terms of section 23(g) of the Act. The Court, therefore held that expenditure had to be apportioned such that the portion of expenditure which passed the deduction test, was allowed as a deduction, while the expenditure that was not allowable as a deduction in terms of the Act, was disallowed.

In the case of *Port Elizabeth Tramway Company Limited v Commissioner for Inland Revenue*, 8 SATC, the court said that there were three qualifications that must exist before money paid out could be deducted from income, and they were:

- ❖ The expenditure must be actually incurred
- ❖ It must not be of a capital nature
- ❖ It must be incurred in the production of income. No deduction may be made unless the expenditure was wholly and exclusively laid out or expended for the purposes of trade. Section 23(g)

It is thus important that before a deduction of expenditure may be considered, the expenditure must pass the test of the three qualifications previously mentioned. In the case of an amount of expenditure, which is laid out for more



than one purpose, the court in ITC No 800, *supra*, held that section 23(g) does not forbid the dissection of a lump-sum amount of expenditure proportionately into sums each allocated to different items of income if this can be done. When examining the terms of section 23(g), nothing is said about the dissection of a lump-sum amount of expenditure.

In the case of *Secretary for Inland Revenue v Guardian Assurance Holdings Ltd*, *supra*, the court had to decide on the deductibility of expenditure, which was incurred for two purposes. The court held that " the total expenses incurred, had 'two dominant motives', namely, the raising of capital and the making of a profit by way of interest, and that, in the absence of any prohibition in the Income Tax Act, there could be no reason in principle why the expenses should not be apportioned, i.e. those expenses relating to the raising of the capital to be regarded as capital expenditure and those which were incurred to make the profit being regarded as revenue expenditure."

The court further held that the expenditure in question was not debarred as a deduction under section 23(g) of the Act. The court further explained that expenditure is disallowed as a deduction, in terms of section 23(g), if it is in part incurred for private purposes whereas (non-trade purpose), on the other hand, where expenditure is incurred for the purpose of raising capital and for the purposes of earning an income (trade purposes), an apportionment is permitted so that an apportioned share of the expenditure can be deducted from the income earned.

It is clear, in the court's analogy, that where expenditure is not wholly or exclusively laid out expended for the purposes of trade, deduction is denied. The court again ruled that in terms of section 23(g) expenditure is disallowed as a deduction if it is in part incurred for private purposes whereas, on the other hand where expenditure is incurred for the purposes of raising capital and for the

purposes of earning income, an apportionment is permitted so that an apportioned share of the expenditure can be deducted from the income earned. The true role of section 23(g) is to reinforce the trade requirement of the opening words in section 11(a) and adding some further safeguard to the 'production of income' test set up by section 11(a). There is an alternative view with regard to section 23(g) that the trade or non trade issue is a dead letter and that the specific purpose of the amended prohibition is to authorize apportionment in a backhanded manner(SILKE: 2001).

#### 4.3 Methods of apportionment

A method of apportionment adopted depends on the particular circumstances of each case but the court in *Local Investment Co v C.O.T. (S.R.)* held that ' the question of fact being to make a fair apportionment to each object of the company's actual expenditure, where items are not in themselves referable to one object or the other'.

A fair method of apportionment is the one which takes the proportion that the capital invested in the operations earning the non-taxable amount bears to the total capital invested. In *ITC 832 (1956) 21 SATC 320*, once it was clear that some reduction had to be made in the expenditure that was deductible because some portion of the company's capital was invested in share investments, the court had the problem of determining whether the basis adopted by the Commissioner in arriving at the figure of deductible expenditure, was a fair and on proper basis. In that case, the Commissioner permitted the deduction of an amount which bore to the expenditure claimed the same ratio as the capital invested in the income producing assets bore to the total sum of the company's invested capital.

The Special court opinion was that there may have been much in the company's criticism that expenditure in relation to a share investment does not really bear

any relationship to the cost of an investment, and it may be that the division of the expenditure upon the basis of the proportions of the costs of the relative assets may be artificial, but, in the court's view, it was no more artificial than the division upon the basis of the proportions of the different amounts of revenue received from the different sources. The court considered that the 'asset to assets' basis adopted by the Commissioner in this case was in no way unfair to the taxpayer.

