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**THE INCOME TAX DEDUCTIBILITY OF THE BROAD-BASED
BLACK ECONOMIC EMPOWERMENT'S CORPORATE SOCIO-
ECONOMIC DEVELOPMENT CONTRIBUTIONS**

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I hereby declare that I have read and understood the regulations governing the submission of the Postgraduate Diploma in Law in Tax Law dissertations, including those relating to length and plagiarism, as contained in the rules of this University, and that this dissertation conforms to those regulations.

SIGNED AT CAPE TOWN ON THIS 15TH DAY OF FEBRUARY 2010

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1. INTRODUCTION

“Corporate giving in South Africa has gradually shifted from being a philanthropic voluntary activity that responded in an *ad hoc* way to welfare needs, to becoming a more professional, performance-driven pursuit, focused on achieving developmental impact.”¹

Corporate social responsibility refers to the “value system which a company adopts in order to be responsible to broader society.”² In South Africa, corporate social responsibility is shaped by the following frameworks:

- indirectly it is shaped by the 2001 Millennium Development Goals, a framework of eight goals adopted by member countries of the United Nations to be achieved by 2015. The goals are to eradicate extreme poverty and hunger, achieve universal primary education, promote gender equality and empower women, reduce child mortality, improve maternal health, combat HIV/ Aids, malaria and other diseases, ensure environmental stability and develop a global partnership for development;³ and
- it is directly shaped by the 2003 Broad-based Black Economic Empowerment Act⁴ and the documents derived therefrom and based thereon.

The purpose of this paper is to focus on a particular aspect of corporate social responsibility in South Africa, namely, that of the broad-based black economic empowerment’s corporate socio-economic development contributions and to determine whether the contributions by businesses to corporate socio-economic development are deductible in terms of section 11,

¹ Trialogue *The CSI Handbook* 9ed (2006) 6.

² Trialogue *The CSI Handbook* 8ed (2005) 6.

³ Samuel Njenga and Arnold Smit *Leading the way through CSI* (2007) 2.

⁴ Broad-Based Black Economic Empowerment Act, 53 of 2003, hereinafter referred to as the “B-BBEE Act”.

read with section 23(g), of the Income Tax Act.⁵ In reaching a conclusion in respect of this issue, due consideration will be given to the case law relating to the interpretation of the requirements of section 11, read with section 23(g) of the Income Tax Act, with specific emphasis on the Supreme Court of Appeal decision in the case of *Warner Lamberts SA (Pty) Ltd v Commissioner, SARS*,⁶ which case considered the deductibility of corporate social responsibility expenditure.

In order to qualify as a tax deductible expense in terms of the Income Tax Act, an expense must be actually incurred, it must be incurred in the production of income, it must not be of a capital nature and it must be derived from a trade carried on by a taxpayer.

Prior to considering the tax deductibility of the broad-based black economic development's corporate socio-economic development contributions, it is necessary to develop an understanding of the framework within which these contributions are made and the nature and purpose of the said contributions.

2. BROAD-BASED BLACK ECONOMIC EMPOWERMENT

Black economic empowerment⁷ can be defined as “an integrated and coherent socio-economic process ... which aims to redress past imbalances by transferring and conferring ownership, management and control of South Africa's financial and economic resources to the majority of its citizens and ensure broader participation of Black people in the economy in order to achieve sustainable development and prosperity.”⁸

⁵ 58 of 1962, hereinafter referred to as the “Income Tax Act”.

⁶ 2003 (5) SA 344 (SCA).

⁷ Hereinafter referred to as “BEE”.

⁸ Black Economic Empowerment Commission ‘Presentation Prepared for the Portfolio Committee on Trade and Industry’ (2000). Available at www.pmg.za/docs/2000/appendices/000913BEE.htm [Accessed 9 February 2010].

The South African government initially adopted a narrow based approach to BEE in that the focus was exclusively on transformation within the spheres of ownership and management. However, with the coming into effect of the B-BBEE Act in 2003, the approach has evolved into one which focuses on transformation and empowerment at all levels of society.⁹

Section 1 of the B-BBEE Act defines broad-based black economic empowerment as follows:

“the economic empowerment of all black people¹⁰ including women, workers, youth, people with disabilities and people living in rural areas through diverse but integrated socio-economic strategies that include, but are not limited to -

- a) increasing the number of black people that manage, own and control enterprises and productive assets;
- b) facilitating ownership and management of enterprises and productive assets by communities, workers, cooperatives and other collective enterprises;
- c) human resource and skills development;
- d) achieving equitable representation in all occupational categories and levels of the workforce;
- e) preferential procurement; and
- f) investment in enterprises that are owned or managed by black people.”¹¹

⁹ Vuyo Jack with Kyle Harris *Broad-Based BEE – The Complete Guide* 1ed (2007) 22.

¹⁰ Section 1 of the B-BBEE Act, defines “black people” as a generic term which means Africans, Coloureds and Indians. References hereinafter to “black people” shall be deemed to refer to the aforesaid definition of the term.

¹¹ B-BBEE Act, s1.

The B-BBEE Act is a concise document which makes provision for the Minister of Trade and Industry to issue explanatory codes of good practice on BEE, which codes are intended to set out the detailed matters giving effect to the objectives of the B-BBEE Act,¹² and also makes provision for the Minister of Trade and Industry to promote and publish in the Government Gazette transformation charters, which charters are intended to advance the objectives of the B-BBEE Act in respect of a particular sector of the economy.¹³

In terms of section 10 of the B-BBEE Act, the codes of good practice are binding on organs of state and public entities in determining and developing criteria for the issuing of licences, concessions and other authorisations in terms of any law, the implementation of a preferential procurement policy, the sale of state-owned enterprises and the entering into partnerships with the private sector.¹⁴ As section 10 of the B-BBEE Act makes no reference to the applicability of the codes of good practice on persons and entities within the private sector, it could be assumed that the B-BBEE Act does not apply to the private sector. However, based on the fact that many businesses within the private sector require statutory licences, concessions and other authorisations in terms of law or could intend doing business with an organ of state or public entity, it is the business needs of such entities which will compel them to comply with the B-BBEE Act and the codes of good practice.

The Codes of Good Practice¹⁵, promulgated in February 2007, gives entities guidance on the implementation of BEE by *inter alia* addressing the following matters:

- the introduction of a generic scorecard which sets out the different elements of a business which will be measured in determining the BEE

¹² B-BBEE Act, s9.

¹³ B-BBEE Act, s12.

¹⁴ B-BBEE Act, s10.

¹⁵ The Codes of Good Practice issued under section 9 of the Broad-Based Black Economic Empowerment Act, 53 of 2003, GNR 112 GG 29617 of 9 February 2007, hereinafter referred to as the "Codes of Good Practice".

status of the business and the weighting attached to the different elements;

- the categorisation of BEE entities depending on their turnover and applying different formulae in respect of the measurement of the BEE status of the different categories of BEE entities; and
- guidelines for the development and gazetting of transformation charters and sector codes.

