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*“The tax deductibility of penalties levied in  
terms of the Competitions Act 89 of 1998  
and related expenditure,  
namely - interest expenditure and legal fees”*



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In fulfillment of the requirements of: CML6015W

Research dissertation presented for the approval of Senate in fulfilment of part of the requirements for the Postgraduate Diploma in Tax Law in approved courses and a minor dissertation. The other part of the requirement for this qualification was the completion of a programme of courses.

I hereby declare that I have read and understood the regulations governing the submission of Post Graduate Diploma 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 \_\_\_\_\_

Dated 14 February 2010

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### **Introduction and overview:**

In the recent Pioneer foods case, on 3 February 2010, the Competition Tribunal imposed a penalty on Pioneer foods for its role in a bread cartel and ordered Pioneer to desist from such conduct forthwith. The cartel involved the four primary bakeries Tiger (Albany), Premier (Blue Ribbon), Foodcorp (Sunbake) and Pioneer, which owns Sasko and Duens bakeries. Together the four bakeries enjoy a market share of between 50-60% of the domestic bread market in South Africa. The penalty is an amount of R195, 718, 614 and Pioneer has 20 business days from the date of the ruling to pay this penalty.<sup>1</sup>

'The largest penalty to date has been the R250 million fine imposed on Sasol Chemical Industries in the consent and settlement agreement of cartel conduct in fertiliser related products. The Tribunal imposed a higher fine of R692 million on Mittal Steel SA in 2007 for excessive pricing, but the Competition Appeal Court set aside the decision and remitted the matter to the Tribunal, which is yet to issue an amended decision.'<sup>2</sup>

From 2002 to 2009 (inclusive) the Competition Tribunal imposed 38 penalties for contravention of the Competition Act No. 89 of 1998. These cases often involved lengthy legal proceedings drawing out for up to two years with vast amounts of expenditure spent on legal fees and advice. With the short time period in which a penalty has to be settled, companies often seek debt financing, resulting interest being incurred.

With penalties of such large figures and a great deal of press around recent cases, the enquiring tax mind is sure to ask, 'But what of the tax consequences?'

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<sup>1</sup> *Competition Commission v Pioneer Foods (Pty) Ltd* (2010) Competition Tribunal

<sup>2</sup> 'Ten years of enforcement by the South Africa competition authorities - Unleashing Rivalry' published by the Competition Commission South Africa and Competition Tribunal South Africa in 2009

This paper will critically evaluate the tax deductibility of these penalties levied in terms of the Competition Act No 89 of 1998 and two commonly related expenditures. The two expenditures to be examined are the legal fees incurred in defending against the penalties and any interest expense incurred on the borrowing of funds to finance such penalties.

In evaluating the above, this paper will refer to the relevant sections of the Income Tax Act No.58 of 1962 ("Act"), the Competitions Act No. 89 of 1998 ("Competition Act"), relevant case law and public policy.

The structure of this paper is as follows:

Part A evaluates the tax deductibility of the penalties themselves. This deductibility is assessed in terms of the general deduction formula, section 11 (a), and its components. Public policy, the principles that underpin the legal system, is also discussed and the extent to which the allowing of a tax deduction for penalties may be contrary to such public policy. Then a specific prohibition section 23 (o)(ii) is discussed. This section, specifically enacted to disallow the deduction of fines and penalties for unlawful actions, is evaluated to determine its application to an administrative penalty levied in terms of the Competitions Act.

Part B and C seek to examine the deductibility of the two commonly related expenditures to penalties levied in terms of the Competition Act, namely the legal fees and interest. The Income Tax Act provides specific sections relating to the deductibility of these two expenditures and the prohibition section 23(o) is not of application. Firstly, in Part B, the legal fees in defending against a potential penalty are evaluated. Legal fees are specifically dealt with in section 11 (c) and this section along with related case law is discussed.

When borrowed funds are used to finance the payment of a Competition penalty, interest expenditure is incurred. Part C evaluates the deductibility of this interest in terms of the specific section 24J along with public policy. Two different types of borrowing, general and specific, are discussed and a brief look at safer ways to structure an entity's financing so as to be more tax efficient are made.

## Part A: Are Competition Penalties Deductible?

### 1. General deduction formula s11(a) and related case law

Perhaps the most well known of the sections to the Act is s11 (a). This section provides for general deductions for which a specific deduction is not available. There is no specific deduction available for fines or penalties and one must therefore refer to s11 (a). Although a general deduction, it is not without its own qualifying criteria. In order for expenditure to be deductible under this section it needs to be:

- Expenditure and losses actually incurred
- In the production of income
- Not of a capital nature
- Expended for the purposes of trade

This last requirement is an overriding principle which applies to all section 11 deductions and is reinforced in s23 (g). Section 23 (g) is a prohibitive section which reads as follows:

‘[No deduction 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 moneys were not laid out or expended for the purposes of trade.’

This paper will now discuss each of the above criteria with reference to applicable case law before moving on to add the public policy debate and s23(o).

#### “Expenditure actually incurred”

‘Actually incurred’ in this context has been determined in case law not to refer to ‘actually paid’, but rather to the existence of an absolute and unconditional legal liability to pay.<sup>3</sup>

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<sup>3</sup> *Port Elizabeth Electric Tramway Co Ltd v Commissioner for Inland Revenue* 1936 CPD 241, 8 SATC 13 at 244

It is clear that when a penalty has been imposed by the court in terms of the Competition Act that there is an absolute and unconditional legal liability to pay and as such no further discussion of this requirement will be made for the purposes of this paper.

“In the production of income”

The requirement for the expenditure to be in the production of income requires a more critical evaluation. ‘Expenditure *per se* does not produce income.’<sup>4</sup> It is actions and activities that produce income and the question which arises is whether or not the expenditure incurred is closely enough related to that income.<sup>5</sup>

This method of determining whether the expenditure is in the production of income was established in the *Port Elizabeth Electric Tramway* case of 1936.<sup>6</sup> The facts of this case involved the tramway company obliged to pay compensation to the widow of an employee who was killed during the course of his employment. Discussing how to determine whether an expense is “in the production of income”, the court stated 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.’<sup>7</sup>

Thus, the test for whether expenditure is in the production of income involves a two step inquiry. Firstly, the act to which the expenditure is attached must be performed in the production of income. Secondly, the expenditure in question

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<sup>4</sup> T S Emslie et al *Income Tax Cases & Materials* 3ed (2001) at 329

<sup>5</sup> *Port Elizabeth Electric Tramway Co Ltd v Commissioner for Inland Revenue* 1936 CPD 241

<sup>6</sup> *supra* (note 5)

<sup>7</sup> (note 5) at 246

must be so closely linked to such act that it can be regarded as part of the cost of performing it.<sup>8</sup>

In *Rendles* case, 'attached to it by chance' was further clarified to mean that the 'risk of the mishap giving rise to the expenditure [must be] inseparable from or a necessary incident of the carrying on of the particular business.'<sup>9</sup>

But what about penalties as a result of unlawful business practices?