In regards to apportionment on the basis of capital employed, the Special Court has held that this must be determined by reference to the initial cost of the assets. The court saw no justification for requiring an annual valuation of assets for purposes of apportionment (ITC 1026 (1963) 26 SATC 26)

It was also suggested in Income Tax Case No 832, 1956, supra, that apportionment of expenditure is possible where a taxpayer such as a company has revenue from more than one source, one such source justifying deductions because revenue is taxable and another such source not justifying deductions because revenue is not taxable, even if particular items of revenue cannot be identified with one or other source of revenue.

Before expenditure can be considered for deduction, it must be established that it is linked to income from which deduction is sought. Where expenditure cannot be linked to any income, the court in Income Tax Case No 607, 14 SATC 366 suggested that apportionment must be disallowed. The Income Tax Act has no provisions for apportionment of expenditure, but it is implied in section 11(a) which permits only deductions of expenditure as is actually incurred in the production of income.

In the ITC No 1026,1963, the appellant, a property and investment company was objecting to the Commissioner's rejection of its claim for deduction of

expenditure from its income during the year in question. The Commissioner dismissed the appellant's objection on the basis that the proportion of expenditure which he had disallowed was incurred in respect of amounts received or accrued which are not included in the term 'income' as defined in the Act and that accordingly section 23(f) of the Act prohibited its deduction. He then proceeded to apportion management expenses of the company on the basis of the respective values of the productive and non-productive assets and disallowed the deduction of the amount relative to the non-productive assets.

The court in the case '*Secretary for Inland Revenue v Guardian Assurance Holding (SA) Ltd* 38 SATC 111, 1976 (4) SA 522 (A)', supra, had to decide the basis on which apportionment of expenditure in question could be made. The court, however agreed with the respondent's suggested method of apportionment that where expenditure is laid out partly for income purposes and partly for capital purposes, but still exclusively for the purposes of trade, an apportionment should be permitted so as to allow a deduction in respect of that part of the expenditure apportioned to income.

Where expenditure has been directly incurred in respect of a particular class of income, for example, where money is borrowed specifically for the purpose of acquiring a rent producing property, then according to *Income Tax Reporter* (1973), the expenditure is properly deductible under section 11(a) from the particular income derived. But where the expenditure has been incurred for the benefit of the company's investment business as a whole and not in respect of a particular class of income, for example, directors' fees, rent, etc, the correct approach must be to apportion the expenditure over the various types of income. No hard and fast rule can be laid down as to the basis of allocation in such circumstances.

The method of apportionment recommended in the case of *Local Investment Co v COT, supra*, is the one based on the proportion, which the different types of income bear to the total income. For example, the bulk of expenditure might be devoted exclusively to operations intended to earn income that in fact earn very little income, whereas from operations that incurred little expenses, relatively large non taxable amounts are earned. In such a case, to apportion the bulk of the expenses to non-taxable amounts would be unfair.

In ITC No 800, 1954, *supra*, the court was of the opinion that only expenditure incurred during the active period of between January to June 1952, should be considered for deduction. The court in this case held that, in a proper case where facts justify it, allocations for expenditure can be made in various ways, namely on a time basis or piece work basis. The court, however, in this instance, made allocation on a time basis because the expenditure that earned income was during the active period and the one outside the active period was disallowed.

The method of apportionment adopted by the court in *CIR v Rand Selections Corporation Ltd, 1956, supra*, was that the amount allocated to the production the dividends should be determined by the proportion which dividends bore to the total amount produced by the expenditure. The court recommended that a formula should be adopted as follows;

$$X \text{ multiplied by } \frac{y}{y+Z}$$

i.e. £367,859 X 2122,311/336,434

The answer from this formula will represent the amount of the expenditure which is deductible under section 11(2)(a).

In *Mallalieu v Drummond 1983* the court found that the purpose of the taxpayer in incurring the expenditure was for business but had an incidental 'effect' of

some private pleasure or advantage. As the taxpayer incurred expenditure partly for revenue purposes and partly for private purposes, the court held that apportionment was permissible either under section 11(a) or section 23(g). Apportionment in this case was not complicated as the amount of expenditure to be allowed as a deduction under section 11(a) could be determined according to time spent in the court room. The time spent in chambers, could be allocated to the time when clothing was used for private purposes, and as such was not deductible.