The elements of the generic scorecard as set out in the Codes of Good Practice are as follows:

- ownership, which measures the effective ownership of enterprises by black people, is allocated a maximum weighting of 20 out of 100 points on the scorecard;
- management control, which measures the effective control of enterprises by black people, is allocated a maximum weighting of 10 out of 100 points on the scorecard;
- employment equity, which measures initiatives intended to achieve employment equity in the workplace under the B-BBEE Act and the Employment Equity Act, 55 of 1998, is allocated a maximum weighting of 15 out of 100 points on the scorecard;
- skills development, which measures the extent to which employers carry out initiatives designed to develop the competencies of black employees, is allocated a maximum weighting of 15 out of 100 points on the scorecard;
- preferential procurement, which measures the extent to which enterprises buy goods and services from suppliers with strong BEE procurement recognition levels, is allocated a maximum weighting of 20 out of 100 points on the scorecard;
- enterprise development, which measures the extent to which

enterprises carry out initiatives intended to assist and accelerate the development and sustainability of other enterprises, is allocated a maximum weighting of 15 out of 100 point on the scorecard; and

- socio-economic development initiatives, which measures the extent to which enterprises carry out initiatives that contribute towards socio-economic development or sector specific initiatives that promote access to the economy for black people, is allocated a maximum weighting of 5 out of 100 point on the scorecard.¹⁶

The generic scorecard is applicable to business entities which have an annual turnover exceeding R35 million. In respect of entities which do not satisfy this requirement, the Codes of Good Practice identify three other business categories, namely:

- exempted micro-enterprises, which have an annual turnover of less than R5 million, are automatically accorded a BEE status which is equivalent to having scored between 65 and 75 points on the generic scorecard;
- qualifying small enterprises, which have an annual turnover of between R5 million and R35 million, can elect to be assessed on any four of the seven elements of the generic scorecard and the said four elements are each allocated a weighting of 25 out of 100 points; and
- start-up enterprises, which qualify as such in the first year following their formation or incorporation, are treated as exempted micro-enterprises.¹⁷

The B-BBEE Act and the Codes of Good Practice give recognition to two other documents which regulate the implementation of BEE, namely, transformation charters and sector codes. A transformation charter, as referred to in section 12 of the B-BBEE Act, is “evidence of the commitment by all stakeholders to promote BEE in the applicable sector and is not binding

¹⁶ Codes of Good Practice, Code 000, Statement 000.

¹⁷ Codes of Good Practice, Code 000, Statement 000.

upon organs of state or public entities”.¹⁸ Notwithstanding the existence of a transformation charter applicable to a particular sector of the economy, the said sector remains subject to the Codes of Good Practice.¹⁹ A sector code which is applicable to a particular sector of the economy, on the other hand, is promulgated under section 9 of the B-BBEE Act and as such enjoys equal status with that of the Codes of Good Practice and any other code promulgated in terms of section 9 of the B-BBEE Act. It should however be noted that if there is any uncertainty in the interpretation of a sector code, the Codes of Good Practice will prevail.²⁰

After the coming into force of the B-BBEE Act but prior to the promulgation of the Codes of Good Practice and in an effort to avoid government intervention in the regulation of BEE, a number of sectors of the economy began processes to formulate charters for their respective sectors. Four such sector charters had been finalised and forty others had been in the process of being finalised at the time the draft Codes of Good Practice were published.²¹ Of these sector charters, two sectors of the economy went a step further and adopted their sector charters into the legislation which applied to the said sectors, namely, the Mining Charter and Scorecard of the mining sector is contained in the Mineral and Petroleum Resources Development Act²² and the Petroleum and Liquid Fuels Charter of the petroleum and liquid fuels sector is contained in the Petroleum Products Amendment Act.²³ A unique approach developed within the mining sector to drive BEE is that the MPRD Act authorises the Department of Minerals and Energy to base the granting of mining rights and licenses upon the BEE compliance of a particular applicant.

To date, the following sector codes have been promulgated and transformation charters have been gazetted, namely:

¹⁸ Codes of Good Practice, Code 000, Statement 010, para 7.

¹⁹ Codes of Good Practice, Code 000, Statement 010, para 7.

²⁰ Codes of Good Practice, Code 000, Statement 010, para 7.

²¹ Trialogue (note 1) at 14.

²² 28 of 2002, hereinafter referred to as the “MPRD Act”.

²³ 58 of 2003, hereinafter referred to as the “PPA Act”.

- the Integrated Transport Sector Codes;²⁴
- the Forestry Sector Code;²⁵
- the Construction Sector Code;²⁶
- the Tourism Sector Code;²⁷
- the Property Sector Charter;²⁸
- the Financial Sector Charter;²⁹
- the Agri-BEE Charter;³⁰ and
- the Marketing, Advertising and Communication Sector Charter.³¹

3. CORPORATE SOCIO-ECONOMIC DEVELOPMENT

As previously stated, one of the elements of the generic scorecard as set out in the Codes of Good Practice is that of socio-economic development, which is allocated a weighting of 5 out of 100 points on the generic scorecard. The

²⁴ Integrated Transport Sector Codes, issued under section 9(1) of the Broad-Based Black Economic Empowerment Act, 53 of 2003, GNR 1162 GG 32511 of 21 August 2009, hereinafter referred to as the "Integrated Transport Sector Codes".

²⁵ Forestry Sector Code, issued under section 9(1) of the Broad-Based Black Economic Empowerment Act, 53 of 2003, GNR 873 GG 32320 of 12 June 2009, hereinafter referred to as the "Forestry Sector Code".

²⁶ Construction Sector Code, issued under section 9(1) of the Broad-Based Black Economic Empowerment Act, 53 of 2003, GNR 873 GG 32320 of 12 June 2009, hereinafter referred to as the "Construction Sector Code".

²⁷ Tourism Sector Code, issued under section 9(1) of the Broad-Based Black Economic Empowerment Act, 53 of 2003, GNR 862 GG 32305 of 5 June 2009, hereinafter referred to as the "Tourism Sector Code".

²⁸ Property Sector Charter, issued under section 12 of the Broad-Based Black Economic Empowerment Act, 53 of 2003, GNR 1248 GG 30333 of 5 October 2007, hereinafter referred to as the "Property Sector Charter".

²⁹ Financial Sector Charter, issued under section 12 of the Broad-Based Black Economic Empowerment Act, 53 of 2003, GNR 110 GG 29610 of 9 February 2007, hereinafter referred to as the "Financial Sector Charter".

³⁰ Agri-BEE Sector Charter, issued under section 12 of the Broad-Based Black Economic Empowerment Act, 53 of 2003, GNR 314 GG 30886 of 20 March 2008, hereinafter referred to as the "Agri-BEE Sector Charter".

³¹ Marketing, Advertising and Communication Sector Charter, issued under section 12 of the Broad-Based Black Economic Empowerment Act, 53 of 2003, GNR 924 GG 31371 of 26 August 2008, hereinafter referred to as the "Marketing, Advertising and Communication Sector Charter".

measurement of the socio-economic development element of the generic scorecard is based on net profit after tax and is calculated as 1% of the annual average net profit after tax of an entity.