In the *Alexander von Glehn* case, a leading case on fines and penalties in the United Kingdom, the Court of Appeal considered that, because the fine was imposed on the company for breaking the law, the expense could not be connected with or arising out of the company's trade.<sup>10</sup>

In *Mann v Nash*, the court referred to *Alexander von Glehn*, and observed that:

'[T]he decision in the case was that payment of those penalties was nothing to do with the trade or business; it was not an expense for the earning of the profits, but it was an expense in the form of an inconvenience which supervened later when the profits were made, because illegality had been committed in the course of earning them.'<sup>11</sup>

These early United Kingdom decisions suggest that a deduction is denied on the basis that the required statutory connection or nexus between the fine/penalty and trading is absent.<sup>12</sup>

In the South African *Port Elizabeth Electric Tramway* case, *Watermeyer* AJP qualified his statement that: '[P]rovided 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.' In qualification of the above he stated that, '[I]f the act done is unlawful or negligent and the attendant expense is occasioned by the

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<sup>8</sup> T S Emslie et al (note 4) at 330

<sup>9</sup> T S Emslie et al (note 4) at 582 on case *COT v Rendle* 1965 (1) SA 59 (SRAD),

<sup>10</sup> *IRC v Alexander von Glehn and Co Ltd* (1919) 12 TC 233

<sup>11</sup> (1932) 16 TC 523 at 529

<sup>12</sup> Interpretation Statement 09/01, '*Fines and penalties – Income Tax deductibility*' at 3 available at <http://www.ird.govt.nz/technical-tax/interpretations/> (accessed 30 January 2010)

unlawfulness or, possibly, the negligence of the act, then probably it would not be deductible.’<sup>13</sup>

There have however also been South African court cases as far back as 1918, which raised the argument that expenditure brought about through unlawful actions may indeed be deductible. The *Delagoa Bay Cigarette Co Ltd* case is the authority for the proposition that expenditure incurred in producing income, from immoral, illegal or ultra vires activities, may be deductible.<sup>14</sup> In this case the court stated that,

‘If the income itself is taxable it follows I think that if the [expenditure] would have been a legitimate deduction, had the business been legal, they would equally be a legitimate deduction if the business is illegal. The deductions permitted by our statute are not made to depend on any question of legality or illegality... Indeed it seems common sense that if illegal profits are taxable they must be subject to the same deductions as if they were legal.’<sup>15</sup>

When considering an income producing transaction, which constitutes unlawful behaviour, one must differentiate between the business operation and the unlawful behaviour, which is committed coincidentally to the business operation. This was stated in *ITC 1199* where the court further stated that ‘...the nature and character of a fine as a punishment exacted by the State are such that it could not properly, naturally or reasonably be regarded as part of the cost of performing the business operation.’<sup>16</sup>

The court cited with approval the following passage from the Australian case of *Herald & Weekly Times Ltd*:

‘The penalty is imposed as a punishment of the offender considered as a responsible person owing obedience to the law. Its nature severs it from the expenses of trading. It is inflicted on the offender as a personal deterrent, and it is not incurred by him in his character of trader.’<sup>17</sup>

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<sup>13</sup> (note 5) at 17

<sup>14</sup> : G Goldswain ‘Illegal activities’ *Tax Planning* (2008) v 22 No 6 at 143

<sup>15</sup> *Commissioner for Inland Revenue v Delagoa Bay Cigarette Co Ltd* (1918) TPD 32 SATC 47 at 49

<sup>16</sup> (1973) 36 SATC 16 (T) at 20-21

<sup>17</sup> *Herald & Weekly Times Ltd v Federal Commissioner of Taxation* (1932) 2 ATD 169 at 172

More recently, in a Canadian court case, the court stated that:

'[O]ne legitimate test of whether fines should be deductible as a business expense is that of avoidability of the offences... The question here is not: could the taxpayer have run his business more cheaply? It is: could the taxpayer have reasonably been expected to run his business in consistent conformity to this kind of law?'<sup>18</sup>

In applying this Canadian ruling to the deductibility of Competition penalties one is led to the question of whether or not businesses can be reasonably expected to operate in line with the rules of the Competitions Act.

Due to the nature of the actions for which Competition penalties are imposed and that the penalties are preventative in nature, it is reasonable to assume that in the majority of circumstances, businesses can reasonably be expected to operate within these rules. Penalties paid in contravention of the Competitions Act are not a necessary cost of doing business in the same way that negligence is not.

The trade requirement:

Prior to its amendment in 1993 the trade requirement, found in s23(g), required expenditure to be wholly and exclusively for purposes of trade in order to be deductible. Now amended this section provides that expenditure is not deductible *to the extent* that it is not laid out for the purposes of trade and therefore allows for apportionment where expenditure is both for a trade and non-trade purpose. Although mostly prior to this amendment, case law is still useful in determining what does and does not constitute a trade purpose.

In general expenditure that is laid out for purposes of making a profit is always considered to be for purposes of trade. However,

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<sup>18</sup> *Amway of Canada v The Queen* [1996] 2 CTC 162 at 172

'the absence of a profit does not necessarily exclude a transaction from being part of the taxpayer's trade...Where, however, a trader normally carries on by buying goods and selling them at a profit, then as a general rule a transaction entered into with the purpose of not making a profit, or in fact registering a loss, must, in order to satisfy s 23(g), be shown to have been so connected with the pursuit of the taxpayer's trade, e.g. on ground of commercial expediency or indirect facilitation of the trade, as to justify the conclusion that, despite the lack of profit motive, the moneys paid out under the transaction were wholly and exclusively for the purposes of trade'.<sup>19</sup>

The paying of penalties does not in itself produce income however the company is legally bound to pay the penalty and failure to do so could result in forced closure, liquidation, loss of licences and a number of other consequences not conducive to a good trading situation.

As stated in the *Warner Lambert* case, 'To qualify as moneys expended in the course of trade, an outlay does not itself have to produce a profit.'<sup>20</sup>

However, in the most recent case to consider the deductibility of fines the judge stated,

'[It seems] illogical to seek to deduct fines relating to a breach of the law as if they were a business expense, because they relate to activities which do not conform to the law and so are not within the permitted scope of the business. I consider that a penalty/fine arising from a taxpayer's illegal activities...cannot have a sufficient nexus with the taxpayer's income earning process so as to create deductibility for that cost of the fine.'<sup>21</sup>

### Is it of a capital nature?

Although this is a matter often overlooked when discussing the deductibility of such penalties it is worth considering. As mentioned above, the penalties may not be in the production of income themselves, but rather are paid in preservation of the environment conducive to the production of income. One

<sup>19</sup> *De Beers Holdings (Pty) Ltd v CIR* 1986 (1) SA 8 (A), 47 SATC 229

<sup>20</sup> *Warner Lambert SA (Pty) Ltd v Commissioner, SARS* 2003 (5) SA 344 (SCA) at 16

<sup>21</sup> *Case Z6* (2009) 24 NZTC 14,068

may argue that this preservation of the income earning structure is therefore of a capital nature<sup>22</sup>, however the Supreme Court of Appeal has ruled this not to be so. In the *Warner Lambert* case it was ruled that expenditure incurred to preserve, or avert the risk of harm to, the income earning structure are payments of a revenue nature, in the same manner as insurance payments are of a revenue nature.<sup>23</sup> This case allows one to draw the distinction between payments to create an income earning structure – capital nature, and payments made to preserve it – revenue nature.