#### 4.4 Attitude of the courts towards apportionment of expenditure

The courts are obliged to act in accordance with the provisions of the Income Tax Act whenever they are called upon to decide on a particular case. The same is expected of them when deciding on the deductibility of expenditure incurred for more than one purpose. Whilst there is no specific provision of the Act which direct apportionment of expenditure, the courts have in the past used apportionment as a solution which is fair and reasonable in the circumstances of the particular case (ITC 1589 (1993 57 SATC 153 (Z)).

The court in CIR v Rand Selection Corporation had to decide as to whether the company under section 12(2)(a) read with section 12(f) was entitled to deduct the whole amount of £367859 or a portion thereof. This expenditure was incurred in the production of income amounting to £336434. This income amount consisted of £212311, which was a return of floating capital, and £124123, which was a dividend.

In terms of section 11(2)(a) expenditure actually incurred in the production of 'income' may be deducted while the effect of section 12(f) is that expenditure incurred in the production of dividends is not allowable as deduction. The liquidation dividends consisted, therefore, of 'dividends' and 'income' and thus it would have been wrong to regard the amount of expenditure as having

produced 'income' only, but 'income' plus 'dividends' and, being so, the court decided to apply apportionment as envisaged by section 11(2)(a) read with section 12(f) together.

The court decided to apportion expenditure so as to allow deduction of expenditure incurred in the production of 'income' and to disallow the deduction of expenditure incurred in the production of dividends. The court, it is evident in this case, applied apportionment of expenditure in terms of the provisions of sections 12(2)(a) and 12(f) of the Income Tax Act.

In *Mallalieu v Drummond* (1983) 2 All ER 1095 (HL) the court had to look at the question of whether expenditure had been wholly and exclusively expended for the purposes of the taxpayer's trade. In order to establish whether the moneys were expended to serve the purpose of the taxpayer's business, it is necessary to discover the taxpayer's 'object' in making the expenditure. Section 23(g) in its present form prohibits the deduction of expenditure to the extent to which it is expended for the purposes of trade.

It is therefore important to establish whether expenditure is laid out entirely for the purposes of trade, if not, then to determine apportionment. In determining whether expenditure is deductible, the purpose of the taxpayer in incurring the expenditure must be established first. If the taxpayer incurred expenditure partly for revenue purpose and partly for capital purposes but wholly for trading purposes, there can be apportionment under section 11(a). If the taxpayer incurred expenditure for two purposes, one of them a 'trading' purpose and the other not, then it seems that an apportionment can be made either under section 11(a) or under section 23(g).

The court in this case, held that expenditure had been made not only for the purposes of appellant's profession, but also for personal purposes, namely so

that she could be warmly and decently clothed, thus expenditure had been incurred for a dual purpose and in this instance disqualified from deduction. The court disqualified the deduction of expenditure because, in terms of the previous version of section 23(g), expenditure which is not 'wholly and exclusively' expended for the purposes of trade is debarred from deduction.

Expenditure incurred for a dual purpose, one being 'income' and the other being non income, but wholly for the purposes of trade, was looked into by the court in *SIR v Guardian Assurance Holdings (SA) Ltd 1976 (4) SA 522 (A)*. The court held that where the expenditure is laid out partly for private purposes, no apportionment, and therefore no deduction, should be allowed, as that could lead to abuse, whereas in the case where expenditure is laid out for the purposes of trade, an apportionment should be permitted so as to allow a deduction in respect of that part of the expenditure apportioned to income.

The court in this case established that the expenditure in question was incurred for the taxpayer's trade and therefore section 23(g) was not applicable. The expenditure had been incurred to raise capital and also to produce income in the form of short-term interest. In terms of section 11(a) of the Act, expenditure incurred for the production of income, in this case, interest, is deductible whereas expenditure laid out for to raise capital is considered to be capital expenditure and is debarred from deduction from income. For this reason the court decided to apportion expenditure in accordance with the provisions of the 'general deduction formula'.

