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**TOPIC:** Deductibility of actual expenditure and losses incurred, respectively, as a result of theft or defalcation and liability for damages or compensation

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## 1. INTRODUCTION

The area of income tax law in South Africa pertaining to the deductibility of expenses and losses incurred, respectively, as a result of theft or defalcation, on the one hand, and liability for damages or compensation, on the other, is replete with uncertainty particularly in light of the courts' inconsistency on this subject. Indeed, on review of case law in this area it appears, with respect, that in some cases the judicial personages, rather than have regard to the applicable principles, are prone to 'cut the sails to fit the trim' once a decision has been made to rule the one way or the other. The courts' inconsistencies and the resultant uncertainty on the part of taxpayers are, in my view, also exarcebated where more than one approach -- often leading to contrasting results -- to resolving the problem at hand are apposite. On such occasions it is difficult to fault the court's tendency to decide a case consistently with its unarticulated policy considerations.

Finally, another factor that, in my view, contributes to the uncertainty and inconsistency in this area of income tax law is the old judicial *adagium* that each case must be decided on its own facts. Although this is a sound legal principle it has, with respect, been used by the courts to find distinctions between cases where none exist in order to arrive at a particular preconceived result. These observations will become apparent in the discussion and analysis of case law in the body of this paper. Thus, the purpose of this paper is to revisit some of the reported judgments on this subject with a view to discussing and, in some cases, critically analyzing the manner in which the courts have applied (or failed to apply) the principles involved in determining the issue at hand. In the course of the paper, some reference (with a brief discussion on occasions) to Australian and English cases will be made with a view both to a comparative study with our law and tapping into the jurisprudence of these two nations in this difficult area of income tax law.

## 2. PREFIX

For purposes of determining the deductibility or otherwise of expenditure or losses incurred by the taxpayer, the "general deduction formula"[1] is usually applied. Essentially the formula provides that deductible amounts are those that constitute:

(a) **expenditure and losses**

(b) **actually incurred in (or outside) the Republic**

(c) **in the production of the income**

(d) **to the extent to which they were laid out or expended for the purpose of trade**[2]

(e) **provided that such expenditure and losses are not of a capital nature.**

There is authority, albeit coming from a provincial division of the Supreme Court, for the proposition that expenditure must be deducted in the year in which it is actually incurred, irrespective of when payment is made.[3] Similarly, to qualify for a deduction the expenditure or losses must have been incurred during the year of assessment in question.[4]

The inquiry is usually whether it can be said that the expenditure or loss in question

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1 s 11(a) or (b) read with s 23(g) of the Income Tax Act, 58 of 1962.

2 Most reported cases on this topic, and indeed all cases cited in this paper, were decided before s 23(g) was amended to read as here set out. Before the amendment, the section allowed only for the deduction of those expenditure and losses that were laid out or expended **wholly or exclusively** for the purposes of trade.

3 *Concentra (Pty) Ltd v CIR* 1942 CPD 509.

4 *Sub-Nigel Ltd v CIR* 1948 (4) SA 580 (A) at 589: "For the whole scheme of the Act shows that, as the taxpayer is assessed for income tax for a period of one year, no expenditure incurred in a year previous to the particular tax year can be deducted."

was incurred in the production of the income of the taxpayer.[5] The other common inquiry is whether or not the expenditure or loss in question is of a capital nature. It is in search of an answer to the offensive launched by these two inquiries that our courts have, with respect, developed an arsenal of ill-sorted weaponry that has left taxpayers and their advisers in a sorry state of disrepair by way of uncertainty.

For purposes of convenience and systematic presentation, I propose dividing the cases I have chosen for discussion and analysis into three categories and then discussing them accordingly. By this system of presentation it is by no means sought to suggest that each category has principles and tests that are applicable exclusively to it. Indeed, in some instances a case can be properly assigned to more than one category. These categories are defalcation cases (otherwise embezzlement or theft cases); negligence cases; and damages and legal expense cases. Because of the volume of cases involved, and also for clarity of presentation as well as convenience, the damages and legal expense category is divided into five sub-categories. These are expenditure incurred in the acquisition or protection of a capital asset that produces income; expenditure incurred to protect existing income or prevent its diminution; expenditure incurred to increase existing income; expenditure incurred to eliminate competition; and expenditure incurred on traffic fines.

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[5] 'Income' in this context means income as defined in s 1 of the Act (ie. gross income less exempt income) so that expenditure incurred in the production of exempt income or income falling outside the definition of gross income is not deductible. Therefore, expenditure incurred in the production of both income as defined, on the one hand, and exempt income or income that falls outside the definition of gross income, on the other, must be apportioned so that only that portion which was incurred in the production of income as defined is deductible (*CIR v Nemojim (Pty) Ltd* 1983 (4) SA 935 (A)).

Finally, I should point out that the categorization adopted herein is in no measure attributable to my administrative qualities. It is rather that which can be gleaned from the various reported judgments of our courts in this area of our law.

## 3. DEFALCATION CASES

In *Lockie Bros Ltd v CIR*[6], the leading case in cases dealing with losses as a result of embezzlement or theft of the taxpayer's own funds by its employees, Mason J said that the words 'in the production of the income' cannot be construed in their literal sense because, although losses cannot produce income and expenditure in respect of a business that has resulted in losses for that year cannot be said to have been incurred in the production of a non-existent income, the section does allow a deduction of such expenditure. His Lordship then attributed the following construction to the words:[7]

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

His Lordship then found that, although the act of embezzlement by the taxpayer company's manager was performed during the course of the company's business operations, it was nonetheless not an operation undertaken for the purposes of the business. It was accordingly

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6 1922 TPD 42

7 At 44

held that the loss incurred by the taxpayer as a result of the manager's embezzlement was not deductible because it was not incurred in the production of the taxpayer's income.

In his concurring judgment[8] De Waal J held that to the extent that the taxpayer company's loss arose from the expenditure of its funds in pursuits that are not incidental to its business, such loss is not deductible. His Lordship said:[9]

> **[A]re defalcations of [the manager] losses incidental to the production of the income of the company? *The nature and the scope of his employment as manager was to manage the company's business and not to steal its funds.* He was authorised to draw on the company's banking account for all purposes incidental to its enterprises, but not to draw thereon for his own purposes... . [M]oneys withdrawn from the bank to cover a fictitious purchase of rice are neither outgoing nor loss incurred by the company in terms of the section of the Act.** (My italics)

It is respectfully submitted that the strict approach pertaining to the construction of the words 'in the production of the income' adopted in both judgments in the *Lockie Bros* case is rather harsh and, with respect, out of step with the practical realities of business operations. Indeed, and as Hill AJ correctly pointed out in *ITC 1383*,[10]:

> **Petty pilfering no doubt happens frequently in the course of business operations but *thefts by senior employees are by no means rare occurrences and the risk of such thefts is, in my opinion,***

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8 In his judgment De Waal J also held that the loss occasioned through Cheeseman's defalcations was a loss of a capital nature inasmuch as it was the company's asset converted into cash, thereby forming part of the company's capital.

9 At 48

10 46 *SATC* 90 at 94

> ***equally inseparable from or a necessary incident of the income-producing operations of a business.* (My italics)**

In my view, and for reasons set out below, the test expressed and adopted by Watermeyer J in *ITC 1242*[11] for purposes of determining whether or not a particular loss was incurred in the production of the taxpayer's income in defalcation cases is preferable to that used in *Lockie Bros*. Watermeyer J expressed the test in the following terms:

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

In *ITC 1242* the taxpayer company was a publisher and wholesaler of books. It employed two clerks whose job was to draw cheques, place orders on behalf of the company and handle a limited amount of cash. During the year of assessment in question the taxpayer company incurred a loss as a result of misappropriation by the clerks. This took the form of theft from petty cash, appropriations of moneys paid to them by other members of staff for the account of the company, drawing cheques on the company's banking account and destroying them on return from the bank, and ordering goods in the name of the company for their personal use.

One of the reasons that the test set out in *ITC 1242* is preferable to that set out in

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[11] 37 *SATC* 306

*Lockie Bros* for purposes of determining whether or not the losses in question were incurred in the production of the taxpayer's income in defalcation cases is that a strict adherence to the 'purpose test' (on the basis of which the appeal in *Lockie Bros* was dismissed) would have the effect that no taxpayer would be entitled to claim losses from defalcation as a deduction under the general deduction formula. To take the very example used by Mason J in the *Lockie Bros* case,[12] if a servant injures a person by negligent driving while performing his master's business and the master is successfully sued and obliged to pay damages, the master would, in my view, not be entitled, on the basis of the 'purpose test', to claim such payment as a deduction because negligent driving is not an operation undertaken for the purpose of conducting the master's business. The purpose of the master's business is, say, to deliver his goods to customers by means of a vehicle. It is not to drive the master's vehicle negligently. In fact, the harsh effect of this test -- which in my view could not have been intended by the legislature -- is borne out by De Waal J's own ipsissima verba in the same case.[13] Essentially, Mason J held that inasmuch as the nature and scope of a manager's employment is to manage the business of the taxpayer company and not to steal its funds, any drawings from the company's banking account for his own purposes is not an act performed for the purposes of the company's business (although performed in the course of such business) and therefore any loss incurred as a result of such act is not deductible under the Act.