If Competition penalties are not paid the business would be foreclosed. Such payments are therefore of a revenue nature as they protect the income earning structure.

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<sup>22</sup> *Smith v Secretary for Inland Revenue* (1968) 30 SATC 35 at 37

<sup>23</sup> (note 20) at 18

## 2. Public Policy

'Public policy is based on the premise that the law should serve the public interest. It assists judges in the concurrent development of the common law and statutory interpretation...

Public policy is a collection of principles that judges consider the law has a duty to uphold. This distinction is important because, although a rule of law binds, a principle merely guides. If an Act incorporates a rule, that rule is binding for the purposes of the Act. In contrast, as a principle is not binding, it leaves scope for more flexible application depending on the circumstances of a particular case. However, while there is flexibility in the application of judicial principles, it is expected that judges take heed of the principles in relevant cases.'<sup>24</sup>

In the Australian *Mayne Nickless* case<sup>25</sup>, the taxpayer, a transport operator who ran armoured cars, had incurred a multitude of fines and penalties related to a variety of motoring offences. *Ormiston J* examined all the relevant authorities and concluded that none of the outgoings was deductible for reasons best described as public policy reasons.

'The critical feature of the fines and penalties are that they are imposed for purposes of the law in order to punish breaches thereof... This deterrent aspect makes it undesirable for a fine to be deductible, whether for serious or minor regulatory offences... To allow such deductions is seen as frustrating the legislative intent, as the punishment imposed will be seen to be, diminished or lightened.'<sup>26</sup>

The above judgment was cited with approval in the South African Tax Court by *Melamet J* in 1990.<sup>27</sup>

Another public policy argument is that allowing a tax deduction for such fines and penalties would enable the offender to share such expenses with the very public the laws are enacted to protect.

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<sup>24</sup> (note 12) at 11-12

<sup>25</sup> *Mayne Nickless Ltd v FCT* (1984) 15 ATR 752

<sup>26</sup> *supra* at 772-773

<sup>27</sup> *ITC 1490* (1990) 53 SATC 108 (T) at 113-114

To allow deductibility of fines and penalties may also bring about inequities amongst taxpayers. In a New Zealand case it was stated that,

‘[this practice would] prefer business lawbreakers over individuals as the business lawbreaker would obtain the benefit of deductibility of the amount of the fine or penalty whereas the individual would have to bear that particular expense personally. Additionally it would tend to allow, and encourage, lawbreaking and in some instances, to even treat it as a legitimate business option resulting in deductibility.’<sup>28</sup>

‘Public policy is never static: it evolves over time. This evolution is due to the constant change in the wide sphere of interest that constitutes the public interest. For example, changes in society’s economic needs, social costs, customs, and moral aspirations can affect the public interest. Although public policy may change in response to signals from any part of society at any time, changes usually occur incrementally. This functional aspect separates public policy from rules of law.’<sup>29</sup>

As noted by *Ormiston J*,

‘Many aspects of public policy have been and remain controversial largely because the courts have attempted to express and apply policies which did not derive directly from the common law or statute, but were derived from what were said to be accepted social or economic beliefs at the time. These beliefs have not always remained constant, so that difficulties arise in determining whether ‘public policy’ can change or expand.’<sup>30</sup>

It is noteworthy that section 59(2) of the Competitions Act places a ceiling or cap on the maximum penalty that can be imposed. This is set at 10% of the offending firm’s turnover during the firm’s preceding financial year. ‘The fact that it is set out in this way and not, as in section 74, which provides a set maximum penalty for criminal offences, suggests that the legislature intended the penalty to be relative to the economic impact of the respondent in the market... This relative, as opposed to absolute cap, is more consistent with a

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<sup>28</sup> *Nicholas Nathan Ltd v CIR* (1989) 11 NZTC 6,213 at 6,217 at 9

<sup>29</sup> (note 12) at 11-12

<sup>30</sup> (note 25) at 772

deterrent than a punitive model, [as] it requires greater administrative penalties to be imposed on larger players.’<sup>31</sup>

As was well put by *van Dorsten*, a South African tax practitioner, ‘The deterrent effect of the administrative penalty would be ‘diminished or lightened’ if it were to be allowed as a tax deduction. This would result in the legislative intent behind section 59(1) of the Competition Act being frustrated. It must, accordingly, be concluded that it would be contrary to public policy to allow expenditure incurred as a result of the imposition of an administrative penalty to be deducted in terms of section 11(a) of the Act.’

Public policy plays an important role in relation to the tax deductibility of fines and penalties. From the perspective of serving the public interest, the general aim of the public policy approach to fines and penalties is understandable.

Anti-competitive behaviour is often in the production of income. One would expect this to be the case as it is indeed the motivation behind such illegal actions. Due to this, and that usually most of the other s11(a) requirements can be shown to be met, one can conclude that it is often easier for judges to refer to public policy in the prohibition of such deductions.

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<sup>31</sup> J van Dorsten “The tax implications of competition penalties” *Taxpayer* (2009) v 58 No 8 at 145

### 3. The prohibition section 23(o):

Section 23(o) was introduced into the Act by section 28(1)(e) of the Revenue Laws Amendment Act, No. 31 of 2005 with effect from 1 January 2006. It applies in respect of any year of assessment commencing on or after that date and reads as follows:

**'23. Deductions not allowed in determination of taxable income.**

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

(a) – (n). . . . .

(o) any expenditure incurred—

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

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

Before the introduction of s23 (o), the Act did not specifically address the non-deductibility of expenses incurred in respect of illegal activities, and the matter had to be considered under the general deduction formula (section 11(a) taking into account section 23(g)). As discussed earlier; it is often argued that bribes, fines and penalties incurred in the course of carrying on a trade are deductible for income tax purposes on the basis that they are an in the production of income and incurred in carrying out the taxpayer's trade. So as not to rely on the courts subjective application of public policy s23 (o) was introduced so as to put an end to the debate.

The policy reason for inserting section 23(o) was explained as follows in the Explanatory Memorandum to the Revenue Laws Amendment Bill, 2005:

'From a policy perspective the deduction of fines and penalties for tax purposes cannot be justified where those payments relate to unlawful activities. The granting of a deduction for fines and penalties would

reduce the burden of the penalty or fine and be contrary to the rationale of the law in terms of which it is imposed.’<sup>32</sup>

S23(o)(i) relates specifically to corrupt activities and is therefore not relevant to the scope of this paper. What must be considered is whether an administrative penalty imposed in terms of section 59(1) of the Competition Act is in fact a ‘penalty imposed as a result of an unlawful activity’, as contemplated in section 23(o)(ii) of the Act.