It is evident that whilst the Income Tax Act does not provide any guidance with regards to apportionment of expenditure incurred for a dual purpose, apportionment is implied in section 11(a) read with section 23(g) of the Income Tax Act. In *ITC 607,1945*, the court said " It is true that the Act itself does not contain provisions for such apportionment, but it may be regarded as implied



from the terms of section 11(2)(a), which permits only the deduction of such expenditure as is actually incurred in the production of income”.

In ITC 800, *supra*, the court had to apply apportionment on the basis of time. In this case the taxpayer was claiming deduction of expenditure for the whole year from income produced during a specific active period i.e.(from January to June). The court contended that expenditure is only deductible from income if there is a direct relationship between expenditure and the income produced. The same test of deductibility of expenditure from income was used in ITC No 73 (SATC 64).

In this case the appellant became the owner of certain premises from the 1<sup>st</sup> of April, 1925, and as the owner he became liable to pay rates levied for twelve months ended the 31<sup>st</sup> December, 1925, payment of which fell due in April in each year. The court held that the Commissioner was correct in apportioning the expenditure on rates to the period of the tax year during which the appellant occupied the premises, i.e., a quarter, during which the appellant had derived income from the property.

In ITC No 318 (8 SATC 174) there was a break of six months due to rebuilding operations. During this time there was no earning of income. Here the Commissioner's disallowance of the expenditure on rates during the period of unproductiveness, was upheld.

Judge C.J. Ingram, K.C. President, in delivering the judgement of the court, summarized the approach of the court to apportionment as follows: “The underlying principles laid down by these decisions is that the expenditure, the deduction of which is claimed, must be linked to the income that is earned; and where it is possible to apportion the expenditure to the income so earned such apportionment must be made; and that expenditure which cannot be so linked,

apportioned must be disallowed. Further, that where the expenditure overlaps the tax year a similar apportionment must take place”.

The court in ITC 832 pointed out that it is recognized that where a taxpayer such as a company has revenue from more than one source, one such source *justifying deduction because the revenue is taxable and another source not justifying deductions because the revenue is not taxable, even if the particular items of revenue cannot be identified with one or other source of revenue, an attempt can be made to apportion.*

It is clear from cases such as *Local Investment Co v Commissioner of Taxes, 1958 R & N 116*, and *AGM Ltd v Commissioner of Taxes, Income Tax Appeal No 25 of 1962* not yet reported, that the attitudes of the courts is that where a taxpayer engages in activities which are productive of both ‘income’ as defined in the Act and of amounts which are not ‘income’ as so defined, it is proper to apportion such items of general expenditure incurred by the taxpayer as cannot be directly connected with any particular amount received by the taxpayer, between the taxpayer’s productive and non-productive activities, and to allow as a deduction only that portion of such general expenditure as can be fairly and reasonably be said to appertain to the activities of the taxpayer which are productive of income.

The court in ITC 800, 1954, laid out the principles as regards to apportionment of expenditure as being that where a lump-sum expenditure is sought to be deducted from one’s taxable income, that sum must have been wholly or exclusively expended for the purposes of trade. If portion of such lump-sum was so laid out and portion was not and if it is not possible to allocate each portion to its appropriate purpose, then no portion of such lump-sum can be deducted. The allocation can be made in various ways, namely, on a time basis, or perhaps on a piece-work basis.

Corbett JA in *Commissioner for Inland Revenue v Nemojim (Pty) Ltd* (1983) 45 SATC 241 described apportionment as a device which has been resorted to where expenditure in a globular sum has been incurred by a taxpayer for two purposes, one of which qualifies for deduction and one of which does not. He continued:

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

In conclusion, the courts use apportionment as a solution to the problem, which if left unsolved, would create imbalances to all parties to the dispute. While the legislature has made no provision with regards to expenditures with dual motives, the courts have used the provisions of the Income Tax Act, to make equitable and fair decisions on apportionment of expenditure disputes.

## Chapter 5

### Conclusion

#### 5.1 Expenditure must be incurred 'in the production of income'

All cases and literature analyzed showed that an expenditure sought to be deducted by a taxpayer, should first pass the test of deductibility in terms of section 11(a) read with section 23(g) before any apportionment exercise is undertaken. In the determination of a person's taxable income from carrying on any trade in any year, it was suggested in *Sub-Nigel Ltd v CIR 1948 (4) SA 580 (a)*, 15 SATC 381, that, in terms of section 11(a) expenditure actually incurred by him in the production of income, is deductible from such a person's income.