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12 At 44

13 At 48

What is more, it is respectfully submitted that emphasis in cases of this nature should rather be on *the risk* of loss than *loss* itself.[14] In *Rendle*'s case Beadle CJ, referring to expenditure incurred by a firm of chartered accountants in compensating client companies as a result of the firm's employee having misappropriated the companies' funds, said:[15]

> **In deciding whether such expenditure is deductible, it seems to me the enquiry must be whether the 'chance' of such expenditure being incurred is sufficiently closely connected with the business operation. The enquiry is not whether the actual expenditure itself (should it ever eventuate) is sufficiently closely connected.**

In my view, this principle should be equally applicable to losses. In fact, it appears to have been so applied in *ITC 1221.*[16] In that case the taxpayer, a departmental store (much like Edgars), employed one F in its secretarial and accountancy division. His duties included the payment of staff salaries, ordering of office stationery and equipment, supervision of office administration and keeping of books of account. No sooner had he been employed in that position than he started to steal taxpayer's money in such a manner that the thefts were not detected until ten years later. He concealed the thefts by wrongfully including amounts in the purchases made by the taxpayer for the year. As a result of these inclusions the amounts were claimed and allowed as deductions, being the purported cost of purchases. Upon discovery of the thefts, however, the Commissioner added these amounts back to the

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[14] See *COT v Rendle* 1965 (1) SA 59 (SRAD); *ITC 1242* supra; *ITC 1383* supra.

[15] At 62

[16] 36 *SATC* 233

taxpayer's income. The court dealt with the thefts that took place, and so the losses incurred, during the year of assessment ended 31 March 1970.

The court, per EJ Whitaker QC, took judicial notice of the fact that it is necessary for a departmental store to employ a secretary/accountant, and that the embezzlement of funds by secretary/accountants from businesses in which they are employed is a familiar and recognisable hazard. The court then expressed the applicable test as follows:[17]

> **The essential question to be answered is whether *the risk* of embezzlement by F, employed as he was and exercising the authority that he did, was an incident of the carrying on of the appellant's trading activities. ... The further fact that has to be dealt with is whether *the risk* of embezzlement was an incident of the trading activities... (My italics)**

It may appear that there is no difference between the first and second inquiry in the above passage. In my view, however, the two inquiries are quite different. The inquiry whether the risk of embezzlement is an incident of the carrying on of trading activities is essentially an inquiry whether the risk of embezzlement is a necessary incident for purposes of running a business of the nature in question. The second enquiry -- whether the risk of embezzlement is an incident of the trading services -- is, in my view, an inquiry whether such risk of embezzlement is so inseparable from the trading activities that it can be regarded as part of the cost of running the business in question.

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[17] At 235 *in fine* - 236 *in principe*

On applying the test as expressed by the court above, the court then held -- correctly in my view -- that the risk of embezzlement by F was a necessary incident of the carrying on of the appellant's trading activities, and that the losses incurred as a result of F's embezzlement were sufficiently closely linked to the business of the taxpayer as to be regarded as part of the cost of running its business operations.

An *obiter* remark that is worth noting appears at 235 of the judgment. The Commissioner sought to argue that one of the grounds on which it should be held by the court that the risk of embezzlement by F was neither a necessary incident of, nor inseparable from, the carrying on of the taxpayer's business was that F was a senior employee. The Commissioner was probably relying on, among other judgments, Beadle CJ's remark that:[18]

> ***Lockie Bros* case can, I think, be distinguished on the grounds on which Fieldsend P distinguished it in *ITC 952* ... . In the *Lockie Bros* case the defalcations were by a managing director and not by a subordinate employee. The risk of theft by a managing director can hardly be regarded as inseparable from the carrying on of the business.**

The logic behind this argument is, presumably, that theft of money by the very person who owns it or, put differently, by the very person for the benefit of whom it is earned by the business, amounts to loss of a capital nature.

What made this argument attractive to the Commissioner was, presumably, that on

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[18] *Supra* at 66

occasions when the taxpayer's managing director was away on long leave F would perform the managing director's tasks such as dealing with requests for donations and advertising and attending to customers' complaints. What is more, his job as secretary and accountant of the taxpayer included the signing of cheques on the taxpayer's behalf. EJ Whitaker QC dismissed the argument thus:[19]

> **A good deal of argument was directed to the nature and scope of F's duties and whether he should be categorised as a subordinate employee. I doubt, however, that any benefit is to be derived from such a categorisation.**

It is respectfully submitted that, on the facts of this case, the Commissioner's point on the categorisation of thieving employees in cases where the deductibility of losses as a result of such thefts is claimed was well made. Much benefit is to be derived from such categorisation in cases of this nature. The duties performed by the employee in question were of the nature performed ordinarily by persons occupying the post of proprietor. He paid staff salaries, signed cheques on behalf of the taxpayer, hired and dismissed junior office staff, approved expenditure on advertising and dealt with requests for donations. For all intents and purposes F was, but in title only, clearly in the position of proprietor. If EJ Whitaker QC's remark that no benefit is to be derived from categorisation of employees in cases of this nature were to be followed, it would be fairly simple to obtain a deduction of 'losses' resulting from thefts by a managing director who gives himself the title of 'junior accountant'.

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[19] At 235

In my view, losses incurred as a result of thefts by persons in positions of proprietor -- not only by title but also by the nature and scope of their duties -- ought not to be deductible. This appears to be the view taken by Beadle CJ in *Rendle's* case[20] and Hill AJ in *ITC 1383*[21]. Moreover, this appears to be the view of the Australian courts if the following statement is anything to go by:[22]

> **If the loss is occasioned through the acts of a clerk or other employee of the taxpayer (be it 'purloining by office boys' or embezzlement by a managing clerk) the loss may be deductible ... but if the wrongful act is committed by a proprietor, including a partner, no deduction is permitted under that section. Between these two classes of persons a line has been drawn by the Courts, namely where the loss is occasioned through the acts of a managing director or a manager of a company who 'is in the position of a proprietor' the proprietor has been denied a deduction of the loss.**

In my view, this approach -- which ought, in my view, to be extended to include among proprietors not only proprietors by title but also proprietors by duties -- would, if adopted, lend some clarity to the uncertainty in our law regarding the inquiry of whose theft will qualify a taxpayer for a deduction in defalcation cases where the taxpayer's pelf is stolen or misappropriated by its own employees. The *Lockie Bros* case has never been expressly

[20] At 65 *in fine*

[21] At 94

[22] Gunn's *Commonwealth Income Tax Law and Practice* (7 ed) 617

overruled,[23] whether by a provincial division of the Supreme Court or by the Appellate Division.[24] Many Income Tax Special Courts have simply felt constrained to follow it by reason of the *stare decisis* principle. Until another division of the Supreme Court (including the Appellate Division) intervenes, the position will remain uncertain.

With a view to illustrating the courts' inconsistency in defalcation cases, I now propose discussing briefly a few cases of similar facts but confusing dicta. The first case is *ITC 184*[25] in which a firm of accountants, which acted as secretary to a building society, employed a clerk to carry out its secretarial duties. The clerk stole the building society's funds and the firm was obliged to repay the stolen sum. The taxpayer, who was a partner in the firm, sought to deduct his share of the loss. He also sought to distinguish the *Lockie Bros* case on the basis that *Lockie Bros* dealt with theft of the taxpayer's own funds while in the case there under consideration the employee had stolen from a third party. The court did not specifically join issue with the taxpayer on this point but simply gave a literal meaning to the words 'in the production of the income' by saying that refunds made by a taxpayer to its client as a result of an employee's theft thereof are not made in the production of the income and are therefore not deductible. The court said:[26]

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23 It was simply distinguished in *Rendle's* case on the ground that the employee there in question was a managing director.

24 The Appellate Division has not yet ruled on the deductibility of losses incurred as result of theft of taxpayers' money by own employees.

25 5 *SATC* 268

26 At 270

> **When a man employs a person who subsequently is discovered to be a thief, and that employee steals a considerable amount of money for which his employer is liable, one can hardly say, nor can it be argued, that the loss caused by the defalcations of the employee, is a loss incurred by the employer in the production of any income. When he put the man in the position of trust, the employer never contemplated the case of the employee stealing any money. That was a misfortune which would not have occurred to him in the ordinary course of business... . To my mind the production of the income and the defalcations of the employee have no relationship whatsoever.**

It appears that the court simply followed *Lockie Bros* against all protestations by the taxpayer to the contrary on the basis of the abovementioned distinction.