The existing sector codes and transformation charters include the concept of “socio-economic development” in the following forms:

- the Integrated Transport Sector Codes consist of eight separate sub-sector codes, all of which duplicate the element of socio-economic development contributions and the measurement thereof from the generic scorecard but, in addition thereto, seven of these sub-sector codes state that contributions to certain projects will be enhanced by a factor of 1.25. The result of such enhancements is that there is further incentive for entities within this sector to contribute towards poverty alleviation, HIV/ AIDS, education, community development, the provision of housing, industry awareness and rural development structures;³²
- the Forestry Sector Code duplicates the element of socio-economic development contributions and the measurement thereof from the generic scorecard. The Code also makes provision for bonus points so that an enterprise can obtain a maximum of an additional three points for 0.75% of net profit after tax spent on sector specific initiatives on socio-economic development;³³
- the Construction Sector Code utilises the term “corporate social investments”, which it defines as projects “aimed primarily at black groups, communities and individuals that contribute towards transformation and have a strong developmental approach”. The Code commits members of the particular sector to utilise the resources at

³² Integrated Transport Sector Codes (note 24) at paras 3-4 of the Bus Commuter and Coach Services Sub-Sector Code, paras 6-7 of the Taxi Industry Sub-Sector Code, para 3 of the Road Freight Sub-Sector Code, para 3 of the Public Transport Sub-Sector Code, para 3 of the Maritime transport and Services Industry Sub-Sector Code, para 3 of the Forwarding and Clearing Sub-Sector Code, para 3 of the Rail Sub-Sector Code and para 3 of the Domestic Aviation Sub-Sector Code.

³³ Forestry Sector Code (note 25) at paras 14-15.

their disposal to initiate and contribute to corporate social investment projects and registered development oriented non-profit organisations that primarily benefit black people and that promote development in under resourced areas. The Code allocates a weighting of 5 out of 100 points to corporate social investment and states that each enterprise will achieve a target of 0.25% of the annual payroll of the enterprise on corporate social investment by 2013;³⁴

- the Tourism Sector Code utilises the term “socio-economic development and industry specific” to describe this category of the scorecard and allocates a weighting of 25 out of 175 points to this category. Included within this category are approved socio-economic development contributions (measured as 1% of net profit after tax) and the recruitment of black new recruits with no prior work experience (measured as 10% of total number of new recruits);³⁵
- the Property Sector Charter utilises the term “corporate social investments”, which it defines as projects “aimed primarily at black groups, communities and individuals that contribute towards transformation”. The Charter allocates a weighting of 2 out of 100 points to corporate social investment which is measured as 1% of the net profit after tax. This Charter also recognises a further element of investment and property development in under-resourced areas and allocates a weighting of 8 out of 100 points to this element which is measured as 10% of total annual investments;³⁶
- the Financial Sector Charter utilises the term “corporate social investments”, which it defines as projects “aimed primarily at black groups, communities and individuals that contribute towards transformation and have a strong developmental approach”. The Charter allocates a weighting of 3 out of 100 points to corporate social investment and states that each financial institution to which the Charter applies will achieve a target of 0.5% of the post tax operating profits of

³⁴ Construction Sector Code (note 26) at paras 5, 7 and 8.

³⁵ Tourism Sector Code (note 27) at para 8.

³⁶ Property Sector Charter (note 28) at paras 11, 12, 18 and 19.

the institution on corporate social investment by 2014;³⁷

- the Agri-BEE Charter utilises the term “rural development, poverty alleviation and corporate social investment” to describe this category of the scorecard and allocates a weighting of 10 out of 100 points to this category. The Charter measures this as 1.5% net profit after tax spent on corporate social investment contributions and/ or 10% of land made available to farm workers. The Charter also makes provision for an additional 1 bonus point for corporate social investment contributions benefiting black people in rural communities or geographic areas identified in the government's integrated sustainable development programme and urban renewal programme;³⁸ and
- the Marketing, Advertising and Communication Sector Charter duplicates the element of socio-economic development contributions and the measurement thereof from the generic scorecard but adds that the measurement of 1% of net profit after tax is to be increased to 5% of net profit after tax by the year 2014.³⁹

As aforesaid, the Mining Sector Charter is contained in the MPRD Act. Section 100 of the MPRD Act refers to the development of a broad-based socio-economic empowerment charter to address the objects of the MPRD Act, including the promotion of employment and the advancement of the social and economic welfare of all South Africans and contributions towards the socio-economic development of areas in which holders of mining and production rights operate. The MPRD Act enforces the Mining Charter as follows – a determining factor in the granting of a mining right is compliance with the objects of the Mining Charter,⁴⁰ the holder of a mining right/ permit holder and a production right must submit annual reports to the Director-General of the Department of Minerals and Energy on the extent of the entity's compliance with the Mining Charter and the said annual reports will also be considered in the renewal application of any right in terms of the

³⁷ Financial Sector Charter (note 29) at para 13.

³⁸ Agri-BEE Charter (note 30) at para 5.

³⁹ Marketing, Advertising and Communication Sector Charter (note 31) at para 7.

⁴⁰ MPRD Act, s 23(1)(h).

MPRD Act.⁴¹ The Mining Charter refers to integrated socio-economic development for host communities, major labour sending areas and areas that due to the unintended consequences of mining have become ghost towns and states that the mining sector undertakes to formulate integrated development plans for these areas and communities.⁴²

The Petroleum and Liquid Fuels Charter, as contained in the PPA Act, states that in considering licence applications in terms of the said Act, effect must be given to the Petroleum and Liquid Fuels Charter and proof of implementation thereof. It should be noted that the Petroleum and Liquid Fuels Charter makes no provision for corporate socio-economic development in any manner or form, other than indirectly by means of capacity building, procurement, employment equity and financing of historically disadvantaged companies. Despite this exclusion within the Petroleum and Liquid Fuels Charter, it could be argued that because the B-BBEE Act requires all sector codes and charters to be in line with the B-BBEE Act and to be approved by the Minister of Trade and Industry, the petroleum and liquid fuels sector may be obliged to comply with the Codes of Good Practice or amend their own charter to bring it in line with the Codes of Good Practice.

The Codes of Good Practice include the following concepts in its formulation of the term “socio-economic development”:

- monetary or non-monetary contributions carried out for the benefit of any projects approved for this purpose by any organ of state or sectors, including without limitation, projects focusing on environmental conservation, awareness, education and waste management, and projects targeting infrastructural development, enterprise creation or reconstruction in underdeveloped areas, rural communities or geographic areas identified in the government's integrated sustainable

⁴¹ MPRD Act, s 25(2)(h) and s 28(2).

⁴² Broad-Based Socio-Economic Empowerment Charter for the South African Mining Industry, paras 2 and 4. Available at http://www.dme.gov.za/minerals/mining_charter.stm [Accessed 9 February 2010].

rural development or urban renewal programmes;⁴³ and

- programmes in the form of development programmes for women, youth, people with disabilities and people living in rural areas, support of healthcare and HIV/ AIDS programmes, support for education programmes, resources and materials at primary, secondary and tertiary school level, as well as bursaries and scholarships, and community training, skills development for unemployed people and adult basic education and training or support of arts, culture or sporting development programmes.⁴⁴

“Corporate social investment”, the term used in certain of the sector codes and transformation charters instead of the term “socio-economic development” has been defined as “the way in which companies care for the well-being of the social and ecological environment of the communities in which they operate. To this end they invest, in a variety of ways, in the advancement of certain socially and/ or environmentally defined needs, projects or causes extraneous to their regular business activities.”⁴⁵

In the context of BEE and for purposes of this paper, the term “corporate socio-economic development” shall be used to refer to the terms “corporate social investment” and “socio-economic development”.

4. DEDUCTABILITY IN TERMS OF THE INCOME TAX ACT

4.1 General deduction formula

⁴³ Codes of Good Practice, sch 1, part 2, definition of “approved socio-economic development contributions”.

⁴⁴ Codes of Good Practice, sch 1, part 2, definition of “socio-economic development programmes”.

⁴⁵ Njenga and Smit (note 3) at 4.