The principle of the deductibility of expenditure was laid out in *Port Elizabeth Electric Tramway Company Ltd v CIR 1936 CPD 241*, 8 SATC 13, where the court held that an expenditure is deductible in terms of section 11(a) if the purpose of the taxpayer in doing the act which entail the expenditure was to produce income, and also if the expenditure was so closely linked to that act as to be regarded as part of the cost of performing it.

The second test of deductibility of expenditure, is the trade test in terms of section 23(g) of the Act, which, according to *Joffe & Co Ltd v CIR, 1946 AD 157*, allows as a deduction all expenditure necessarily attached to the performance of the operations which constitute the carrying on of the income earning trade, and also all expenditure which, though not attached to the trading operations of necessity, is yet bona fide incurred for the purpose of carrying on trade, provided such payments are wholly and exclusively made for that purpose and are not expenditure of a capital nature.

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In *CIR v Genn & Co (Pty) Ltd* 1955 (3) SA 293 (A): 20 SATC 113, the court held that when determining how expenditure should properly be regarded, the Court 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 effects. Section 11(a) read with section 23(g) of the Act compel a taxpayer to show that, any amount claimed as a deduction under section 11(a), was actually incurred in the production of income.

In all the cases analyzed that deal with apportionment of expenditure, the courts seem to agree, as was the case especially in *Rand Selections* case, *supra*, that *the Income Tax Act makes no provision for apportionment of expenditure which cannot be specifically identified with particular items, or explain how to determine what portion of expenditure may be deducted from 'income' or whether the whole of the expenditure is deductible from such 'income'*. Whilst there is consensus that the Act contains no provision for apportionments, *however but it may be implied from the terms of section 11(a) which permits only the deduction of such expenditure as is actually incurred in the production of income.*

Many courts' decisions do recognize that where a taxpayer has revenue from more than one source, one such source justifying deductions because the revenue is taxable and another such source *not justifying deductions* because the revenue is not taxable, an attempt can be made to apportion (ITC No 832: 1956). It is clear that in most cases, including, *Schonegevel v CIR* 1937 CPD 258, the courts use apportionment of expenditure as a device to solve a problem, where expenditure in a globular sum has been incurred by a taxpayer *for two purposes, one of which qualifies for deduction and one of which does not.*

Corbett JA in CIR v Nemojim (Pty) Ltd, supra, held that apportionment of expenditure is a practical solution to what otherwise would be an intractable problem. In making such apportionment the courts consider what would be fair and reasonable in all circumstances

The courts use apportionment of expenditure to solve problems created by expenditure incurred for dual motives, namely

1. Where expenditure is laid out to receive non taxable income and taxable income (CIR v Nemojim (Pty) Ltd 1983 (4) SA 935 (A), 45 SATC 241)
2. Where a taxpayer incurs expenditure for two purposes one business and the other one private (Mallalieu v Drummond 1983 2 All ER 10955 (HL))
3. Where a taxpayer incurs expenditure with a dual motive of producing both income and capital. (SIR v Guardian Assurance Holdings (SA) Ltd 1976 (\$) SA 522 (A), 33 SATC 111)
4. Where expenditure is incurred during the period when income is not earned, in other words, during the period when no income is produced, is not to be allowed be deducted (ITC No 490:1941)

5.2 Apportionment sanctioned by the Section 11(a) read with section 23(g) of the Income Tax Act no 58 of 1962

The principle of apportionment of expenditure is a robust one, and enjoys the support of both the courts and the Receiver of revenue, as was said in the "Explanatory Memorandum on Income Tax Bill, 1992" that, "it has been a long standing practice of Inland Revenue, which has in the past been accepted by the courts, to allow apportionment of expenditure incurred partly for purposes of trade and partly for purposes other than trade". The current section 23(g) explicitly envisages apportionment, whilst it prohibits deduction on moneys only

'to the extent to which' they are not laid out or expended for the purposes of trade.

The court in ITC No 607, 1945, held that apportionment should be regarded as implied from the terms of section 11(a) of the Income Tax Act, which permits *only the deduction of such expenditure as is actually incurred in the production of income.*

The current role of section 23(g) is to ensure that amounts claimed as deductions against income derived from trade were in fact laid out or expended for the purposes of trade. In other words, section 23(g) reinforce the 'trade' requirement of the opening words of section 11(a) of the Act and adding some further safeguard to the 'production of income test set up by section 11(a) of the Act.