Neither ‘penalty’ nor ‘unlawful activity’ is defined in the Act. It is therefore prudent to apply the literal interpretation rule as established in the *Summit Industrial Corporation* case.<sup>33</sup> This rule requires words to be given their ordinary grammatical meaning, unless to do so would cause a nonsensical result or would be contrary to the intention of the legislation.

*Black’s Law Dictionary*<sup>34</sup> defines the above terms as follows:

‘Penalty’ - ‘a penalty is a sum of money which the law exacts payment of by way of punishment for doing some act which is prohibited or for not doing some act which is required to be done.’

‘Unlawful’ - ‘That which is contrary to, prohibited, or unauthorised by law. That which is not lawful. The acting contrary to, or in defiance of, the law; disobeying or disregarding the law.’

In *Rex v Laughton*, Matthews J stated:

“‘Penalty’, when used in a statute – though it may not always import a punishment for a criminal offence – does at least imply some form of sanction declared or operating by order of a court of law.’<sup>35</sup>

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<sup>32</sup> at 24

<sup>33</sup> *Summit Industrial Corporation v Claimants against the Fund Comprising the Proceeds of the Sale of the MV Jade Transporter* (1987) 2 SA 547 (A) at 596

<sup>34</sup> Bryan A. Garner *Black’s Law Dictionary* 8th ed (2004)

<sup>35</sup> 1930 NPD 47 at 53

It is clear from the dictionary and judicial definitions of the word 'penalty' that an administrative penalty falls within the ambit of the ordinary meaning of 'penalty'.<sup>36</sup>

Law has been defined as 'any law, proclamation, ordinance, Act of Parliament or other enactment having the force of law.'<sup>37</sup>

Whether or not the actions which bring about the penalty are 'unlawful' requires an examination of s59(1) of the Competition Act, which lists the only contraventions for which a penalty may be imposed. As the penalty may only be imposed on firms that contravene or disregard specific provisions of the Competition Act or orders of the Competition Tribunal or the Competition Appeal Court, and this Act is enacted by Parliament and signed by the President, there can be no doubt that such conduct is unlawful.<sup>38</sup> This was confirmed in relation to price-fixing in *American Natural Soda Ash Corporation* case, where Davis JP stated:

'The Court also upheld the decision of the Tribunal to the effect that section 4(1)(b) of the [Competition] Act rendered unlawful the setting of a selling price regardless of whether conduct which fell within the section could be justified on efficiency grounds.'<sup>39</sup>

It follows that an administrative penalty constitutes a penalty imposed as a result of an unlawful activity', as contemplated in section 23(o) (ii) of the Act and, as such, does not qualify for deduction.

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<sup>36</sup> (note 31) at 146

<sup>37</sup> J van Dorsten *Revenue words and phrases – Judicially considered*. (1989)

<sup>38</sup> (note 31) at 146

<sup>39</sup> *American Natural Soda Ash Corporation and Another v Competition Commission of South Africa and Others* (2003) 2 CPLR 221 (CAC) at 222

It is worth noting that in the *Draft Interpretation Note* on section 23(o)<sup>40</sup>, SARS has indicated, in paragraph 4.2.2, that it regards the practices prohibited by the Competition Act as unlawful acts for the purposes of section 23(o)(ii). However, interpretation notes are not enacted into law and therefore are not binding.

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<sup>40</sup> Para 4.2.2

#### 4. Conclusion for the deductibility of Competition penalties:

For many years courts have been faced with having to decide the deductibility of fines, penalties and damages incurred as a result of unlawful acts. The two approaches adopted have been that of focusing on the 'production of income' requirement, or relying on public policy. There are arguments both for and against the fines and penalties being in the production of income and there is case law to support either argument. Public policy however, does not support the deductibility of such penalties as it would diminish their punitive nature, treat business lawbreakers more favourably than non-business lawbreakers, and encourage lawbreaking as a legitimate business option.

As the application of public policy is not an exact science, but rather a more subjective approach, s23(o) was enacted to prohibit the deductions of bribes, fines and penalties relating to unlawful activities. Using the 'literal interpretation rule' for the words 'penalty' and 'unlawful' it appears evident that this prohibition section indeed encompasses fines and penalties levied by the Competition Act.

Although this paper now concludes that penalties levied by the Competitions Act 58 of 1962 are not deductible for tax purposes, an investigation into the related expenditures is still required as these are not 'fines' or 'penalties' and therefore not prohibited by s23(o).

## **Part B: Deductibility of related legal fees**

### **1. Introduction**

Legal fees are an important expense to consider and can often amount to more than the amounts of the claims, damages or penalties. In a High Court case involving a defamation charge, a taxpayer was ordered to pay damages of R35, 000 whilst his legal fees amounted to R451, 952.<sup>41</sup>

Where a case is successfully won against the Competition Commission, costs may or may not be awarded. Where costs are not awarded, legal fees will still have to be paid despite the court finding in favour of the taxpayer. As such the deductibility of the legal fees is as important, if not more so, than the penalties themselves.

This paper will now seek to examine the deductibility of these related legal fees in both the circumstances where the proceedings were found in favour of the taxpayer (i.e. no penalty paid) and where the taxpayer was ordered to pay a penalty over to the Competition Commission.

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<sup>41</sup> ITC 12459 (2009) SATC *The Taxpayer* (2009) v 58 No 8 at 152

## 2. Section 11(c) deduction and related case law

The deductibility of legal fees is governed by s11(c) of the Act and provides for the deductibility of, 'any legal expenses *actually incurred* by the taxpayer during the year of assessment in respect of any claim, dispute or action at law arising in the course of or by reason of the *ordinary operations* undertaken by him in the *carrying on of his trade*'.<sup>42</sup>

Legal fees are defined as 'being fees for the services of legal practitioners, expenses incurred in procuring evidence or expert advice, court fees, witness fees and expenses, taxing fees, the fees and expenses of sheriffs or messengers of court and other expenses of litigation which are of an essentially similar nature to any of the said fees or expenses'.<sup>43</sup>

A proviso to s11(c) then limits this deduction to so much thereof as--

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

The scope of this section is specific to the legal fees relating to the defence of having to pay penalties to the Competition Commission in terms of the Competition Act. Subsection (iii) is therefore not relevant as it relates to legal fees for proceedings in which the taxpayer seeks the receipt of payment. Subsection (iv) shall also not be discussed as it is merely an enforcement of subsections (ii) and (iii).

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<sup>42</sup> Income Tax Act No. 58 of 1962

<sup>43</sup> *supra*

From the legislation one can draw the following: In order for legal fees, actually incurred in defending against a penalty imposed to be deductible, they need to be in the *ordinary course of operations* undertaken in the *carrying on of trade*. Such legal fees must not be of a *capital nature* and furthermore must not be prohibited by proviso (ii). There is no requirement for the legal fees to be in the production of income as with section 11 (a).

The issue of whether or not legal fees are in the *ordinary course of operations undertaken in the carrying on of trade* is not one which has often come up in court. Where legal fees have been disallowed as a deduction it is usually on the basis that they are not in the production of income or are of a capital nature.