In terms of section 11(a) of the Income Tax Act, a taxpayer carrying on any trade is allowed to deduct certain expenses from its income provided that the following requirements are satisfied, namely:

- the expense was actually incurred;
- in the production of income; and
- the expense is not of a capital nature.⁴⁶

Section 23(g) of the Income Tax contains a proviso to section 11 in that it states that an expense will not be deductible from income derived from trade to the extent that the amount sought to be deducted was not expended for the purposes of trade.⁴⁷

Section 11, read with section 23(g), of the Income Tax Act is considered to be the general deduction formula and all the different components of the general deduction formula have to be satisfied in order for an expense to be deductible for tax purposes.⁴⁸ Based on the foregoing, it is necessary to understand the components of the general deduction formula prior to considering the applicability of the general deduction formula to the broad-based black economic empowerment's corporate socio-economic development contributions.

4.1.1 Expense actually incurred

Although section 11(a) of the Income Tax Act applies to expenses and losses, this paper will be limited to the consideration of section 11(a) of the Income Tax Act as it relates to expenses. Expenditure "is not restricted to an outlay of

⁴⁶ Income Tax Act, s 11(a).

⁴⁷ Income Tax Act, s 23(g).

⁴⁸ Huxham and Haupt *Notes on South African Income Tax* 28ed (2009) 87 and 91.

cash but includes outlays of amounts in a form other than cash.”⁴⁹ However, when the expense is in a form other than cash, one will need to determine the cost to the taxpayer in quantifying the expense for tax purposes.⁵⁰

In the case of *Port Elizabeth Electric Tramway Co Ltd v CIR*⁵¹ the taxpayer attempted to deduct from its gross income the damages paid by it as a result of the death of a driver employed by the taxpayer. In his judgment, Waterman AJP held that the term “actually incurred” does not require that the expense must be necessary and the authorities can therefore not penalise one taxpayer for conducting his business extravagantly while rewarding another taxpayer for conducting his business efficiently.⁵² Despite the foregoing, the other components of the general deduction formula could be effective in determining that an expense is excessive and not in the production of income and for the purposes of trade.⁵³

In the *PE Tramway* case the court stated that “expenses ‘actually incurred’ does not mean ‘actually paid’”⁵⁴ and one should consider whether the liability to pay the expense has been actually incurred rather than whether it has in fact been paid.⁵⁵

In *Edgars Stores Ltd v CIR*,⁵⁶ the taxpayer attempted to deduct the rental paid in respect of the business premises leased by the taxpayer. In the dissenting judgment of Corbett JA, the law applicable to the term “actually incurred” was summarised and it was held that “only expenditure (otherwise qualifying for deduction) in respect of which the taxpayer has incurred an unconditional legal obligation during the year of assessment in question may be deducted

⁴⁹ Madelaine Stiglingh et al *Silke: South African Income Tax 2009* (2009) 95.

⁵⁰ David Meyerowitz *Meyerowitz on Income Tax 2008-2009ed* (2009) 11-13.

⁵¹ (1936) CPD 241, 8 SATC 13, hereinafter referred to as the “*PE Tramway case*”.

⁵² *Ibid* at page 244.

⁵³ Meyerowitz (note 50) at 11-41.

⁵⁴ *PE Tramway case* (note 51) at page 244.

⁵⁵ *Ibid*. See also *Nationale Pers v Kommisaris van Binnelandse Inkomste* (1986) 48 SATC 55.

⁵⁶ 1988 (3) SA 876 (A), hereinafter referred to as the “*Edgars Stores case*”.

in terms of s11(a) from income returned for that year. The obligation may be unconditional *ab initio* or, though initially conditional, may become unconditional by fulfilment 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 (the other requirements of deductibility being satisfied).⁵⁷

4.1.2 In the production of income

Section 11(a) of the Income Tax Act refers to expenditure incurred in the production of income. As an expense is not in and of itself an act which can produce an income, one needs to give consideration to the action associated with the said expense in order to determine if this requirement is satisfied.⁵⁸

In the *PE Tramways* case, it was stated that “income is produced by the performance of a series of acts and attendant upon them are expenses. Such expenses are deductible expenses provided they are so closely linked to such acts as to be regarded as part of the cost of performing them.”⁵⁹

The test for determining whether an expense is incurred in the production of income, as enumerated by Waterman AJP in the *PE Tramways* case, is the leading test on this matter and this test has been approved by the Appellate Division on more than one occasion.⁶⁰

⁵⁷ Ibid at page 889.

⁵⁸ Huxham and Haupt (note 48) at 95.

⁵⁹ *PE Tramway* case (note 51) at page 245.

⁶⁰ Huxham and Haupt (note 48) at 95. See also *CIR v Genn & Co (Pty) Ltd* 1955 (3) SA 293 (A); *CIR v African Oxygen Ltd* 1963 (1) SA 681 (A) and *CIR v Allied Building Society* 1963 (4) SA 1 (A).

In the *PE Tramways* case Waterman AJP stated that there are two questions which arise, namely:

- was the act, to which the expenditure is attached, performed in the production of income?
- how closely is the expenditure linked to the production of income?⁶¹

In respect of the first question, Waterman AJP held that “provided the act is bona fide done for the purpose of carrying on the trade which earns the income the expenditure attendant on it is deductible”⁶² and in respect of the second question, Waterman AJP held that “all expenses attached to the performance of a business operation bona fide performed for the purpose of earning income are deductible whether such expenses are necessary for its performance or attached to it by chance or are bona fide incurred for the more efficient performance of such operation provided they are so closely connected with it that they may be regarded as part of the cost of performing it.”⁶³

In *Joffe and Co (Pty) Ltd v CIR*,⁶⁴ the taxpayer, an engineering company, was held liable in a claim of negligence and attempted to deduct the damages paid from its income. The court used the term “necessary concomitant” in describing the relationship of the expenditure to the income earning operations of the taxpayer⁶⁵ and on application of this test to the facts, the court found that the damages paid were not deductible.

In *Sub-Nigel Ltd v CIR*,⁶⁶ the taxpayer, a mining company, attempted to deduct premiums paid on loss of profits insurance policies. It was argued by

⁶¹ *PE Tramway* case (note 51) at page 245.

⁶² *Ibid.*

⁶³ *Ibid* at page 246.

⁶⁴ 1946 AD 157, hereinafter referred to as the “*Joffe case*”.

⁶⁵ *Ibid* at page 163.

⁶⁶ 1948 (4) SA 580 (A), hereinafter referred to as the “*Sub-Nigel case*”.

the Commissioner that the expense of paying the premiums did not produce an income and the expense was therefore not incurred in the production of income and as a result not deductible. The court held that the question is not whether a particular expense produced a particular income but rather whether the expense was incurred for the *purpose* of producing an income.⁶⁷ Based on the reasoning in this judgment, this requirement of the general deduction formula is not merely a factual test and one should consider the intention of the expense and whether the expense was incurred for the purpose of producing an income.

In the case of *CIR v Nemojim (Pty) Ltd*⁶⁸ Corbett JA found that the expenses sought to be deducted had a dual purpose and he distinguished between expenses which were deductible and those which were not deductible in terms of the general deduction formula. Based on this reasoning, Corbett JA applied a formula to apportion the expenses and as a result allowed certain of the expenses to be deducted. This case is the authority for applying the principle of apportionment to the deduction of expenses under the general deduction formula.