The drawback on this approach is that it reinforces the concept of the general deduction formula that places two clogs on deductibility: in order to be *deductible under the deduction formula, an amount must be incurred in the production of income, and, in addition, that income must be associated with trade.* Technically, then, expenditure incurred to earn 'non-trade' but nevertheless taxable income, for example, interest, is not allowable, although in practice it is usually allowed. There is also an alternative view with regards to the 'trade/non-trade' issue, that, *the specific object of section 23(g) is to authorize apportionment, in a backhanded way.*

Section 12(g) (old version of section 23(g)) does not forbid the dissection of a lump-sum of expenditure proportionately into sums each allocated to different *items of income if this can be done.* This view was expressed by the court in ITC No 800, 1954, the court was interpreting the meaning of section 12(g) which provides that 'any monies claimed as a deduction from income derived from

trade which are not wholly or exclusively laid out or expended for the purposes of trade' may not be deducted from income'.

It would appear that as long as an expenditure is wholly or exclusively laid out for the purposes of trade an apportionment is permissible for the purposes of section 11 (a) read with section 23(g) of the Act (*SIR v Guardian Assurance Holdings (SA) Ltd* 1976 (4) SA 522). In *CIR v Nemojim (Pty) Ltd*, Corbett JA referred to apportionment as a practical solution to a difficult problem. In that case apportionment sanctioned was necessitated by the conjunction of section 11(a) and section 23(f) since the expenditure under review was found to have been incurred partly for the purpose of producing 'income' as defined, and partly with the purpose of producing income exempt from tax in terms of section 10 of the Act.

The prohibition in section 23(g) has not prevented the Appellate Division from approving apportionment of expenditure claimed under section 11(a) in a case involving a taxpayer that incurred expenditure in earning an amount comprised both income and exempt income (*CIR v Rand Selections Corporation Ltd, supra*)

Where expenditure is laid out partly for the purposes of earning income and partly for private purpose or for purposes not connected in anyway with the trade carried on by the taxpayer, it may be said that the expenditure is not wholly or exclusively laid out or expended for the purposes of trade; therefore no portion is deductible in terms of section 23(g) (*CIR v Pick n' Pay Wholesalers (Pty) Ltd* 1987 (3) SA 453 (A)).

The court, in *SIR v Guardian Assurance Holdings (SA) Ltd, supra*, said: "The legislature may well have considered that, in a case where expenditure is laid out *partly for private purposes, no apportionment, and therefore no deduction should be allowed as that could lead to abuse, whereas, in the case where*



expenditure is laid out partly for income purposes and partly for capital purposes, but still exclusively for purposes of trade, an apportionment should be permitted so as to allow a deduction in respect of that part of the expenditure apportioned to income.”

### 5.3 Methods of apportionment

The method the courts adopt to apportion expenditure is, as was held in the case of *Local Investment Co v COT* 19 (3) SA 34 (SR), a question of fact depending upon the particular circumstances of each case, but the courts do their best to ensure that apportionment is fair and reasonable in all circumstances. In *ITC 3 (1906) 1 SATC 3*, once it was clear that some reduction had to be made in the expenditure that was deductible because some portion of the company’s capital was invested in share investments, the court had the problem of determining whether the basis adopted by the Commissioner in arriving at the figure of deductible expenditure was fair and proper basis.

In that case the Commissioner permitted the deduction of an amount which bore to the expenditure claimed the same ratio as the capital invested in the income producing assets bore to the total sum of the company’s invested capital.

The court considered that the ‘assets to assets’ basis adopted by the Commissioner in this case was in no way unfair to the taxpayer, thus the court held that the Commissioner’s method of apportionment should be adopted.

The court, in *ITC 1017, 1963*, held that apportionment in that case should be on the basis of the capital employed in the various ventures, unless the taxpayer could adduce evidence to the contrary. The Special Court had earlier on suggested that apportionment could be determined by reference to the initial cost of the assets.