In the Port Elizabeth Electric Tramways case, legal fees were disallowed a deduction on the basis that they were not in the production of income. As this is no longer a requirement, since the enactment of section 11 (c), we can conclude that these legal fees would now be deductible, provided they are not of a capital nature.

An example of where legal fees would be of a capital nature is if they were incurred in the acquisition of a capital asset. The legal fees would therefore be of a capital nature and as such not deductible, but rather added to the base cost of the capital asset for future capital gains tax calculation.

As per the discussion in Part A (1), it has been ruled that expenditure for the preservation of income is not of a capital nature.<sup>44</sup> As discussed, the payment of a penalty imposed is in the preservation of the income earning structure of the company and hence of a revenue nature. One can infer further that expenditure incurred to minimise this revenue expenditure (penalties) is also not of a capital nature.

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<sup>44</sup> (note 20) at 18

The general rule for the deductibility of legal fees in defending a claim is that it follows the deductibility of that claim if it were to be paid, this is in general terms what the proviso (ii) to s11(c) seeks to achieve. To clarify, if a company incurs legal fees in defending against a penalty, and if that penalty were incurred it would be deductible, then the legal fees too will be deductible. If the penalty would not be deductible then the legal fees would not be deductible. Note that as legal fees are not *finis* or *penalties* their deduction is not prohibited by section 23(o)(ii).

Proviso (ii) to section 11(c) states that for the legal fees to be deductible the claim for *damages or compensation* must *rank for deduction* under section 11(a). As discussed in Part A, Competition penalties may indeed *rank for deduction* under s11 (a), but are then prohibited by s23 (o)(ii). It can certainly be argued that although s23 (o) prohibits the deduction of the penalties, they do *rank for deduction* under s11 (a) and as such proviso (ii) is not applicable. It is however highly likely that the courts will prohibit the deduction of the legal fees where they prohibit the deduction of the penalty if for no other reason than public policy.

But what of the scenario mentioned in the introduction, where the defendant wins its case and as such no penalties are imposed, yet legal fees are incurred? It would seem unjust for such legal fees not to be deductible, merely based on the fact that had the defendant been found guilty, such penalties would be prohibited from deduction. In a case involving a chemical company which had been found not guilty of negligence resulting in mercury poisoning of its employees, the related legal fees were found to be deductible.

[The court] held on the evidence that legal fees in issue were incurred to defend taxpayer's stance that it had not been negligent and that it had not contravened regulations - [The court] held accordingly that legal costs in issue had been correctly deducted in terms of s11 (c) as those

costs were connected to the taxpayer's income earning operations and consequently not of a capital nature.<sup>45</sup>

It can certainly be said that had the chemical company been found guilty of negligence and/or contravention of regulations, the penalties imposed would most likely not have been deductible. Such a finding would be in line with Joffe's case<sup>46</sup>, public policy and s23(o). That the legal fees were found to be deductible appears to rest on the fact that the chemical company was found not guilty and therefore that proviso ii of s11 (c) would be inapplicable.

In the debate at hand it could further be argued that a penalty/fine imposed by the Competition Tribunal is not *damages or compensation* as mentioned in proviso (ii) and that as such, the proviso would not apply.

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<sup>45</sup> *Commissioner for South African Revenue Service v Thor Chemicals SA (Pty) Ltd* (2000) 62 SATC 308

<sup>46</sup> *Joffe and Co (Pty) Ltd v CIR* (1946) AD 157

### 3. Conclusion for the deductibility of related legal fees

Legal fees incurred in defending against the Competition Commission can often be of great expense due to the lengthy period of time these types of cases can take. As such the deductibility of these legal expenses can have a material impact on the tax paid by the prosecuted company.

Section 23(o)(ii), which prohibits the deduction of Competition penalties does not apply to the related legal fees as they are not a fine charged or penalty imposed as a result of an unlawful activity. The relevant section is solely section 11 (c), a section specific to legal fees.

In the determination of such deductibility, courts have primarily stuck to the principle that the deductibility of legal fees follows the deductibility of that against which you are defending. Legal fees in defence against the Competition Commission can be proven to be *actually incurred* in the *ordinary course of operations* undertaken in the *carrying on of trade* and not be of a *capital nature*. The hurdle which appears is the proviso (ii) to section 11 (c) which requires the *damages or compensation to rank for deduction from income* under s11 (a).

Strict interpretation of the proviso (ii) to section 11 (c) would allow one to infer that the proviso does not apply to Competition penalties as they are not *damages or compensation* and further that the penalties do *rank for deduction* under section 11 (a) despite being subsequently disallowed by section 23 (o). Due to public policy however, so as not to reduce the effect of the penalty, courts are unlikely to allow the deduction of the legal fees where the penalty itself was disallowed as a deduction.

In the situation where no penalty is imposed, proviso (ii) should have no bearing whatsoever as there is no penalty to consider for deduction. There is

also no public policy argument, as the company has been convicted of no wrongdoing, and as such there is no penalty that would be lightened if the legal fees are allowable as a deduction.

It follows that legal fees are deductible where no penalty is imposed but that where a penalty has been imposed for infringement of the Competition Act the legal fees will not be deductible due to public policy reasons.

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## **Part C: Deductibility of related interest expense**

### **1. Introduction**

In the recent Pioneer Foods case finalised on 3 February 2010, Pioneer Foods (Pty) Ltd was ordered by the Competition Tribunal to pay a penalty of R195, 718, 614. The penalty was to be paid to the Commission within 20 business days of the date of the order.<sup>47</sup>

With such large sums of money and the short time period in which penalties often have to be paid, it is intuitive that companies faced with these penalties will need to source financing and in so doing will incur interest expenditure. Such borrowing will either be in the form of general borrowing or specific borrowing and these two forms can have very different tax results.

This section of the paper will examine the relevant sections of the Act and related case law on the deductibility of interest. These principles will then be applied to the specific situation where a company raises a loan in order to pay a penalty imposed by the Competition Tribunal and whether the interest on the loan would be deductible. It will also address how businesses should structure their financing so as to be most tax efficient.

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<sup>47</sup> (note 1)

## 2. Relevant sections of the Act

The deductibility of interest is governed by section 24J of the Income Tax Act. Prior to 1 January 2005 the general deduction formula - s11(a) - was the section under which interest was deducted and s24J was merely a timing section and did not operate as a charging section which provided for the deduction of interest. Section 24J was applied to determine the amount of interest which may be deducted in each year of assessment.

Section 24J was amended by the Revenue Laws Amendment Act No. 32 of 2004 with effect from 1 January 2005, so that section 24J operated as the charging section and a deduction of interest is to be claimed in terms of section 24J(2) (and not section 11(a)).<sup>48</sup>

Section 24J(2) reads as follows:

- ‘(2) Where any person is the issuer in relation to an instrument during any year of assessment, such person shall for the purposes of this Act be deemed to have incurred an amount of interest during such year of assessment, which is equal to –
- (a) the sum of all accrual amounts in relation to all accrual periods falling, whether in whole or in part, within such year of assessment in respect of such instrument; or
  - (b) an amount determined in accordance with an alternative method in relation to such year of assessment in respect of such instrument,

which must be deductible from the income of that person derived from carrying on any trade if that amount is incurred in the production of income.’