4.1.3 Not of a capital nature

The number of court cases which have dealt with the distinction between capital and revenue gives credence to the fact that the distinction is not an easy one to make and as a result one will need to consider the facts of each individual case in order to determine whether the expense is of a capital nature or a revenue nature.

In the case of *CIR v George Forest Timber Co Ltd*,⁶⁹ the taxpayer, a timber

⁶⁷ Ibid at page 394.

⁶⁸ 1983 (4) SA 935 (A).

⁶⁹ 1924 AD 516.

merchant, sought to deduct the purchase price of the land on which the trees grew when it sold timber. The court considered whether the expense was of a capital or a revenue nature and Innes CJ held that “[t]here is a great difference between money spent in creating or acquiring a source of profit, and money spent in working it. The one is capital expenditure and the other is not ...”⁷⁰

In *SIR v Cadac Engineering Works (Pty) Ltd*,⁷¹ the taxpayer, a company with a registered licensed design, brought a court application against a third party which was selling a design similar to that of the taxpayer. The taxpayer attempted to deduct the costs of this court application as an expense in terms of the general deduction formula. The court held that there was an insufficient link between the expenditure and the income-earning structure of the taxpayer and the expense was therefore not deductible. In his judgment, Ogilvie Thompson JA stated that “the mere circumstance that a payment has neither created a new asset nor made any addition to any existing asset is not necessarily conclusive in favour of such payment being a revenue expense.”⁷²

In the English case of *British Insulated and Helsby Cables Ltd v Atherton*,⁷³ the court enquired whether the expense was incurred with a view to creating an enduring benefit and if an enduring benefit was created, it would be indicative of the capital nature of the expense. The court in the case of *CIR v African Oxygen Ltd*⁷⁴ adopted this test into South African law.

The main test developed by our courts in determining whether an expense is of a capital nature or a revenue nature was formulated in the case of *New*

⁷⁰ Ibid at page 526.

⁷¹ 1965 (2) SA 511 (A).

⁷² Ibid at page 522-523.

⁷³ 1926 AC 205.

⁷⁴ 1976 (4) SA 522 (A).

State Areas Ltd v CIR.⁷⁵ The taxpayer in this case was a mining company which sought to deduct the cost of constructing sewers. In his judgment Waterman CJ held that there was a distinction between floating capital and fixed capital. The court stated that the question is whether the “expenditure ... should properly be regarded as part of the cost of performing the income earning operations or as part of the cost of establishing or improving or adding to the income-earning plant or machinery.”⁷⁶ Waterman CJ continued to state that the “true nature of each transaction must be inquired into in order to determine whether the expenditure attached to it is capital or revenue expenditure. Its true nature is a matter of fact and the purpose of the expenditure is an important factor.”⁷⁷

In the case of *Rand Mines (Mining and Services) Ltd v CIR*,⁷⁸ the taxpayer was a company which was part of a larger group of companies and provided management services to the group. The group of companies acquired a new mining company and required the taxpayer to pay millions of rands in order to acquire the management contract with this new mining company. The taxpayer in this case sought to deduct this expenditure under the general deduction formula. The court considered a number of factors which indicated that the expenditure in issue was of a capital nature and therefore not deductible, including the following:

- the management contracts themselves were not the stock-in-trade of the taxpayer’s and it was the managements services provided by the taxpayer which were its stock-in-trade;⁷⁹
- the acquisition of the management contracts were part of the income earning structure of the taxpayer as without the contracts, the taxpayer would not have the opportunity to generate an income;⁸⁰ and
- on a balance of the facts, the expenditure in issue was more closely related to the cost of adding to or enhancing the income earning structure of the taxpayer’s business than to the cost of performing its

⁷⁵ 1946 AD 610, hereinafter referred to as the “*New State Areas case*”.

⁷⁶ Ibid at page 620-621.

⁷⁷ Ibid at page 627.

⁷⁸ 1997 (1) SA 427 (A), hereinafter referred to as the “*Rand Mines case*”.

⁷⁹ Ibid at page 434.

⁸⁰ Ibid at page 435.

income earning operations.⁸¹

It is true that there is no halfway house between capital and revenue and that if an expense is not of a capital nature then it must be of a revenue nature.⁸² However, in the case of *SIR v Guardian Assurance Holdings (SA) Ltd*,⁸³ the court apportioned an expense into a capital and revenue component. Muller JA held that “in the case 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.”⁸⁴

In the recent case of *BP Southern Africa (Pty) Ltd v Commissioner, SARS*,⁸⁵ the taxpayer sought to deduct the royalties paid by it to BP worldwide for the use of the trademarks, etc relating to the BP brand. The court had to decide whether the expenditure sought to be deducted was of a capital or a revenue nature and in reaching its decision the court considered previous case law on this issue and found that the expenditure was of a revenue nature. In his judgment, Poonan JA stated that “[t]he anticipated and actual recurrent nature of the disputed payments is a strong indicator that they related to revenue rather than capital. The recurrent cost of procuring the use of something which belongs to another is usually recognised as being of a revenue nature.”⁸⁶

4.1.4 Trade requirement

“Trade” is defined in section 1 of the Income Tax Act as “every profession, trade, business, employment, calling, occupation or venture, including the

⁸¹ Ibid at page 436.

⁸² Huxham and Haupt (note 48) at 98.

⁸³ 1976 (4) SA 522 (A), hereinafter referred to as the “*Guardian Assurance case*”.

⁸⁴ Ibid at page 534.

⁸⁵ 69 SATC 79, hereinafter referred to as the “*BP case*”.

⁸⁶ Ibid at para 14.

letting of any property and the use of or the grant of permission to use any patent or any design or any trade mark or any copyright, or any other property which is of a similar nature.”⁸⁷

Both section 11(a) and section 23(g) of the Income Tax Act refer to “trade” and it has been argued that as the trade requirements of section 23(g) are more onerous than that of section 11(a), “[a] taxpayer passing the test of s 23(g) simultaneously passed the trade requirement embodied in s 11(a).”⁸⁸

In the preamble to section 11, reference is made to income derived from “carrying on any trade”⁸⁹ and if one was to read section 11(a) together with the preamble to section 11, it could be interpreted to mean that the expenses sought to be deducted “must be incurred in the production of income derived from the carrying on of a trade.”⁹⁰

Section 23(g) of the Income Tax Act states that “[n]o deductions shall in any case be made in respect of ... any moneys, claimed as a deduction from income derived from trade, to the extent to which such money were not laid out or expended for the purposes of trade.”⁹¹ It should be noted that section 23(g) was amended in 1992 with the result that much of the case law relating to the interpretation of this section deal with the former section 23(g). Prior to its amendment, section 23(g) prohibited the deduction of expenses not “wholly or exclusively laid out or expended for the purposes of trade” and the effect of the amendment to section 23(g) is that apportionment between expenses incurred for a trade and non-trade purposes is allowed.⁹²

⁸⁷ Income Tax Act, s 1.

⁸⁸ Trevor Emslie et al *Income Tax Cases and Materials* 3ed (2001) 406.

⁸⁹ Income Tax Act, s 11.

⁹⁰ Emslie et al (note 88) at 406.

⁹¹ Income Tax Act, s 23(g).

⁹² Emslie et al (note 88) at 405.