The court in ITC No 607,14 SATC 366, approved the principle that where a taxpayer such as a company has revenue from more than one source, one such source justifying deductions, because the revenue is taxable and another such source not justifying deductions, because the revenue is not taxable, even if particular items of revenue cannot be identified with one or the other source of revenue, an attempt can be made to apportion. The court, in this case, further held that before any expenditure can be considered for deduction, a link to the income that is earned, must be established. Where it is possible to apportion expenditure to the income so earned, such apportionment must be made. Expenditure, which cannot be linked and apportioned, must be disallowed. Where expenditure overlaps the tax year, a similar apportionment must be made.

An example of apportionment of expenditure which could not be identified with either the revenue that was taxable or revenue that was not taxable but which was obviously incurred in respect of both such types of revenue appears in the case of Commissioner for Inland Revenue v Rand Selections Corporation, Ltd, supra. In that case, the court held that a proper method of apportionment of expenditure was to adopt the formula employing the proportion, which, the income from the one source bore to the revenue received by dividend from the other source.

The appellant in ITC No 703, 1950, was claiming a deduction on expenditure for services rendered and the erection of a factory. The court disallowed the deduction on expenditure incurred for the erection of the factory but approved the claim for the services rendered. The court, in this case, apportioned expenditure on a pro rata basis, that is, expenditure incurred for services rendered was allowed as a deduction and expenditure expended on the erection of the factory was disallowed because it was of a capital nature in terms of section 11(a).

The principle laid out in these court decisions was that where a lump-sum expenditure is sought to be deducted from one's taxable income, that sum must have been wholly or exclusively expended for the purposes of trade. If portion of such lump-sum was so laid out and the other portion was not and if it is not possible to allocate each portion to its appropriate purpose, then no portion of such lump-sum can be deducted. But if such lump-sum can be apportioned and the portion expended for the purposes of trade can be identified, such portion may be deducted. The apportionment, the court suggested, can be made in various ways, namely, on a time basis or on a piecework basis (ITC No 832 1956).

There are instances and situations where it becomes imperative to apportion expenditure in order to solve a problem, which, if nothing is done, there would be dissatisfaction from both parties in the dispute, namely:

1. where expenditure is antecedent to the production of any income
2. where a period intervenes due to some external cause during which no income is produced
3. where owing to business ceasing to function or becoming unprofitable, no further income is derived, or
4. where the expenditure overlaps the tax year, being partly attributable to a prior year or to a succeeding year.

It is true that the Act contains no provisions for apportionments, but several courts' decisions have confirmed that apportionment is implied in section 11 (a) of the Act, which permits only the deduction of such expenditure as is actually incurred in the production of income (ITC No 607:1956).

## Chapter 6

### Recommendations

#### 6.1 Apportionment of expenditure should be used as a solution

Apportionment of expenditure should be used as a solution to the problem where *a single amount has been expended for more than one purpose*. The deductibility or non-deductibility of expenditure can only be established if the purpose of the act entailing expenditure is known. It is therefore important to analyze the expenditure properly in order to establish its true nature. The courts have recommended that apportionment must be fair and reasonable depending *on the circumstances of the case*. Apportionment of expenditure must also take into account the provisions of general deduction formula.

#### 6.2 The legislature involvement

The Legislature can also assist by providing direction with regards to the method of *solving the problem posed by expenditure with mixed motives*. The amendment of section 23(g) of the Act is not clear cut to ordinary tax payers who are forced to consult expensive tax consultants for assistance. The Income Tax Act no 58 of 1962 should be amended so that apportionment of expenditure with mixed motives must be dealt with in a wholehearted manner, to avoid *confusion to the taxpayers*.

The South African Revenue Services need to take a lead in guiding taxpayers with regards to solving the problem of deductibility of expenditure incurred for a dual purpose. SARS must issue a Practice Note with regards to its approach to this problem of the deductibility of expenditure with mixed motives.

In conclusion it is evident from the findings of this dissertation that the courts have been playing a vital role resolving cases where the deductibility of

expenditure incurred with more than one purpose, was the issue. The approach by our court, according to the opinion of the researcher, was the correct one, because, the courts never deviated from the provisions of the Income Tax Act. The courts' main approach to the deductibility of expenditures with a dual purpose was to be fair in all respects to all parties concerned.

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