In *ITC 815*[27] the taxpayer was a partner in a firm of attorneys. The firm had advanced a loan from trust funds to a person as a result of fraudulent misrepresentation. It earned part of its income from investing funds on behalf of its clients. The firm then sought, unsuccessfully, to recover the loan and was obliged to repay the trust money. It also suffered losses arising from embezzlement by its employees. The court was called upon to decide whether, on the one hand, the expenditure incurred in repaying the trust funds and the legal costs attendant upon the attempt to recover the loan and, on the other hand, (whether) the losses suffered as a result of employees' embezzlement, was deductible. As in *ITC 184*, the taxpayer sought to distinguish *Lockie Bros* on the basis that the stolen moneys in the present case were trust moneys handled by the firm in the course of its business and from which it derived part of its income. He said that the risk of embezzlement

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[27] 20 *SATC* 487

of such moneys by employees was a necessary concomitant of the business of attorneys who handled trust moneys and that losses of such moneys by embezzlement were therefore losses incurred in the production of income and therefore deductible.

Dealing with the deductibility of the trust fund repayment and the legal costs incurred for the recovery of the loan, the court said:[28]

> **Now the fact that a particular kind of loss may be of rare occurrence, though relevant to the question whether the risk of that kind of loss is a necessary incident of the business, does not necessarily mean that it is not. In the case of attorneys it may be due to the fact that members of that profession are by training inclined to be punctiliously careful. Probably there are few cases in which attorneys are the victims of forgery ... but in dealing, as they often must do, with astute and unscrupulous members of society, the risk of being taken in by a well-planned fraud is undoubtedly a risk incidental to the practice of an attorney's profession... .**
>
> ***As the income of the partnership was earned in part by the investment of money on behalf of clients the loss was incurred in the course of an operation directed to the production of income.*** **(My italics)**

Dealing with losses arising from embezzlement by employees, Roper J said:[29]

> **[I]f [counsel for the taxpayer] had been able to establish that the moneys embezzled were trust moneys it would have been necessary to go into the question whether *Lockie Bros v Commissioner for Inland Revenue* can be distinguished in the way suggested. But the evidence does not in our view establish that the stolen funds were trust moneys.**

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28 At 493

29 At 495-6

It is, in my view, arguable that had there been sufficient evidence to show that the stolen moneys were trust moneys, the court would probably have held that the loss incurred by the firm in repaying trust moneys pursuant to embezzlement by the firm's employees is deductible. Perhaps this view assumes greater significance in light of the court's dictum at 494 in dismissing the Commissioner's contention that the loss as a result of embezzlement was a loss of a capital nature:

> **It was contended on behalf of the Commissioner that the loss was a loss of a capital nature, but I do not consider that this contention can be supported. Though the money invested cannot be regarded as forming part of the firm's stock-in-trade or floating capital it was in a somewhat analogous position, and was certainly not a portion of its fixed capital. *It was money entrusted to the firm for the purpose of its income-earning operations*, and much in the same position as goods entrusted to a transport contractor for delivery and lost en route. If the transport contractor were held liable for the loss and obliged to pay compensation to the owner, it could hardly be maintained that this loss was a loss of a capital nature. (My italics)**

In *ITC 894*[30] the court simply followed *Lockie Bros*. The employees of a firm of attorneys had defalcated trust funds and the partners, having repaid the stolen moneys over a period, sought to deduct the same from their respective incomes. Again, counsel for the partners sought to distinguish *Lockie Bros* on the basis that the court in that case was concerned with theft of the taxpayer's own money while in the case there under consideration the theft was that of trust moneys. It was further contended on behalf of the partners that

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[30] 23 *SATC* 475

the risk of the embezzlement of trust moneys by employees was a necessary concomitant of the business of attorneys who handled trust moneys and that the losses of such moneys by embezzlement were income. Therefore, sums refunded to clients in repayment of the amounts embezzled were a proper deduction from the income subject to normal tax.

The court, following *Lockie Bros* took the view that money lost through a servant's embezzlement was not an expenditure or loss actually incurred in the production of the employer's income. In response to the distinction sought to be drawn by taxpayers' counsel from the *Lockie Bros* case, the court took the view that it is quite immaterial whether the money embezzled is actually the employer's own or is money which he had in trust. The court said that in either event the same principle is applicable. No reference was made to Roper J's remark in *ITC 815* at 495 - 6[31].

Then the court made the following statement[32] without any reference to Roper J's remark in *ITC 815* at 494[33]:

> **Furthermore in my view the expenditure incurred in refunding the amounts embezzled is expenditure of a capital nature. .... [I]f, as a result of a servant's theft, an employer is obliged in law to refund the money to the owner, this represents a loss of a capital nature, and is**

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31 See above at 15

32 At 477

33 See above at 16

**accordingly not allowable as a deduction in terms of s 11(2)(a) of the Act.**[34]

Finally, in *ITC 952*[35] the court was confronted with defalcations of trust moneys by a partner in an attorneys' firm. When the culprit partner committed suicide the remaining partner was obliged to repay the stolen money. He borrowed the sum and settled the trust deficit. Then he sought to deduct the repayment as having been incurred in the production of his income. In dismissing the taxpayer's appeal the court held that defalcations of a partner in an attorneys' firm cannot be said to be the kind of casualty, mischance or misfortune which is a natural and recognised incident of the business. The court held further that inasmuch as the firm had a legal obligation to restore the stolen money to the trust account, it was not a loss or expenditure which could rank as a deduction for tax purposes.[36]

Now, an attempt to reconcile this dictum (as well as that of A Davis K.C in *ITC 184* above[37]) with that expressed by Roper J[38] in *ITC 815* will, with respect, meet with little success. Roper J had said:

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[34] In that case the court was dealing with Act 31 of 1941 and the provisions of s 11(2)(a) thereof were, in all material respects, similar to those of s 11(a) of Act 58 of 1962.

[35] 24 *SATC* 547

[36] At 552

[37] See 14 above

[38] At 493

> **It is immaterial ... that in the paying out of moneys in order to settle a liability or a loss the taxpayer has not done an act directed to the production of income. The question is whether he incurred the loss, or the liability which has caused him the loss, in the course of operations directed to the production of income.**

It is, with respect, even more disconcerting that his Lordship did not even seek to differ expressly from Roper J on this point but simply ignored the dictum. The result, of course, is that the taxpayers and their advisers do not know who is correct and who is not, and of whose dictum to take heed in the event of this issue arising, particularly inasmuch as the two courts are of the same rank in the hierarchy of courts.

What is more, it appears that the court in *ITC 952* premises its finding that defalcations by a partner in an attorneys' firm cannot be said to be the kind of casualty, mischance or misfortune which is a natural and recognised incident of the business on the following dictum:[39]

> **[O]ne does not reasonably expect a senior manager or managing director to make away with his employer's funds, and ... such risk is not reasonably incidental to the trade, as the petty larcenies of servants and the leakages through carelessness or dishonesty to which the revenues of most profit-earning organisations are exposed.**

With respect, it is submitted that to the extent that the court could have held that losses resulting from defalcations of the firm's own moneys by a partner are not deductible

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[39] At 551

the court would, in my view, have been correct. Moreover, the basis for the finding in that case proffered by the court -- namely, that because it is not reasonably expected of a person in the position of a partner to make away with funds, the risk of such theft is not reasonably incidental to the trade -- is hardly convincing. After all, did not Roper J in *ITC 815*, correctly in my view, say the fact that a particular kind of loss may be of rare occurrence does not necessarily mean that it is not deductible even though it is in fact relevant to the question whether the risk of that kind of loss is a necessary incident of the business?[40] What is more, a partner in an attorneys' firm is, with respect, hardly an employee of any description. In the above-quoted passage it appears that the court sought to draw parallels between a partner on the one hand and a senior manager on the other. In my view, such parallels are, with respect, inapposite for a manager is an employee while a partner in a firm is not.

It is respectfully submitted that the courts in the above cases could have disposed of the issues under consideration simply by inquiring whether the risk or chance of the loss or expenditure in question being incurred is, for purposes of the particular trade in question, a more than remote possibility. In other words, they could, with respect, have inquired whether the loss or expenditure is sufficiently closely connected with the running of the business of the nature in question. That done, and the test objectively applied, it is my view that a clearer picture could have emerged.