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<sup>48</sup> A Coetzee and T Solomon ‘Developing a property?’ 24 June 2009

For section 24J (2) to apply there must be an “issuer” and an “instrument”. An issuer is defined in s24J as:

‘in relation to any instrument –

- (a) any person who has incurred any interest or has any obligation to repay any amount in terms of such instrument...’

and an instrument means ‘any form of interest-bearing arrangement, whether in writing or not...’

“Interest” as defined in s24J, ‘includes the

- (a) gross amount of any interest or related finance charges, discount or premium payable or receivable in terms of or in respect of a financial arrangement;
- (b) amount (or portion thereof) payable by a borrower to the lender in terms of any lending arrangement as represents compensation for any amount to which the lender would, but for such lending arrangement, have been entitled; and
- (c) absolute value of the difference between all amounts receivable and payable by a person in terms of a sale and leaseback arrangement as contemplated in section 23G throughout the full term of such arrangement, to which such person is a party...’

For the purposes of this paper the interest involved has the same definition as the common understanding of the word, being expenditure for the use of money borrowed.

As is the case in section 11(a), read with section 23(g), section 24J(2) requires that the interest expenditure be incurred *in the production of income*. However, there is no requirement in section 24J(2) that the expenditure must not be of a capital nature. This is therefore quite different from the legal fees which were not required to be in the production of income but were required to be of a non-capital nature.

Even if it was a requirement for interest not to be of a capital nature there is authority in an Appellate Division case that interest is of a revenue nature as it is paid for the use of money and therefore akin to rental.<sup>49</sup> As far back as 1912 it was stated in *Farmer v Scottish North American Trust Ltd* that,

‘Interest is, in truth, money paid for the use or hire of an instrument of their trade, as much as is the rent paid for their office or the hire paid for a typewriting machine. It is an outgoing by means of which the company procures the use of the thing by which it makes a profit, and, like any similar outgoing, should be deducted from the receipts to ascertain the taxable profits and gains which the company earns.’<sup>50</sup>

It is noteworthy however, that a recent Australian case did actually find interest, in a particular set of facts, to be of a capital nature.<sup>51</sup> This requires no further mention however, since section 24J requires no such classification.

In determining whether or not interest is incurred in the *production of income* it is necessary to consider the purpose with which the interest expense is incurred and what it actually affects.<sup>52</sup> The purpose with which the interest is incurred i.e. the purpose of the borrowing; is discussed in detail in section 2.4 of this paper.

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<sup>49</sup> *CIR v Genn and Co (Pty) Ltd* (1955) 3 SA 293 (A) at 300

<sup>50</sup> (1912) AC 118 at 127

<sup>51</sup> *St George Bank Ltd v Commissioner of Taxation* (2009) FCAFC 62

<sup>52</sup> *CIR v Nemojim (Pty) Ltd* (1983) 4 SA 935 (A) at 948

### 3. General vs. specific borrowing

In *CIR v Standard Bank of South Africa Ltd*<sup>53</sup> the following principles were established to determine the deductibility of interest on money borrowed:

- (1) In deciding whether expenditure is incurred in the production of income, important and often overriding factors are the purpose of the expenditure and what the expenditure actually affects; and in this regard the closeness of the connection between the expenditure and the income-earning operations has to be assessed.
- (2) More specifically, in determining whether interest (or other like expenditure) incurred in respect of moneys borrowed is deductible, a distinction may in certain circumstances have to be drawn between the case where a taxpayer borrows a specific sum of money and applies it to an identifiable purpose, and the case where, a taxpayer borrows money generally and upon a large scale in order to raise floating capital for use in its business.
- (3) In the former type of case both the purpose of the expenditure (in the form of interest) and what it actually affects can readily be determined and identified: a clear and close causal connection can be traced. Both these factors are, therefore, important considerations in determining the deductibility of the expenditure.
- (4) In the latter type of case, however, there are certain factors which prevent the identification of such a causal connection and one cannot say that the expenditure was incurred in order to achieve a particular effect. All that one can say is that in a general sense the expenditure is incurred in order to provide the institution with the capital with which to run its business; but it is not possible to link particular expenditure with the various ways in which the capital is in turn utilised. The most important factor is the purpose of the borrowing.

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<sup>53</sup> *CIR v Standard Bank of South Africa Ltd* (1985) 4 SA 485 (A) at 500-501

The principle of looking at the *purpose for which money was borrowed*, to determine whether or not the interest expense is incurred in the production of income, was established in *Producer v COT*<sup>54</sup> and clarified in *Financier v COT*.<sup>55</sup> The courts held that if money was borrowed for good and sufficient reasons for use in the business, it was of no consequence that it was ultimately used for a purpose which did not produce taxable income; the interest would still be tax deductible. The ultimate use of the money was said to be helpful in determining the purpose of borrowing, but is not the decisive factor. It is the purpose for the loan that is decisive.

‘From the case law, it seems reasonable that where a company regularly accepts loans in the daily running of their business and one of such loans or part thereof is then used to extinguish the liability to pay Competition penalties, that the interest on such money borrowed would still be deductible because if one looks to the purpose of borrowing the money, it was a legitimate business purpose, in the production of income.’<sup>56</sup> The fact that the money is ultimately used for something else does not alter this purpose.<sup>57</sup>

What requires further evaluation is whether the interest on money borrowed specifically for the purpose of paying Competition penalties would be deductible, where the penalties themselves are not deductible. To answer this question it is necessary to evaluate the purpose for which the money was borrowed.

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<sup>54</sup> 1948 (4) SA 230 (SR)

<sup>55</sup> *Financier v COT* 1950 (3) SA 293 (SR)

<sup>56</sup> C Emslie ‘The tax deductibility of interest on money borrowed to pay penalties imposed by the Competition Tribunal in terms of the Competition Act, 89 of 1998’ Unpublished Paper (2009)

<sup>57</sup> *Supra* with reference to *Financier v COT* (note 53)

#### 4. Purpose of borrowing

As stated at length in the previous section the decisive factor in determining whether or not interest expense is deductible is the purpose of the borrowing. The court in the *Allied Building Society* case agreed with this view stating that, 'in determining the purpose of the borrowing, the ultimate user of the money may, no doubt, in certain cases be a relevant factor; but the dominant question remains: what was the true nature of the transaction?'.<sup>58</sup>

In order to fully appreciate the importance of this concept of purpose, an examination of the *Ticktin Timbers* case is required. The simplified facts of this case were that a close corporation borrowed money in order to pay out a dividend. The paying out of a dividend is held not to be in the production of income as it is rather a distribution of income after the fact. The court ruled that,

'the loan was not needed for the taxpayer's income producing activities, and the intention was to increase [the shareholder's] income, not that of the taxpayer. The liability for the interest was accordingly not incurred in the production of the taxpayer's income.'<sup>59</sup>

Even more relevant to the facts of this paper is the obiter in the *Ticktin Timbers* case that,