In the case of *De Beers Holdings (Pty) Ltd v CIR*,⁹³ Corbett JA held that “the absence of profit does not necessarily exclude a transaction from being part of the taxpayer’s trade; and correspondingly moneys laid out in a non-profitable transaction may nevertheless be wholly and exclusively expended for the purposes of trade within the terms of s 23(g). Such moneys may well be disbursed on the grounds of commercial expediency or in order indirectly to facilitate the carrying on of the taxpayer’s trade.”⁹⁴ The court in this case also compared the requirements of trade and production of income and held that an expense must satisfy both requirements in order to be deductible under the general deduction formula.⁹⁵

In *CIR v Pick ‘n Pay Wholesalers (Pty) Ltd*,⁹⁶ the taxpayer sought to deduct an amount paid to a charity on the basis that the payment constituted an advertising expense. Nicholas AJA held that the taxpayer had a dual purpose in making the payments, namely, a philanthropic purpose and a business purpose.⁹⁷ As this case was decided prior to the amendment of section 23(g), the fact that the expense was not incurred wholly and exclusively for the purpose of trade resulted in the expense not qualifying as a deductible expense.

In his critique on the decision of Nicholas AJA in the *Pick ‘n Pay* case, Emslie considered the distinction between purpose and effect and stated that while the taxpayer in the *Pick ‘n Pay* case did “envisage a philanthropic effect, its purpose ... was solely to enhance its business image.”⁹⁸ Emslie went further to state that “one would expect that everything a public company does is for the purpose of its trade.”⁹⁹

⁹³ 1986 (1) SA 8 (A), hereinafter referred to as the “*De Beers case*”.

⁹⁴ *Ibid* at page 36.

⁹⁵ *Ibid* at page 34.

⁹⁶ 1987 (3) SA 453 (A) hereinafter referred to as the “*Pick ‘n Pay case*”.

⁹⁷ *Ibid* at page 471.

⁹⁸ TS Emslie ‘Is generosity a bar to tax deductibility’ (1988) 105 South African Law Journal 214 at 220.

⁹⁹ *Ibid* at 221.

It was the decision in *Solaglass Finance Co (Pty) Ltd v CIR*¹⁰⁰ which led the legislature to amend section 23(g) of the Income Tax Act. In this case the taxpayer was a subsidiary company within a group of companies which was set up with the object of loaning money to the other companies within the group. As it was a money-lender, the losses incurred by the taxpayer were of a revenue nature and therefore constituted deductible expenses. However, in his judgment, Botha JA considered the “nature of the activities carried on, the nature of the expenditure and the closeness (or remoteness) of the connection between the expenditure and the benefit derived therefrom by the group”¹⁰¹ and held that the taxpayer had a dual purpose in making loans, namely, to make a profit and to further the interests of the group of companies and due to the fact that this second purpose was not wholly and exclusively for the purposes of trade, the losses incurred by the taxpayer were not deductible.¹⁰²

In the case of *ITC 1404*,¹⁰³ Friedman J considered the concept of profit as it relates to the trade requirement and held that “[w]here there is no reasonable prospect of the taxpayer making a profit, then, in the absence of any other factors, the Court may well be entitled to infer that the purpose of the expenditure was not trade ... [b]ut what is clear is that the possibility or otherwise of earning a profit is simply a factor, perhaps the most important factor, and perhaps in the absence of anything else, a decisive factor, in considering whether or not, in particular, the requirement of s 23(g) has been met.”¹⁰⁴

4.2 Prohibited deductions

Notwithstanding the general deduction formula, section 23 of the Income Tax

¹⁰⁰ 1991 (2) SA 257 (A).

¹⁰¹ *Ibid* at page 284.

¹⁰² *Ibid* at page 282.

¹⁰³ 48 SATC 1, hereinafter referred to as “*ITC 1404*”.

¹⁰⁴ *Ibid* at page 3.

Act provides that the following expenses cannot be deducted from the gross income of a taxpayer, namely:

- private, maintenance and domestic expenses;
- recoverable expenses under a contract of insurance, guarantee, security or indemnity;
- statutory interest, penalties and taxes;
- provisions and reserves for future expenditure;
- expenses incurred to produce exempt income;
- notional expenditure;
- the costs of scholarships or bursaries granted in lieu of a salary;
- expenses incurred by labour brokers, personal service companies and personal service trusts;
- restraints of trade payments, except those in accordance with section 11(cA) of the Income Tax Act;
- expenses relating to employment income, unless such expenses are specifically allowed in terms of the Income Tax Act;
- assets acquired from government grants; and
- unlawful activities, fines and penalties.¹⁰⁵

4.3 Special allowable deductions

In addition to deductions allowed in terms of the general deduction formula, the Income Tax Act also specifies certain special deductions which would not ordinarily qualify for deduction in terms of the general deduction formula, namely:

¹⁰⁵ Income Tax Act, s 23(a)-(o).

- annuities to former employees or partners and their dependants;¹⁰⁶
- bad debts;¹⁰⁷
- doubtful debts;¹⁰⁸
- donations to public benefit organizations and other qualifying beneficiaries;¹⁰⁹
- finance charges;¹¹⁰
- pension, provident or benefit fund contributions by employers;¹¹¹
- future expenditure to be incurred in performance of obligations under contract from which taxpayer has derived an income;¹¹²
- leave pay;¹¹³
- legal costs;¹¹⁴
- life insurance premiums;¹¹⁵
- regional services councils and joint services board levies;¹¹⁶
- repairs on property occupied for purposes of trade and from which income is derived;¹¹⁷
- restraint of trade payments;¹¹⁸
- learnership deductions;¹¹⁹ and
- assessed losses.¹²⁰

¹⁰⁶ Income Tax Act, s 11(m).

¹⁰⁷ Income Tax Act, s 11(i).

¹⁰⁸ Income Tax Act, s 11(j).

¹⁰⁹ Income Tax Act, s 18A.

¹¹⁰ Income Tax Act, s 11(bB).

¹¹¹ Income Tax Act, s 11(l).

¹¹² Income Tax Act, s 24C.

¹¹³ Income Tax Act, s 23E.

¹¹⁴ Income Tax Act, s 11(c).

¹¹⁵ Income Tax Act, s 11(w).

¹¹⁶ Income Tax Act, s 12(8).

¹¹⁷ Income Tax Act, s 11(d).

¹¹⁸ Income Tax Act, s 11(cA).

¹¹⁹ Income Tax Act, s 12H.

¹²⁰ Income Tax Act, s 20.

4.4 Onus of proving deductibility

In terms of section 82 of the Income Tax Act, the taxpayer claiming a deduction in terms of the Income Tax Act bears the burden of proving that he is entitled to such a deduction and consequently, it is the taxpayer who will have to prove that a particular expense complies with the requirements of the general deduction formula or any special deduction allowed in terms of the Income Tax Act.

5. THE WARNER LAMBERT CASE

The *Warner Lambert* case has particular relevance to the issue being considered in this paper as it dealt with the deductibility of corporate social responsibility expenditure.

In the *Warner Lambert* case the taxpayer, a South African subsidiary company of an American parent company, was compelled to comply with certain obligations imposed on it by its parent company. In 1970, the taxpayer became a signatory to the Sullivan Code, which is a set of seven principles intended to govern American companies operating in South Africa. The principles included the “non-segregation of races in the workplace, equal and fair employment for all employees, equal pay, development of training programmes, increasing the number of disadvantaged persons in management and supervisory positions and improving the quality of employees’ lives outside the work environment ... [and] working to eliminate laws and customs that impede social, economic and political justice.”¹²¹

¹²¹ *Warner Lambert* case (note 6) at para 4.