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[40] See 15 above

In my view, *ITC 815* was, on its facts, correctly decided both in respect of the deductibility of the loan repayments and the loss from embezzlement. It is, however, not clear whether losses resulting from theft of trust funds by employees, as opposed to theft of the firm's own funds, are deductible. In my view there is merit in such distinction because the firm's own money is clearly its capital while that of its clients can hardly be called its capital. It is rather analogous to the firm's stock-in-trade or floating capital.[41]

While the court in *ITC 952* set out the correct applicable test,[42] its decision betrays, with respect, an attempt to arrive at a preconceived result. This is apparent from the discussion of that case above. One example is that the court ignored all the contrary remarks of Roper J in the earlier case of *ITC 815*. In my view losses incurred as a result of defalcations, even by a partner, of trust moneys ought to be deductible because such moneys do not form part of the firm's fixed capital and the risk of such thefts is not inconceivable in the attorneys' and accountants' professions. However, inasmuch as attorneys do insure their practices against losses of this nature, the deduction ought to be limited to the portion not covered by insurance.

In my view, it appears that in *ITC 894* James J simply followed the decision in *Lockie Bros* and, with respect, failed to apply his mind to the matter for the reasons apparent in the

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41 *ITC 815* at 494

42 At 551: The essential factor to be determined is whether the dishonest removal of funds was a reasonably incidental risk to the production of assessable income in the locality at the time. If it can be said that this was the position then it seems to follow that the loss was suffered for the purposes of the trade or in the production of the income.

discussion of this case above.[43] A Davis K.C in *ITC 184* may perhaps be forgiven for his indiscretion inasmuch as his Lordship did not have the benefit of other courts' preceding pronouncements on this issue around which to formulate his opinion. His Lordship was, as it were, treading on uncharted territory at that time. This case was heard in 1930 and it appears that it was the first case to be heard on defalcations of the nature there under consideration.[44]

## 4. <u>NEGLIGENCE CASES</u>

The inconsistency which, with respect, has plagued the courts' reasoning and judgments in defalcation cases, and the attendant uncertainty such inconsistency has created in the minds of many taxpayers and their advisers, continues to rear its ugly head in cases of deductibility of losses or expenditure incurred as a result of negligence. In some cases the courts have, with respect, preferred policy considerations to hold sway rather than the applicable legal principles. One such case was arguably[45] *Joffe and Co (Pty) Ltd v CIR*[46] where the court dismissed an appeal for the deductibility of expenditure incurred pursuant to a damages and costs of suit order as a result of the taxpayer's negligence that caused the

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[43] See 16-18 above

[44] ie. theft of trust monies by the firm's employee. *Lockie Bros*, it may be recalled, dealt with theft by the company's senior employee of the company's own money.

[45] Arguably because the court, with respect, did well to create the impression that the ratio for its decision was not so much the fact that expenditure incurred as a result of negligence are not deductible, as the fact that *there was no evidence to suggest that negligence of the nature that occurred in that case and the liability incurred thereby are the inevitable concomitants of the kind of business in which the taxpayer was involved.*

[46] 1946 AD 157

death of a worker.

The brief facts[47] of that case were that the taxpayer, a company carrying on the business of reinforced concrete engineering, had contracted to supply a building contractor with the steel reinforcement required for a cantilever hood. After construction the hood collapsed, killing a plumber working below. In an action instituted by the plumber's dependants, it was established that the collapse of the cantilever hood was caused by the taxpayer's negligence. The taxpayer was ordered to pay damages and costs of suit. The taxpayer subsequently attempted to deduct these amounts from its income. The Commissioner's decision to disallow the deduction was reversed by the Special Court. The Witwatersrand Local Division in turn reversed the finding of the Special Court and disallowed the deduction. On appeal to the Appellate Division the taxpayer argued that both the damages and the costs were expenditure incurred in the production of income because they arose directly out of an operation performed for the purpose of earning income and were sufficiently closely linked to it to be properly regarded as part of the cost of performing the operation.

The court's decision appears to be based on the taxpayer's failure to discharge an onus that rested on it:[48]

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[47] As they appear in Emslie, Davis & Hutton's *Income Tax: Cases & Materials* (1995 ed) at 556.

[48] At 163 - 164

> **There is nothing in the stated case to suggest that such negligence, and the consequent liability which such negligence entailed, were necessary concomitants of the trading operations of a reinforced concrete engineer; nor was it shown that the liability was incurred *bona fide* for the purpose of carrying on any trading operation. Consequently ... the payment of the damages was not made for the purposes of trade.** (Italics in text)

And again:[49]

> **[T]here is no suggestion in the stated case that negligence such as occurred when the cantilever hood was being constructed and the liability incurred thereby are the inevitable concomitants of the business of a reinforced concrete engineer.**

In my view, however, there is every indication that the taxpayer's case turned not on a question of onus but on policy considerations. That is apparent from the following remarks:[50]

> **Mr Rosenberg further contended that, even if the expenditure in question was not the necessary concomitant of the business of a reinforced concrete engineer, it was an expenditure necessarily arising out of the business methods employed by the appellant and, consequently, was a deductible expenditure. This argument can be put in a slightly different form as follows: *appellant has chosen to conduct his business in a manner which necessarily leads to accidents in which third parties are injured and in respect of which appellant has to pay damages, consequently such damages are a deductible expenditure. ...* [T]here is nothing in the stated case to show that the appellant's method of conducting his business necessarily leads to accidents, and it would be somewhat surprising if there were. Consequently, the basis of Mr Rosenberg's argument**

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49 At 165

50 At 165

**disappears and it cannot be supported. (My italics)**

It is my respectful submission, therefore, that, although the test used by the court in determining whether or not the expenditure in question was incurred in the production of the taxpayer's income is apposite -- ie. the inquiry whether the negligence and the liability incurred thereby were necessary or inevitable concomitants of the taxpayer's income-earning structure or trading operations -- the manner in which it was applied betrays, with respect, public policy rather than legal considerations. What is more, the court's approach appears to suggest that the expenditure incurred *in casu* could only have been deductible if the negligence had been a necessary or a *bona fide* method of carrying on the taxpayer's business operations, and that inasmuch as it was not (in fact "it would be somewhat surprising if [it] were") the expenditure incurred as a result of such negligence cannot be deducted from the taxpayer's income. This approach is, with respect, unduly harsh because, if it were a requirement for a deduction of expenditure and losses incurred in these circumstances, it would be impossible for a taxpayer to prove a case for such deduction. No reputable trader deliberately trades negligently; yet it is common for professionals to insure themselves against liability for negligence and the premiums on such policies are routinely allowed as tax deductions.[51] Moreover, such a requirement would, in my view, fly in the face of his Lordship's own policy considerations.

In the final analysis, therefore, it appears that the taxpayer in *Joffe*'s case (as indeed

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[51] Emslie, Davis & Hutton: *Income Tax: Cases & Materials* (1995 ed) at 558n

would any taxpayer confronted by a court that would adopt the approach adopted by Watermeyer CJ in *Joffe*) was faced with the Scylla and Charybdis of the court's discretion. Damned was he (as indeed he was) if the negligence that gave rise to the expenditure was not his usual method of conducting his business to be regarded as the necessary concomitant of his trading operations, and equally damned was he if he deliberately conducted his business negligently so that such negligence was the necessary concomitant of his trading operations.[52]

It is respectfully submitted that Roper J's approach in *ITC 815*[53] is preferable and more realistic:

> **[I]t is in my opinion clear that negligence in itself affords no reason why a loss caused by it should be held to be non-deductible. And there is no reason in principle why it should make any difference whether the negligence is that of employees or of the taxpayer himself. *Negligence is an element of inefficiency, and an inefficient taxpayer is taxed upon the income which he actually earns and not upon that which he should have earned had he been efficient.* (My italics)**

Moreover, an inquiry into the risk of the mishap occurring rather than the mishap itself would, in my view, have been a better and more realistic approach -- if not the correct approach -- to adopt in the circumstances. This is how Roper J phrased the applicable test in *ITC815*:[54]

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[52] See the passages quoted at 24 - 25 above

[53] 20 *SATC* 487 at 491

[54] At 493

**Where the liability or the loss has arisen as a result of mischance or accident the ... question arises whether the nature of the taxpayer's business is such that *the risk of such mishap* can be said to be inseparable from, or a necessary incident of the carrying on of the business. (My italics)**

The very nature of the business of a reinforced concrete engineer is such that mishaps of the nature that occurred in *Joffe's* case are a real risk and therefore expenditure incurred pursuant to the happening of such risk ought to be allowed as a deduction, being part of the cost of running the business of a reinforced concrete engineer.

Another example of a decision in which the correct applicable test was, with respect, twisted in its application to yield a result consistent with the court's preconceived outcome was that given in *ITC 658*[55]. In that case, the court held that expenditure incurred by a building contractor in paying a damages claim arising from negligent failure to adhere to building specifications was not incurred in the recovery of a debt[56] but in resisting a claim for damages, which was not an operation entered upon for the purpose of earning income, and that such expenditure was therefore not deductible.