'There [is] a clear conceptual distinction between, on the one hand, a case in which a company in good faith... paid a dividend, but shortly thereafter learned the true financial position of the company and realised... that an equivalent sum would have to be borrowed to finance the company's trading activities and, on the other hand a case such as the present [where the money is borrowed to finance the dividend]. The fact that the payment of the dividend was the historical cause of the company needing to borrow [is] irrelevant, the purpose of the borrowing being to finance the company's trading operations after it had parted with its own resources while under the misapprehension that it could afford to do so.'<sup>60</sup>

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<sup>58</sup> *CIR v Allied Building Society* 1963 (4) SA 1 (A) at 13

<sup>59</sup> *Ticktin Timbers CC v CIR* 1999 (4) SA 939 (SCA)

<sup>60</sup> *supra*

The *Ticktin* case can be distinguished from the situation being examined in this paper in that 'the taxpayer in *Ticktin* was 'under no obligation to part with' the money used to make the distribution of dividends. When the Competition Tribunal imposes penalties on a taxpayer, the taxpayer *is* under an obligation to part with that money, and the company would have to, in some way, ensure that after paying the penalty, it is left with sufficient liquid funds to continue to run its business.'<sup>61</sup>

In the case of *SARS v BP South Africa (Pty) Ltd*<sup>62</sup> an amount of interest of R81, 755, 944 was held to be deductible. This case also involved the funds being utilised in the payment of a dividend [expenditure otherwise than in the production of income], but was distinguishable from the *Ticktin Timbers* case in that it had the resources available to pay the dividend and the purpose of the borrowing was rather to fund future business operations.

Based on the *Ticktin* ruling, one may infer that if a company were to borrow specifically for a purpose that is not in the production of taxable income [the payment of the Competition penalty], then such interest would not be deductible. However, if the same company were to exhaust its resources to pay the penalty and at a later date obtain financing in order to continue with its business operations, such interest may be deductible on the basis that its purpose was in the production of income. Further, based on the ruling in the *BP South Africa* case, one can infer that if the company has the necessary resources to pay the penalty, yet it knows that at a future date resources will be required for business operations, it can obtain a loan with the purpose of the borrowing being for business operations in the production of income, and as such, claim

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<sup>61</sup> (note 56)

<sup>62</sup> 2006 (5) SA 559 (SCA)

the interest as a tax deduction. 'The historical cause of the company needing to borrow is irrelevant.'<sup>63</sup>

In determining the deductibility of interest expense, one needs to ascertain the purpose for which the money was borrowed. Whilst the money is ultimately used to pay the Competition penalty, a broader perspective is required to determine the true purpose of the borrowing. If one compares the scenario of paying the penalty versus infringing the levied penalty, it is clear that the second is not a viable action for the continuation of business operations as there exists a legal obligation to pay the penalty and non-payment will most likely force the company into liquidation.

In comparing the options of borrowing versus not borrowing there are two scenarios. If the taxpayer has the necessary resources available and is merely borrowing so as to increase its capacity for expansion, the *BP* case can be used to infer a deduction of the interest. If however the taxpayer does not have the resources available, then it can be argued that although the borrowing is used to pay the penalty, the overriding reason for borrowing was to allow for the continuing trade operations of the business in the production of income and for that reason, the interest is deductible.

When a company receives financing it does not usually do so without some kind of security being offered for the loan and it needs to remain in a solvent position, where its assets exceed its liabilities. Let us compare the scenarios of two companies, A and B, both levied with R25, 000, 000 in Competition penalties. Company A has used a mortgage loan to finance its buildings and has cash and cash equivalents (such as stocks and bonds) available with which to pay the penalty. Company B financed its buildings using its equity reserves

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<sup>63</sup> (note 59)

and therefore requires a loan in order to pay the penalty. The bank requires security for the loan, and to obtain the lowest interest rate Company B obtains a mortgage loan over its buildings.

It is easily deduced that after the payment of the penalty company A and B will be in the same financial situation with their buildings now offered as security for debt. Company A's interest expense on its mortgage would definitely be tax deductible as the loan was taken out in the ordinary course of business operations. It seems an injustice for Company B not to get the tax deduction merely because it did not seek debt financing prior to the imposition of the penalty. Company B is in essence reshuffling its financing arrangements.

In *CIR v DG Smith* the court found in favour of such reshuffling of finances to gain a tax advantage. The facts of this case involved the taxpayer having originally used his own resources (equity financed) to pay for income producing capital and then at a later period withdrawing this capital and replacing it with money sourced through a loan (debt financed). The court accepted this and allowed the subsequent interest as deductible, stating:

'that the fact that the [taxpayers] had, in the past, funded the business from their own resources did not oblige them to continue to do so in the future; there was no obligation on the [taxpayers] to finance the business from their own resources and if they chose to do so by obtaining funds from a source which would charge interest, that interest was, *prima facie* at least, expenditure incurred in the production of income.'<sup>64</sup>

Whilst this reshuffling arrangement is most certainly to gain a tax advantage, the court further stated:

'[T]here was no doubt that the essential, if not the sole, motive of the taxpayer was to gain a tax advantage but the taxpayer's motive must not be elevated beyond its true relevance because the test is not limited to or dominated by a taxpayer's motive; despite the fact that his motive may be to gain some tax advantage, a taxpayer's intention may nevertheless be to earn income and the real question was whether it was in the production of income that the expenditure was laid out.'

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<sup>64</sup> 1997 (60) SATC 397 at 399

Based upon the findings of this case, one can certainly conclude that a company which reshuffles its financing arrangements (such that income producing assets that were previously equity financed are now debt financed) in order to have the resources available to pay a Competition penalty, may indeed claim the related interest as a tax deduction.

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## 5. Public policy

It is argued that since the actions resulting in a Competition penalty are unlawful, the related interest is linked to this unlawful action and therefore a deduction should be prohibited. As section 23(o) does not apply to such interest expenditure, this argument stems purely from a public policy perspective. The purpose and nature of public policy has been thoroughly discussed in Part A (2) of this paper. What remains to be addressed is how public policy relates specifically to the deduction of interest on borrowed money utilised in the paying of Competition penalties.

In considering these public policy aspects, it is necessary to consider whether or not the interest expenditure is sufficiently removed from the original unlawful act, so as to be examined separately from the penalty itself for deduction. 'One could argue that without the unlawful conduct of the taxpayer, the penalty would not have been imposed and the obligation to pay which led to the borrowing of money and the consequent interest expenditure would not have arisen...'<sup>65</sup>

While this may indeed be the case, it is not the unlawful activity which has brought about the interest expense, but rather the decision to use borrowed money to settle the penalty. Even companies without finances available have the option to sell off income generating assets in order to pay the penalty. The reason such a decision is usually not made is due to the company wanting to continue to trade and generate a profit. So whilst the penalty itself is due to the unlawful activity, the interest expense is due to a subsequent business decision to borrow in order to continue to trade and generate income. This decision is neither unlawful nor tainted.