In 1986, the United States Comprehensive Anti-Apartheid Act compelled American parent companies to ensure that their South African subsidiary companies complied with the Act, failing which the American parent company would be liable to pay fines and the directors of the parent company could also face imprisonment.

In the *Warner Lambert* case, the taxpayer argued that in order to comply with the Sullivan Code and the associated requirements of its parent company, it incurred certain expenses relating to social upliftment, including participation in national conventions, peace initiatives, information technology support, adopting schools and assisting start-up business operations.¹²² The taxpayer stated that compliance was necessary to the parent company so as to avoid political embarrassment and to protect its businesses in the United States with the result that if the taxpayer failed to comply with the Sullivan Code, the business of the taxpayer could be closed by the parent company or the parent company could sell the business of the taxpayer to a third party.¹²³ The taxpayer proved that these concerns were valid as other American parent companies had taken such action against their South African subsidiaries for failure to comply with the Sullivan Code.

In his assessment, the Commissioner disallowed the deduction of the Sullivan Code expenditure on the basis that the expenditure had not been incurred in the production of income.¹²⁴

On appeal by the taxpayer to the Special Income Tax Court under case number *ITC 1717*,¹²⁵ Davis J held that the expenditure was incurred in the production of income. However, Davis J held further that because the expenditure was incurred to protect the income earning structure of the taxpayer, the expenditure was capital in nature and the deduction of the

¹²² Ibid at para 6.

¹²³ Ibid at para 5.

¹²⁴ Ibid at para 3.

¹²⁵ 64 SATC 32.

expenditure could therefore not be allowed.

On appeal by the taxpayer to the Supreme Court of Appeal, the Commissioner argued that there were three purposes to the expenditure which the taxpayer sought to deduct in the *Warner Lambert* case, namely:

- to save the parent company of the taxpayer from embarrassment and sanctions;
- altruism; and
- to protect the income-earning structure of the taxpayer.¹²⁶

With regard to the first purpose identified by the Commissioner, Conradie JA stated that “[m]oney spent by a taxpayer in order to advance the interests of the group of companies to which it belongs is not regarded as expenditure in the production of income. The link between the expenditure and the production of income is too tenuous.”¹²⁷

With regard to the second purpose identified by the Commissioner, Conradie JA stated that “[m]oneys expended by a taxpayer from motives of pure liberality also fail to qualify as expenditure in the production of income.”¹²⁸

In considering the third purpose identified by the Commissioner, Conradie JA stated that “[i]t is quite easy to mistake the purpose of an act for its consequences”¹²⁹ and even though the “consequences of an act often proclaim its purpose,”¹³⁰ the court must look at the evidence and “[i]f there is credible evidence about a taxpayer’s purpose it is not open to the Court to

¹²⁶ Warner Lambert case (note 6) at para 10.

¹²⁷ Ibid at para 11.

¹²⁸ Ibid.

¹²⁹ Ibid at page 13.

¹³⁰ Ibid at para 14.

turn what is in reality a consequence into a purpose and ascribe that to the taxpayer.”¹³¹

The court held that “[t]o qualify as moneys expended in the course of trade, an outlay does not itself have to produce a profit.”¹³²

Based on the foregoing and the facts before the court, the court found that the “Sullivan Code expenses were bona fide incurred for the performance of the [taxpayer’s] income producing operation and formed part of the cost of performing it. The social responsibility expenditure was therefore incurred for the purposes of trade and for no other.”¹³³

A factor which the court took into consideration in reaching its decision was the different treatment accorded to the different forms of Sullivan Code expenditure. In the *Warner Lambert* case it was only the social responsibility expenditure which was a problem as the other expenditure relating to the Sullivan Code satisfied the requirements of the general deduction formula and was therefore deductible. In this regard, the court held that if the purpose of both the deductible expenditure and the contested expenditure was the same then the tax treatment of both should also be the same.

With regard to the decision of the court a quo in relation to the capital nature of the expenditure, Conradie JA held that the taxpayer’s income earning structure was already established and periodic payments were required to protect its earnings.¹³⁴ The court likened these expenses to premiums on insurance policies, which are of a revenue nature, and as result the court concluded that the expenditure in the *Warner Lambert* case was of a revenue

¹³¹ Ibid.

¹³² Ibid at para 16.

¹³³ Ibid.

¹³⁴ Ibid at para 18.

nature.¹³⁵

Emslie, in a brief commentary on the *Warner Lambert* case, stated that the reasoning of the court in this case “may in appropriate circumstances apply also to equivalent types of expenditure incurred in modern South Africa to comply with legislative obligations or commercial exigencies which entail expenditure that might be classified under the rubric of ‘social responsibility.’”¹³⁶

6. RECENT DEVELOPMENTS

In May 2009 the South African Revenue Service¹³⁷ issued a binding class ruling in accordance with section 76R of the Income Tax Act and in respect of expenditure incurred on corporate social investment programmes.¹³⁸

In terms of section 76R of the Income Tax Act, a taxpayer can apply to SARS for a binding class ruling regarding the application or interpretation of the Income Tax Act to a specific class of persons in respect of a proposed transaction. Such rulings can be published by SARS but without revealing the identity of the applicants or class members.¹³⁹

The binding class ruling issued in May 2009 was the result of an application by a South African holding company and its subsidiary companies,¹⁴⁰ which intended to enhance its corporate social investment programme in order to comply with the BEE scorecard applicable to the class members.

¹³⁵ Ibid.

¹³⁶ Trevor Emslie et al *Supplement to Income Tax Cases and Materials* 3ed (2008) 65.

¹³⁷ Hereinafter referred to as “SARS”.

¹³⁸ SARS Binding Class Ruling dated 12 May 2009 under reference number BCR002. Available at www.sars.gov.za [Accessed 9 February 2010].

¹³⁹ Income Tax Act, s 76O.

¹⁴⁰ Hereinafter jointly referred to as the “class members”.

In order to comply with the socio-economic development element of the Codes of Good Practice, the class members were required to spend 1% of their net profit after tax on corporate social investment programmes. The scheme which the class members intended to undertake was that it would provide bursaries to persons from underprivileged backgrounds. The structure of this scheme would involve the group of companies as a whole and the authority would be exercised by the holding company to manage the process of identifying recipients and making recommendations as to their applications. The final decision would be taken by the executive committee of the holding company and each class member would then be required to contribute to the scheme in accordance with the decision of the executive committee of the holding company.

The ruling of SARS was that expenditure incurred by the class members in complying with the requirements of the Codes of Good Practice and in respect of the corporate social investment programmes undertaken by the class members would be deductible under the general deduction formula, subject to the following conditions:

- the deduction claimed by each class member shall relate to expenditure actually incurred by the said class member for purposes of its own BEE-rating and not for purposes of the BEE-rating of the group of companies as a whole; and
- each class member claiming a deduction for expenditure related to the corporate social investment programme must carry on a trade in terms of section 23(g).

Despite the fact that the aforesaid binding class ruling is only binding as between SARS and the class members, it is submitted that the decision of SARS in this ruling is indicative of the approach which SARS could take in its treatment of corporate socio-economic development expenditure.