The court then made -- and I say this with the greatest respect to his Lordship -- two

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[55] 15 *SATC* 498

[56] Presumably the taxpayer had instituted action for payment of fees for services rendered and the defendant instituted a claim in reconvention for the said damages. Although this aspect of the case is not apparent from the reported facts, it seems to me to be the only reasonable basis on which the taxpayer could have argued that the expenditure in question was incurred in recovery of a debt.

rather ghastly findings[57] in my view. The first was that there was nothing on the facts to suggest that negligence in observing the plans and specifications, and the liability consequent thereupon, were the inevitable or necessary concomitants of the taxpayer's trading operations. The second was that inasmuch as the taxpayer had paid the damages "without admission of liability and with a view to avoiding litigation",[58] the primary object of the payment was the avoidance of legal costs and that therefore the expenditure could not be regarded as one "wholly and exclusively laid out for the purposes of trade".

It appears that this decision was premised upon the finding in *Joffe*'s case. There is even an attempt, as in *Joffe*, to attribute the decision not to allow the expenditure as a deduction to the taxpayer's failure to discharge an onus that the negligence of the nature there under consideration was an inevitable and necessary concomitant of the taxpayer's trading operations. Perhaps the taxpayer indeed led no evidence to that end, which would be very strange because all that is required, in my view, to discharge the onus would be to call other building contractors as expert witnesses pertaining to the nature of their trade and the frequency with which such mishaps occur in the course of their work. That notwithstanding, it seems to me that the risk of the negligence of the nature there in question, not unlike the risk of a motor mechanic who, in repairing one fault in the car, negligently causes another thereby causing the customer to collide with another vehicle and thus causing patrimonial loss to his customer, forms part of a building contractor's trading operations. Expenditure arising

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57 At 502

58 ibidem

from such negligence ought therefore to be readily deductible.

What is more, an approach which holds that sums paid without admission of liability and with a view to avoiding litigation in settlement of legal disputes are precluded from being regarded as having been paid for the purposes of trade or in the production of income would, in my respectful view, be too remote from the realities of commercial litigation.

In my view, *ITC 658* appears to be on all fours with another case with similar facts[59], *COT v Cathcart*[60], where the court -- correctly in my view -- said:[61]

> **If, therefore, an architect or a building contractor gives a guarantee that a building to be designed or built by him will be free of certain defects, then it seems to me that if those defects do occur in the building, then the reasonable cost of remedying them is properly deductible. ... And, in my view, it would be artificial to hold that the extra cost incurred by the architect or building contractor in putting right the defects in order to earn his full fee or contract price would not be expenditure 'wholly or exclusively incurred for the purposes of his trade or in the production of his income'. I cannot see that there is any difference in principle when the defects covered by the guarantee occur at a later stage after the architect or building contractor has been paid the fee or the contract price as the case may be.**

Nothing turns on the presence of a guarantee in my view inasmuch as the court also said that

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59 Except that in that case the architect taxpayer had given a guarantee to his client to the effect that the building he was designing and in respect of which he undertook to render the usual services of an architect would be waterproof, on which distinction nothing turns in my view. He was then sued for breach of the guarantee.

60 1965 (1) SA 507 (SRAD)

61 At 510

the fact that architects do not normally give guarantees is irrelevant.[62] This remark seems to suggest, in my view, that where defects arise from the negligence of an architect or building contractor in the performance of his trade, the cost of repairing such defects is deductible expenditure. It is therefore submitted that at least the cost of repairing the defects in the instant case should have been allowed as a deduction.

In a rather abrupt obiter quirk, the court said:[63]

> **In my view, however, it would only be the bare cost of putting right the defects which would be deductible under such a guarantee, unless the contract expressly provided for liability for consequential loss to the building owner as well, for the building owner could not say to the architect or building contractor: "I am withholding payment not only until you put the defect right in terms of your guarantee, but also until you pay me compensation for the consequential damages which I have suffered as a result of the defect".** ***He would have to sue separately for those damages, and if they were paid by the taxpayer, it could not be said that they represented expenditure or loss 'wholly or exclusively incurred for the purposes of his trade or in the production of his income'. They would not have paid for the purpose of earning the income, and it could not be said, in normal circumstances, that they were a necessary concomitant of the income-earning operation.*** **(My italics)**

It is, with respect, difficult to understand how the cost of repairing the defects arising from a contractor's negligence can be regarded as expenditure 'wholly or exclusively incurred for the purposes of trade or in the production of income', but not payment in settlement of a claim for consequential damages arising from the same negligence. In my

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62 ibidem

63 At 511

view, such a distinction in rather tenuous.

*X v COT*[64] provides, with respect, a sigh of relief not because the court decided in favour of the taxpayer but because the legal principle involved was applied properly. In that case a firm of attorneys had, through one M who was a member of the local stock exchange, sold municipal stock on behalf of a deceased estate which it was administering. The taxpayer was a partner in the firm. A scrip and completed transfer forms were delivered to M before payment of purchase price had been made to the taxpayer's firm. When M subsequently received the purchase price, he misappropriated it. The firm had to make good the loss to the deceased estate. As partner, the taxpayer claimed his share of the loss as a deduction which, naturally, was disallowed and so was the objection.

On appeal to the Southern Rhodesia High Court, the appeal was allowed on the ground that the loss that may be incurred by attorneys in the course of dealing with trust property as a result of negligence is an ever present risk in the attorneys' practice. It is respectfully submitted that this approach is preferable to that adopted in *Joffe's* case.

*ITC 1058*[65], however, was not cause for much merriment, again, not so much because the decision went against the taxpayer as the manner in which the result was

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[64] 1960 (2) SA 679 (SR)

[65] 26 *SATC* 305

reached. The facts[66] were that the taxpayer was a manufacturer and had been a co-defendant together with the South African Railways ("the Railways") in an action arising out of a collision between the plaintiff's motor vehicle and a railway trailer parked on a public road running past the taxpayer's factory. The Railways had delivered a load of raw materials and left it at the side of the road opposite the taxpayer's factory. The taxpayer's servants unloaded the raw materials and, as it was blocking the entrance to the factory, moved the trailer farther away in order to provide easier access to the factory premises. They left the trailer standing partly on the tarred portion of the road. That night the plaintiff's motor car collided with the rare end of the trailer, which was unlit. At the trial it was held that the trailer had been moved by servants of the taxpayer in the course of their ordinary duties and that the act of leaving the trailer unlit was a negligent act attributable equally to the two defendants. As a result the taxpayer paid damages, plaintiff's party and party costs and its own attorney and client costs.

The court examined the respective sections applicable in respect of the deductions of the nature there in question as they stood, respectively, prior to 1960 and during 1960. It then came to the conclusion that only the costs incurred by the taxpayer in the action, and not the payment in respect of damages, was deductible under s 11(2)(b)bis of the Income Tax Act, 31 of 1941.

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66 Substantially as they appear in Emslie, Davis & Hutton: *Income Tax: Cases and Materials* (1995 ed) at 569.

Now, prior to 1960 the relevant sections read as follows:

**s 11(2) The deductions allowed shall be --**

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

**s 12 No deductions shall in any case be made in respect of the following matters:**

**(g) any moneys, claimed as a deduction from income derived from trade, which are not wholly or exclusively laid out or expended for the purposes of trade.**

In 1960 s 11(2)(b)bis was added to allow as a deduction:

**[a]ny expenditure, other than that of a capital nature, actually incurred by the taxpayer during the year of assessment *in respect of any 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.* (My italics)**

The court then reasoned,[67] firstly, that damages could in suitable circumstances be deducted only under the old sections[68] and that, if it had been the intention to widen the basis on which damages could be deducted, the obvious manner of achieving that result would have been to amend s 11(2)(a) with that object in mind. The court said further that if s 11(2)(b)bis should be meant for damages plus costs and, in addition, a more generous basis for both, then s 11(2)(a) would have become quite redundant.

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[67] At 307 - 308

[68] ie. the relevant sections as they stood prior to 1960.

With respect, inasmuch as s 11(2)(a), read with s 12(g), was of more general application and s 11(2)(b)bis was introduced to provide specifically for the deductibility of legal expenses, it is difficult to understand how s 11(2)(a) could become redundant upon the introduction of s 11(2)(b)bis. The expenditure incurred by the taxpayer in settlement of a damages claim was, in my view, perfectly within the provisions of s 11(2)(b)bis for the litigation there in question arose by reason of the ordinary operations undertaken by the taxpayer in the carrying on of his trade. In fact there could, in my view, be no satisfactory reason why the observations made by the court in holding that the costs are deductible should not be equally applicable to holding that the damages sum is also deductible:[69]

> **The costs were clearly incurred in respect of an action at law. ... Delivery of raw materials by the Railways was a regular and indispensable routine for the carrying on of the trade. If the vehicle bringing the raw materials is unloaded and then has to be removed because it blocks the access to a place to which access is necessary in the course of business, then such removal is part of the 'ordinary operations'. If the removal is done in a manner giving rise to an action at law, then the action certainly arose 'by reason of the ordinary operations'.**

And, inasmuch as the damages arose from negligence that forms part of the taxpayer's ordinary operations as aforesaid, the expenditure (or 'losses' if one insists) is therefore deductible.