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<sup>65</sup> (note 56)

Although interest can often amount to a large figure, allowing for its deductibility would not reduce the penalty imposed, but merely reduce the cost of borrowing. Allowing such interest as a deduction is unlikely to reduce the deterrent effect of the penalty, but rather serve as an incentive to borrow, rather than cutting back on operations, or expansion projects as a result of the penalty.

Apart from the deterrent effect, public policy also aims for justice and equality. One can therefore infer that it would be contrary to public policy to bring about the inequality in the company A versus company B scenario.

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## 6. Conclusion on the deductibility of related interest

Interest is the cost paid for the borrowing of money, just as rental is paid for the use of a thing. The deduction of interest is governed by s24J which requires the interest to be *in the production of income* and there is no requirement for it to be not of a capital nature. Even if there were this requirement however, there is case law to show it may indeed meet the revenue nature requirement.<sup>66</sup>

In determining whether or not interest is incurred in the *production of income* it is necessary to consider the purpose with which the interest expense is incurred and what it actually affects.<sup>67</sup> In determining this purpose it is necessary to distinguish between two types of borrowing; general borrowing of a pool of money for use as needed in the business and specific borrowing where money is borrowed for an identified purpose. With general borrowing there are certain factors which prevent the identification of a causal connection between the interest expense and a particular effect. All that one can say is that in a general sense the expenditure is incurred in order to provide the business with the capital with which to run its income producing operations.<sup>68</sup> From the case law, one can infer that where a company regularly accepts loans in the daily running of its business and part of such borrowings is then used to pay Competition penalties, that the interest on such loans would still be deductible as the purpose of the overall borrowing is undisputedly in the production of income.<sup>69</sup>

With regard to specific borrowing, the purpose of the borrowing can be more readily determined. However; one can deduce that the purpose of the borrowing is not to pay a Competition penalty. Whether or not the company chooses to finance this obligation using debt or not, the penalty will still have to be paid. It is the decision to pay the penalty with debt that brings about such

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<sup>66</sup> *CIR v Genn and Co (Pty) Ltd* (note 47) and *Farmer v Scottish North American Trust Ltd* (note 48)

<sup>67</sup> (note 52)

<sup>68</sup> (note 53)

<sup>69</sup> (note 56)

interest and not the penalty itself. The purpose of the borrowing is to leave available for income producing operations the assets and floating capital necessary. While it is by no means certain, there is enough case law to support the finding of this paper that such borrowing is therefore in the production of income and hence the interest is deductible under s24J.

A wise taxpayer would, however, when faced with the payment of such Competition penalties, use its available cash and reserves and subsequently borrow where such funding is required for income producing operations. This structure would rely on the principles established in the *Ticktin* and *BP South Africa* cases. Alternatively a reshuffling of financing arrangements could be arranged so as to debt finance a previously equity financed asset in order to free up capital for use in the business, which could then be used to pay the penalty. This method of gaining an interest deduction would rely on the principles of the *DG Smith* case as discussed.

### Conclusion of paper:

One's first instinct may be to decide that penalties for unlawful actions and all related expenditure should be disallowed as a tax deduction. However, the expenditure needs to be evaluated in terms of the legislation and each criterion individually addressed. In doing this and looking more closely at the purpose of the expenditure, the decision turns out not to be quite so straightforward.

For many years, courts have been faced with having to decide the deductibility of fines, penalties and damages incurred as a result of unlawful acts. The two approaches adopted have been that of focusing on the 'production of income' requirement, or relying on public policy. It is important to remember that the penalty is linked to the unlawful action that created it. This action whilst in the production of unlawful income is none the less in the production of taxable income. When producing unlawful income the risk of a penalty being imposed is an inevitable concomitant of the unlawful actions. The penalty could therefore in this regard be argued as in the production of 'unlawful' yet taxable, income

There are many arguments both for and against the fines and penalties being in the production of income and there is case law to support either argument. Public policy however, does not support the deductibility of such penalties as it would diminish their punitive nature and appear to justify the penalty as a legitimate business expense. As the application of public policy is not an exact science, but rather a more subjective approach, section 23(o) was enacted to prohibit the deductions of bribes, fines and penalties relating to unlawful activities. Administrative Competition penalties are indeed found in this paper to relate to unlawful activities, as they relate to activities in contravention of the Competition Act, and this Act is enacted by Parliament, therefore s23(o)(ii) applies.

Due to the lengthy proceedings in these types of cases, legal fees are an important expense to consider, often amounting to very large sums. Section 23(o)(ii), which prohibits the deduction of Competition penalties does not apply to the related legal fees, as they are not a fine charged or penalty imposed. The relevant section is section 11 (c), a section specific to legal fees. In determining such deductibility, courts have primarily decided that the deductibility of legal fees follows the deductibility of that against which one is defending. It is the finding of this paper that legal fees meet all the general criteria of section 11(c). Proviso (ii) to section 11 (c) which requires the *damages or compensation to rank for deduction from income* under s11 (a) is found not to be of application to Competition penalties due to the fact that they are not *damages or compensation* and further that the penalties do *rank for deduction* under section 11 (a) despite being subsequently disallowed by section 23 (o). Due to public policy however, it is reasonable that legal fees are not deductible where the court levied a penalty which itself is not tax deductible. However, where a company wins its case against the Competition Commission and no penalty is levied, this paper finds that such legal fees should be deductible.

With such large sums of money and the short time period in which penalties often have to be paid, it is intuitive that companies faced with these penalties will need to source financing and in doing so will incur interest expenditure. Interest is the cost paid for the borrowing of money, just as rental is paid for the use of a thing and as such it is of a revenue nature. Borrowing is either in the form of general borrowing or specific borrowing and these two forms can have very different tax results.

In determining whether or not interest is incurred in the *production of income* it is necessary to consider the *purpose* with which the interest expense is incurred.

For general borrowing, one can infer from the case law that where a company regularly accepts loans and part of such borrowings is then used to pay

Competition penalties, that the interest on such loans would still be deductible as the purpose of the overall borrowing is undisputedly in the production of income.

For specific borrowings, this paper concludes that the *purpose of the borrowing* is not in fact to pay the Competition penalty. Regardless of how the company decides to finance it, the penalty will still have to be paid. It is the *decision* to pay the penalty with debt that brings about such interest and not the penalty itself. The *purpose* of the borrowing is to leave available for income producing operations the assets and floating capital necessary. As discussed in this paper, there is certainly enough case law to support the finding that such borrowing is in the production of income and hence the interest is deductible.

An astute taxpayer should, however, before the final penalty is levied, mortgage properties and acquire general loans so that when faced with the payment of such Competition penalties, there are available cash reserves.

Whilst the answers are by no means definite, this paper has come to the conclusion that penalties levied in terms of the Competitions Act 89 of 1998 are not deductible, due to s23 (o)(ii) and public policy considerations. As far as the related expenditure is concerned, section 23 (o) does not apply. The deductibility of the related legal fees is determined to be deductible where the defendant is found not to have to pay a penalty and perhaps not deductible where a penalty is levied, again due to public policy considerations. It is the finding of this paper, however, due to the reasons stated above, that where borrowed money is used to finance the penalty, the related interest is deductible.

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