7. THE INCOME TAX DEDUCTIBILITY OF CORPORATE SOCIO-ECONOMIC DEVELOPMENT CONTRIBUTIONS

Businesses within all sectors of the South African economy are required to make a contribution to corporate socio-economic development in order to comply with the Codes of Good Practice or an applicable sector code or sector charter. The effect of compliance is ultimately that of business necessity as a business is required to have a good BEE-rating in order to do business with any government entity and in respect of certain business sectors, BEE-ratings and compliance is related to the acquisition of licenses, permits, etc. required by a business to operate its business or to generate an income. In addition to these reasons for BEE compliance, there is a trend amongst businesses to have a good BEE-rating and to require their respective business suppliers to also have a good BEE-rating with the result that there is a knock-on effect to BEE compliance.

In order to qualify as a tax deductible expense in terms of the Income Tax Act, a taxpayer must prove that the corporate socio-economic contributions satisfy the requirements of the general deduction formula or qualify as a special allowable deduction in accordance with the provisions of the Income Tax Act.

In terms of the general deduction formula, the expense must be actually incurred, it must be incurred in the production of income, it must not be of a capital nature and it must be derived from a trade carried on by a taxpayer.

The case law interpreting the requirements of the general deduction formula have been discussed in detail above and in applying these requirements to the issue at hand, due consideration must be given to the opinions and

interpretations of the learned judges and academics referred to above.

With regard to the requirement that the expense must be actually incurred, there appears to be nothing inherent in corporate socio-economic development contributions that would prevent such contributions from complying with this requirement. The reasons for this assumption are as follows:

- In terms of the definition of “approved socio-economic development contributions,” as contained in Schedule 1 to the Codes of Good Practice, such contributions can take the form of monetary and non-monetary contributions. This therefore conforms to the general understanding of an expense.¹⁴¹
- The facts of each case will determine whether there is an unconditional legal obligation to pay an expense (*Edgars Stores* case) and a taxpayer which seeks to deduct the corporate socio-economic development contributions must ensure that the amount sought to be deducted is not an amount which is to be incurred in the future and in respect of which the taxpayer has no unconditional legal obligation to pay. For example, a taxpayer which has a five-year corporate socio-economic development plan cannot deduct the contributions in respect of all five years in the first year, unless the taxpayer can prove that he has an unconditional legal obligation to make the said contributions for the five-year period as at the first year.
- Furthermore, it is submitted that even though it could be argued that a taxpayer’s contributions to corporate socio-economic development are not necessary, the fact of the matter is that, subject to satisfying the other components of the general deduction formula, considering the necessity of the contributions is irrelevant (*PE Tramway* case).

With regard to the requirement that the expense must be incurred in the

¹⁴¹ Madelaine Stiglingh et al (note 49).

production of income, one needs to consider the purpose of the expense (*Sub-Nigel* case) and the close connection between the expense and the income-producing operation of the taxpayer (*PE Tramway* case). On application of these considerations to corporate socio-economic development contributions, it could be argued that the purpose of the contributions is to comply with the requirements of BEE, which compliance can, in certain instances, be necessary for the performance of the business of the taxpayer (*PE Tramway* case). For example, in the case of a mining company which requires a mining license to operate its business, compliance with the Mining Charter and the MPRD Act is essential. The said mining company would therefore be compelled to contribute to socio-economic development in order to obtain the mining license and the mining company could therefore argue that the contributions are a necessary concomitant (*Joffe* case) to its mining operations and therefore qualify as an expense incurred in the production of income.

It should be noted that compliance with this requirement is dependant on the facts of each case and there could be instances in which it would be difficult to satisfy the requirement as it is likely that not all taxpayers can establish a close connection between compliance with BEE and the income-producing operations of the taxpayer.

With regard to the requirement that the expense cannot be of a capital nature, there appears to be conflicting arguments to be made in respect of the nature of corporate socio-economic development contributions. To understand these arguments, a comparison can be made between a taxpayer with a well-established business and a taxpayer in the beginning stages of establishing its business.

- In the *Warner Lambert* case, the Supreme Court of Appeal rejected the decision of the court a quo as relates to the capital nature of the corporate social responsibility expenditure and found that the expenditure was of a revenue nature. The court's reasoning was that

the income earning structure of the taxpayer was already established and periodic payments were required to protect its earnings. The court also likened the expenditure in question with that of insurance premiums. It would appear that the reasoning of the court in the *Warner Lambert* case could assist a taxpayer with a well-established business to prove that the corporate socio-economic contributions were of a revenue nature.

- In contrast, a taxpayer which is in the beginning stages of establishing its business may be bound by the decision of the Appellate Division in the *Rand Mines* case. In this case, the court found that the acquisition of certain contracts were part of the income-earning structure of the taxpayer as without the contracts, the taxpayer would not have an opportunity to generate an income. If one were to apply this reasoning to the aforementioned taxpayer, it could be argued that the corporate socio-economic development contributions of the taxpayer were part of the taxpayer's income-earning structure as the taxpayer was dependant on a good BEE-rating in order to generate an income and as a result the contributions were of a capital nature. A taxpayer in such a situation could attempt to rely on the recurrent nature of the contributions to be made in order to prove that the contributions were in fact of a revenue nature (*BP* case).

Notwithstanding the conflicting arguments to be made in respect of the capital nature of corporate socio-economic development contributions, it should be noted that the true nature of the expense is a matter of fact (*New State Areas* case) and furthermore, an apportionment is possible if it is found that an expense is partly of a revenue nature and partly of a capital nature (*Guardian Assurance* case).

With regard to the trade requirement, it is clear that an absence of profit does not exclude a transaction from satisfying this requirement (*De Beers* case, *ITC 1404* and *Warner Lambert* case). This is an important consideration as

corporate socio-economic development contributions are by their very nature not intended to produce a profit.

In the *Warner Lambert* case the court distinguished between purpose and consequence and stated that these two concepts should not be mistaken when determining the trade purpose of an expense. It is submitted that the distinction between purpose and effect, as stated by Emslie in his commentary on the *Pick 'n Pay* case, is identical to the distinction made in the *Warner Lambert* case. Based on the foregoing distinction, it could be argued that even though the consequences or effects of corporate socio-economic contributions could entail certain non-trade elements, the purpose for which these contributions are made are related to the trade of the taxpayer and therefore deductible.

The introduction of apportionment into section 23(g) has the result that in a case where it is found that there is a dual purpose to an expense (*Pick 'n Pay* case), the expense will be deductible to the extent of the trade purpose thereof and it is therefore possible that a portion, if not the entire expense, could be deductible in such a case.

With regard to the applicability of the special allowable deductions to the deduction of corporate socio-economic development contributions, one would need to consider the facts of each situation. It should, however, be noted that special consideration should be given to section 18A of the Income Tax Act, which deals with the deduction of donations to public benefit organisations and other qualifying beneficiaries as it is possible that certain corporate socio-economic development contributions would qualify for deduction under this section and as a result one would not need to consider the general deduction formula.

8. CONCLUSION

In light of the foregoing discussion, it is clear that one cannot adopt a standard approach as relates to the deductibility of the broad-based black economic empowerment's corporate socio-economic development contributions. The intention and purpose of the taxpayer and the facts of each case are key factors in determining whether the corporate socio-economic development contributions of a particular taxpayer are deductible.

The judgment of the Supreme Court of Appeal in the *Warner Lambert* case as well as the Binding Class Ruling issued by SARS are strong indicators of the direction in which the deductibility of these contributions are headed and it is only a matter of time before this issue will be before our courts for deliberation.

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9. REFERENCES

9.1 Primary Sources

South African Cases

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