The second observation made by the court was that under the old section damages were always brought under 'losses'. The court said inasmuch as the legislature is presumed

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69 At 308

to know the interpretations given by the courts, it would have added the word 'losses' in s 11(2)(b)bis if it had been intended to cover damages.

It is respectfully submitted that, on the plain construction of the section, emphasis lies therein not so much in the choice of words describing the nature of the payment (whether it be expenditure, loss, payment, or expense) as in the purpose for which or in respect of which such payment was made. In other words, emphasis properly lies in the words 'in respect of any dispute or action at law arising in the course of or by reason of the ordinary operations undertaken ... in the course of ... carrying on ... trade'. What is more, the fact that the word 'losses' -- as opposed to 'expenditure' -- is used in practice to refer to settlement of damages claims is not, in my view, a conclusive indication that such settlement is a loss rather than an expenditure. One ought to guard against elevating hackneyed words and expressions to axiomatic proportions.

Thirdly, the court made the following, with respect, startling remark upon which I shall not make an attempt to improve:[70]

> **A 'dispute or action at law' is essential under 11(2)(b)bis. If damages should be deductible in terms of it, one could get the absurd result that the taxpayer who pays damages without demur cannot deduct them because there was no dispute, whereas the argumentative taxpayer who denies liability, and causes a dispute, can deduct the capital as well as the costs.**

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[70] At 308

With respect, the realities of commercial litigation are such that on some occasions the parties reach an out-of-court settlement whether that be to cut their losses or to avoid adverse publicity. To suggest that looses or expenditure incurred in such settlements are not deductible as not being disputes or actions at law would, with respect, be out of step with commercial realities indeed.

The court also considered the deductibility of the damages under s 11(2)(a), as read with s 12(g), and found that they were not deductible because they were not wholly or exclusively laid out or expended for the purposes of the taxpayer's trade. In coming to its conclusion, the court sought to draw a, with respect, tenuous distinction between the leading case of *Port Elizabeth Electric Tramway Co Ltd v CIR*[71] and the instant case on the basis that in the *Tramway* case the employment of drivers was necessary for carrying on the business of the company, while in the instant case "the third party who happens to drive past the factory at night is not essential to the appellant's trade".[72] With respect, this basis of distinction needs only to be mentioned to refute itself.

In *SIR v Raubenheimer*[73] the court appears to have gone the opposite route, using the same method, to the one taken by the court in *ITC 1058*. In the former case the taxpayer farmer had been instructed by the Department of Agricultural Technical Services to eradicate

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71 1936 CPD 241

72 At 310

73 1969 (4) SA 314 (A)

dense bush on his farm. He chose to burn the bush and, as a result of negligence, the fire got out of control and caused extensive damage to neighbouring farms and plantations. Claims were then preferred against him which he initially disputed. When legal proceedings were instituted he settled the claims. He then sought to deduct the expenditure in respect of such damages from his income. He succeeded on appeal to the Special Court but the Commissioner appealed directly to the Appellate Division where the taxpayer again prevailed.

The decision of the court turned on the proper construction of s 11(c)[74] of Act 58 of 1962, the court holding that inasmuch as the words 'any costs ... in respect of any dispute or action at law' were capable of both a narrower and a wider meaning they had to be construed contra fiscum. The court held further that if the legislature had intended to exclude damages in the provisions of paragraph (c) it would have avoided the word 'expenditure'[75] or it would have defined the concept of an immediate relationship to a dispute or legal action, as such, more precisely than with the words 'in respect of'.

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[74] It is my respectful submission that the court preferred to follow this route because perhaps it wished to find for the taxpayer. There is no conceivable reason, in my view, why it did not rather apply the established tests for determining whether or not the expenditure or loss there in question was incurred in the production of the taxpayer's income. In my view, there is fairly strong likelihood that had the court followed the latter route it would found it difficult to find that the farmer expenditure or loss was a necessary incident or inevitable concomitant of his income-earning operations.

[75] Compare *ITC 1058* at 308 where the court said the exact opposite in respect of a similar provision:

> **The legislature is presumed to know the interpretations given by the Courts and would have added the word 'losses' in s 11(2)(b)bis if it had been intended to cover damages.**

## 5. DAMAGES FOR COMPENSATION AND LEGAL EXPENSES CASES

This category of cases is, with respect, replete with inconsistencies which can for the most part be attributed to the courts' activistic tendencies. Although this area of the law is now governed by s 11(c) of the Act, the established principles are, in my view, still applicable to determine the deductibility of expenditure or loss incurred in paying damages and legal costs in the course of trade.

### 5.1 Expenditure or Loss Incurred in the Protection or Acquisition of a Capital Asset that Produces Income

In order to illustrate the gravity of the uncertainty prevailing in this area of the law, I propose beginning the discussion under this sub-category with two cases which, though their respective facts are identical and deductibility under the same provision was the issue with which the courts were seized, the respective courts nonetheless came to contrary decisions. The first case is *ITC 992*[76]. In that case the taxpayer was a registered public accountant and auditor. He also served as auditor, secretary, director and public officer in various companies for which he was remunerated. One of the companies in which he held appointments as secretary, director and public officer was placed in liquidation in insolvent circumstances. The taxpayer and certain other officers of the company were indicted on charges of fraud and contravention of the Insolvency Act, 24 of 1936. They were later acquitted of all charges after a preparatory examination and trial. The taxpayer then sought to deduct the legal costs incurred by him in defending the criminal charges in terms of

[76] 25 *SATC* 129

s 11(2)(b)bis of the Income Tax Act, 31 of 1941. Under that provision, what was deductible was --

> **any expenditure, other than that of a capital nature, actually incurred by the taxpayer during the year of assessment in respect of any 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.**

The court, per Ludorf J, held that if legal expenses are incurred for the preservation of the capital of the taxpayer those expenses are of a capital nature and are therefore not claimable as a deduction under the section there in question.[77] [78] In arriving at its decision, the court purported to rely on *CIR v Hersov*[79] where it was purportedly held that the taxpayer's legal expenses incurred in asserting his right to a permanent directorship and directorship fees were of a capital nature.[80]

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77 At 130

78 Compare *ITC 838* (21 *SATC* 419) where it was held that the costs of opposing an application for the liquidation of a company were of a capital nature and not expenses incurred in the production of income. In *ITC 1241* (37 *SATC* 300), however, legal expenses incurred by a taxpayer that carried on business as a scrap-metal merchant in defending an action with the clear purpose of preserving an income-earning structure (a machine which the taxpayer used to crush and shear metal and from the use of which it earned its income) were held to be deductible.

79 1952 (1) SA 485 (A)

80 In fact, with respect, this is not what the court in the *Hersov* case decided. The case was there concerned with the *taxability* of a value of shares allotted to a taxpayer as compensation for a surrender by the taxpayer of his right to a permanent directorship. The court then held that such value was of a capital nature and did not constitute gross income in the hands of the taxpayer. It is, with respect, rather an inference that one can draw that the expenditure incurred by the company allotting and transferring the shares would similarly be of a capital nature and therefore not deductible.

The other case is *Smith v SIR*[81]. The facts were identical with those in *ITC 992* excepting that Smith was, in addition, charged with the contravention of the Companies Act, 61 of 1973. The issue before the court was whether or not the expenditure incurred by the taxpayer in defending a criminal action was of a capital nature in terms of s 11(2)(b)bis of Act 31 of 1941. The majority, per Steyn CJ, took the view that the word 'capital' had to be given its ordinary meaning. His Lordship said:[82]

> **Broadly speaking and for present purposes, [capital] may be said to connote money and every form of property used or capable of being used in the production of income or wealth. Such a commercial or business sense is the sense in which one expects it to be used in the context here in question, and it is to capital in that sense that, for purposes of s 11(2)(b)bis at any rate, expenditure is to be related in order to determine whether or not it is expenditure of a capital nature.**

And further:[83]

> **[I]n *ITC 992* ... there is mention of the right of a professional man to practice his profession lawfully. I do not conceive of this as property employed by the appellant to produce an income. His right to practice is the right to enter into contracts of employment as an accountant. That right is not a commercial commodity. The requirement of registration under the Public Accountants' and Auditor' Act, 1951, imposes a limitation upon that right. This limitation does not alter its nature, so as to turn it into a right of property. The control of his activities arising from registration and the power of the Public Accountants' and Auditors, Board to remove his**

81 1968 (2) SA 480 (A)

82 At 490G - H

83 At 491A - D

> **name from the register or to suspend him from practice does not alter the fact that his income is produced by his trained wits and labour. These are not property and do not constitute capital in the ordinary sense, as contemplated in s 11(2)(b)bis.**

His Lordship then said that even if part of the taxpayer's purpose for the expenditure was to defend the goodwill of his practice, the dominant purpose would nevertheless have been to prevent a conviction which would in all probability have entailed a term of imprisonment and certainly lasting disgrace to him as a man.[84] He then concluded:[85]

> **I am unable to regard freedom from imprisonment and from such disgrace as capital assets in the ordinary sense.... In the result, I am of the opinion that the appellant's expenditure in defending himself against the charges preferred against him is not of a capital nature.**

Thus the majority held that the expenditure in question was deductible under s 11(2)(b)bis of the said Act.

In his dissenting judgment, Holmes JA took the view that if these 'destructive charges' had been proven against the taxpayer not only would he have been imprisoned; the goodwill of his professional practice would also have collapsed. The learned Judge of Appeal then regarded the statement of case -- which provided that the taxpayer had been forced to defend the charges in order to preserve, among other things, his good private and professional name, his freedom from imprisonment or other punishment, his right to remain

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[84] At 491G - H

[85] At 491 in fine

on the register of accountants, his social standing, his family life and his general acceptability for income-producing employment -- and said:[86]

> **The Special Court did not hold that the defence of the goodwill was the dominant purpose of the expenditure.... It seems to me clear, however, on a true interpretation of the stated case, that this was one of the main purposes of the expenditure. If the other main purposes are non-capital, such as defence of his personal good name and family life, it follows that there is no dominant purpose either way; and it is therefore at the least doubtful whether the expenditure was "other than that of a capital nature". Hence ... the taxpayer has not discharged the *onus*, imposed on him by sec. 78 of Act 31 of 1941, of showing that the deduction was wrongly disallowed. The appeal must accordingly fail. (Italics in text)**

It is respectfully submitted that Holmes JA's approach is preferable to that of the majority. In my view, even if the taxpayer's sole purpose was to preserve his freedom from imprisonment, thereby preserving also his personal good name, family life and social standing, the fact of the matter is that on the facts of this case freedom from imprisonment was inextricably linked to the goodwill of the taxpayer's practice and his professional good name. He could not practice from within prison nor would any reasonable person who was aware of his criminal record on grounds of fraud trust him with his financial affairs. Thus the goodwill of his practice would also be eradicated by imprisonment. In any event, inasmuch as the stated case revealed both capital and non-capital purposes for the expenditure, and no single purpose stood out as a dominant one, the taxpayer should have failed on the basis of failure to discharge the onus that rested on him of showing that the main purpose for the expenditure was not, for example, to protect the goodwill of his

[86] At 494D - F

business or his professional good name but to preserve his family life.

*ITC 992* was, in my view, correctly decided on its facts. It is inconceivable that a professional man whose income depends upon his professional good name and integrity should expend money in legal fees to defend a criminal charge with a dominant purpose other than the preservation of that professional good name and integrity. In any event, where such a professional man defends his good name in a defamation action and is awarded damages for the impairment of his good name, such receipt can hardly be regarded as revenue in nature.

Australian jurisprudence appears to favour an approach similar to that adopted in *ITC 992*. For example, in *Knight (Inspector of Taxes) v Parry*[87] the court held that a taxpayer -- an assistant solicitor (candidate attorney) about to leave the principal's office to set up his own practice -- who had been sued by his principal for breach of contract arising from soliciting the support of the principal's client, had two purposes for defending the action: first, to protect himself against the charge of professional misconduct[88] and, second, to defend himself against a claim for damages. The purpose of protecting himself professionally, said the court, was not wholly or exclusively referable to the carrying on of his trade as a solicitor but to see that he was not precluded from doing so (ie to protect his

[87] [1973] STC 56 (ChD)

[88] The principal had also taken the matter up with the law society which suggested that he brings a breach of contract action before it could proceed with the matter further.

capital right to practice as a solicitor and thereby earn a living).

Another pair of cases that deserves a discussion is that of *SIR v Cadac Engineering Works (Pty) Ltd*[89] and *ITC 1528*[90]. The facts of the former case were briefly that the taxpayer was a manufacturer of a cooking appliance under licence (which it held exclusively) from another company ("Marcovitch") under whose name a design was registered in terms of the then Patents Designs Trade Marks and Copyright Act, 9 of 1916. Upon discovering that another company, Homegas, was marketing and manufacturing similar cooking appliances, the taxpayer caused Marcovitch to bring proceedings interdicting Homegas from continuing to manufacture the cooking appliances on the basis that it was an infringement of Marcovitch's registered design. The taxpayer undertook to Marcovitch to pay the costs of such application. The interdict was refused and the taxpayer sought to deduct the legal costs so incurred from its income.

Applying the principle expressed in *CIR v Genn and Co. (Pty) Ltd*[91] that the court must, in an inquiry of the nature entertained in this case, always asses the closeness of the connection between the expenditure in issue and the income-earning operations, having regard both to the purpose of the expenditure and to what it actually effects, Ogilvie-

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[89] 1965 (2) SA 511 (A)

[90] 54 *SATC* 243

[91] 1955 (3) SA 293 (A) at 299

Thompson JA said:[92]

> **The expenditure in issue, directed as it was towards the protracted, if not permanent, elimination of Homegas as a competitor, was, in my view, expenditure to protect, and perhaps expand, the taxpayer's existing market and goodwill. The expenditure was directed towards preserving, and perhaps expanding, the field in which the taxpayer's business operated. In short, the expenditure was incurred in order the better to exploit the taxpayer's existing capital assets, which latter included the exclusive licence to manufacture the Marcovitch cooker. So regarded, the expenditure would appear to me to be more closely related to the taxpayer's income-earning structure than to its income-earning operations.**

The court then found that the expenditure in question was not deductible as it was of a capital nature.

On the other extreme, and on fairly similar facts, the court in *ITC 1528* elected a path, in coming to its decision, that is, with respect, uncharacteristically devoid of the public policy considerations that the courts are prone to conjure up in cases similar to this one.[93] The taxpayer was a manufacturer and distributor of diaphragm valves, widely used in South Africa to handle industrial fluids. In order to manufacture and sell these, the taxpayer copied the valves made and distributed by a British company through a process of reverse engineering. The valves were not protected by patent in South Africa as the patent of the

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92 At 523B - E

93 Perhaps Melamet J was not particularly fond of the English.

British company had expired. For purposes of its trade, the taxpayer issued promotional brochures which mentioned the British company by name and claimed the products to be fully interchangeable with the products of the British company. In manufacturing the products, the British company used engineering drawings in respect of which it held valid copyright. The British company considered that the manufacture by the taxpayer of the product constituted a reproduction in a three-dimensional form of the engineering drawings concerned and as such infringed its copyright. It then brought interdict proceedings against the taxpayer and the latter unsuccessfully defended the application and lost again on appeal to the Appellate Division. It then sought to deduct the legal expenses incurred in these proceedings.

The issue before the court was whether or not the expenditure was of a capital nature. The court accepted that the taxpayer had not any patent, trade mark or copyright, nor lawfully reproduced engineering drawings in respect of the products. The court also accepted that the taxpayer had acted unlawfully in copying and manufacturing the products concerned. It was held nonetheless that:[94]

> **What has to be determined is whether the expenditure in question was designed to protect the profit structure or its asset structure. Was it part of the costs of performing the income-earning operations or part of the costs of establishing or improving or adding to the income-earning structure. In the present case nothing would have been added to the income-earning structure of the [taxpayer]. The [taxpayer], if successful, would have continued trading as before with no additional asset. It ... would have been able to continue manufacturing the valves in the Republic**

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[94] At 251

**of South Africa as has been done hitherto.**

And again:[95]

> **In our view the expenditure was not designed to bring into being or protect an asset peculiar to the [taxpayer].** ***It was designed merely to remove an obstacle in the way of the income-earning operations.*** **(My italics)**

The court then found that the expenditure in question was deductible as it was not of a capital nature. It also distinguished *Cadac Engineering Works* on the basis that the expenditure there in question was found to be directed towards eliminating competition, to protect and perhaps expand the taxpayer's existing market and goodwill.

It is my respectful view that *stricto lege*, and having regard to their respective facts, both cases were correctly decided.[96] However, the basis on which the court distinguished *ITC 1528* from *Cadac Engineering Works* is, with respect, rather tenuous. The labels attached by the respective courts to expenditure should hardly be regarded as being conclusive of the nature of the expenditure in question as, in my view, the one court could just as easily have found on the basis on which the other found. Does not the elimination of competition and protection of existing market and goodwill in the manner used by the taxpayer in *Cadac Engineering Works* also amount to the removal of an obstacle in the way

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95 At 251 - 252

96 ie. the outcome of the cases was, in my view, correct.

of income-earning operations? In my view, it is obvious that competition is necessarily an obstacle in the way of income-earning operations. Similarly, the court in *ITC 1528* could, correctly in my view, just as easily have found that the taxpayer's expenditure there in question was incurred for the purpose of protecting its existing market and goodwill (albeit earned in dagger-and-cloak fashion).

At least one case in this sub-category that is an example of a correct outcome but unconvincing and, in my view, clearly incorrect reasoning, is *African Greyhound Racing Association (Pty) Ltd v CIR*[97]. In that case, the court found that money spent on legal representation of the association before a commission of inquiry, which was inquiring into whether or not dog-racing should be allowed or its extent curtailed, was incurred for the purpose of *preventing the total* or partial *extinction of the business from which the income of the association was derived.* The court then held that the expenditure on such representation was not closely connected with the earning of the income of the association to be regarded as part of the cost of earning it.

With respect, it is difficult to consider how an expenditure incurred for the purpose of preventing the total extinction of one's source of income can be said to be not closely connected with the earning of one's income. In my view, the court could have reached the same outcome by inquiring into the capital or revenue nature of the expenditure. Clearly, the expenditure there in question was incurred to protect a capital asset (much like the

[97] 1945 TPD 344

majority shareholders of a company incurring expenditure to oppose the placing of a company in liquidation[98]) and was thus of a capital nature.

The courts have, however, been fairly consistent in finding that expenditure incurred for acquisition of a capital asset is not deductible for such expenditure cannot be said to be not of a capital nature.[99]

The English and Australian courts, with respect, do not seem to shed much light on the difficulties that arise in this area of the law. In *Southern (Inspector of Taxes) v Borax Consolidated Ltd*[100], where the taxpayer had incurred legal expenses in defending its title to land, said:

> **Where a sum of money is laid out for the acquisition or improvement of a fixed capital asset it is attributable to capital, *but ... if no alteration is made in the fixed capital asset by the payment, then it is properly attributable to revenue, being in substance a matter of maintenance, the maintenance of the capital structure or the capital assets of the company.* (My italics)**

In *Lawson (Inspector of Taxes) v Johnson Matthey plc*[101] the court found it more convenient to classify an expenditure that was, in my view, clearly incurred for the

[98] Compare *ITC 838* (21 *SATC* 419)

[99] *ITC 790* (20 *SATC* 96); *ITC 819* (21 *SATC* 71); *ITC 843* (21 *SATC* 431); *ITC 1539* (54 *SATC* 394).

[100] [1941]1 KB 111

[101] [1992] STC 466 (HL)

preservation of a capital asset (and thus capital expenditure) as one incurred for the removal of an obstacle to the earning of income and thus revenue expenditure and deductible. One of the taxpayer company's subsidiaries, which carried on the business of banking, became insolvent and the taxpayer's board considered that the subsidiary's collapse would result in loss of confidence in the taxpayer and demands by lending institutions for the repayment of moneys owed to them by the taxpayer company. The taxpayer would then go out of business. It was considered further that the subsidiary would have to be wound up post-haste[102] unless further financing of its business, which the taxpayer company could not afford, was made available. Upon broaching the news of the subsidiary's insolvency to the Bank of England the latter offered to purchase the entire issued share capital of the said subsidiary for 1 pound provided that the taxpayer company injected a sum of 50 million pounds into the subsidiary company. An agreement was finally sealed on the basis that the Bank of England would provide the subsidiary company with a stand-by facility of 250 million pounds and the taxpayer would injected 50 million pounds. The taxpayer then sought to claim the payment of 50 million pounds as a deduction on the basis that it was made *to preserve its trade from collapse as a result of the collapse of the subsidiary company and therefore that it was incurred wholly and exclusively for purposes of its own trade.*

The court of first instance[103] found the expenditure to be of a revenue nature and

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[102] In fact it was resolved that the subsidiary would not open its doors for business the next morning.

[103] [1990] STC 149 (ChD)

therefore deductible. It said:[104]

> **[T]he ... payment *was made to preserve the trade of the [taxpayer company] from collapse ... and, as a payment to preserve an existing business, it was of a revenue nature.* (My italics)**

The Court of Appeal,[105] however, found as follows:[106]

> **[As] JMB was a capital asset of the taxpayer company ... the payment seems to me to be a payment by the taxpayer company to enable it to get rid of a capital asset. That asset was not onerous ... but its continued retention was harmful to the taxpayer company. In my view the common sense of the matter is that the [payment] was capital expenditure.**

The House of Lords (per Lord Templeman) took the view that inasmuch as the expenditure did not bring into existence nor procure an advantage for the enduring benefit of the taxpayer company's trade *but removed once and for all the threat to the business of the taxpayer company* constituted by the insolvency of JMB;[107] inasmuch as the expenditure *preserved the business of the taxpayer company although it did not preserve any particular asset*;[108] and inasmuch as the expenditure did not improve the taxpayer company's goodwill *but save*

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104 At 154

105 [1991] STC 259 (CA)

106 Per Fox LJ at 265

107 At 470f - g

108 At 471e

*it from extinction*[109], therefore the expenditure was one of a revenue nature. Lord Templeman viewed the expenditure as one incurred to remove an obstacle in the way of income-producing operations[110], while Lord Goff of Chieveley viewed it simply as a contribution toward the rescue of an ailing subsidiary.[111]

In similar vein, in *IRC v Carron Co*[112] the court, in rejecting the Revenue's argument that an expenditure -- incurred by the taxpayer company in obtaining a supplementary charter (Articles of Association) to replace the original charter which was too restrictive and primitive for the modern business world and to buy out two dissenting shareholders who were intent on frustrating the replacement of the original charter -- was of a capital nature because it produced an enduring advantage to the company, had said:[113]

> **Of course they obtained an advantage: companies do not spend money either on capital or income account unless they expect to obtain an advantage. And money spent on income account, for example on durable repairs, may often yield an enduring advantage. In a case of this kind what matters is the nature of the advantage for which the money was spent. This money was spent *to remove antiquated restrictions which were preventing profits from being earned.* It created**

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[109] At 471f - g

[110] Compare *ITC 1528 (supra) at 251 - 252*

[111] At 475j

[112] [1967]45 TC 18

[113] At 68

**no new asset. (My italics)**[114]

On the contrary, legal expenditure incurred by a taxpayer company in fending off a widow who had inherited her late husband's 51% shareholding thus, together with her own 5% shareholding, likely to gain control of the company -- which was a prospect not quite relished by the old gentlemen of the board[115] and who thus considered her a threat best not left to her own devices -- was held to be expenditure not wholly and exclusively laid out for the purposes of the company's trade.[116]

## 5.2 Expenditure Incurred to Protect Existing Income or Prevent its Diminution

The cases that I have grouped under this sub-category are not without their problems. *ITC 83*,[117] for example, is in my view problematic. In that case the taxpayer carried on business as a baker and confectioner. He was sued by a person who carried on business as a boarding-house keeper in the proximity of his bakery for damages caused by excessive smoke emanating from the chimney of the bakery. He defended the action, lost it and was ordered to pay damages. He paid the damages and sought to deduct the same

[114] Compare *Cadac Engineering Works*. It appears, in my view, that the facts in *Carron*'s case are capable of a contrary finding on the basis that the expenditure there in question was incurred in order the better to exploit the taxpayer's capital asset (that asset being greater borrowing powers, alienation powers and the like typically found in a company's articles of association).

[115] She also sat on the board

[116] *Hammond Engineering Co Ltd v IRC* [1975] STC 334 (ChD)

[117] 3 *SATC* 142

from his income. He also sought to deduct the costs awarded against him. The court held that the expenditure was not deductible. In arriving at that decision, the court relied on an English case of *Strong and Co. of Romsey v Woodifield*[118] where it had been ruled that expenditure incurred by a brewery in the form of damages paid as a result of a chimney that had fallen and injured a customer who had been sleeping in an inn owned by the brewery company was not deductible on the basis that such expenditure was too remote from the brewery business.

Relying on that case, Maritz P said that the concluding words of the Lord Chancellor were apposite to the facts of the instant case. The words to which the President was referring were the following:[119]

> **[L]osses sustained by a railway company in compensating passengers for accident in travelling might be deducted. On the other hand, if a man kept a grocer's shop, for keeping which a house is necessary, and one of the window shutters fell upon and injured a man walking in the street, the loss arising thereby to the grocer ought not to be deducted.**

Maritz P then concluded as follows,[120] clearly following the reasoning in that case:

> **In order to carry on the bakery appellant had to have a chimney, and had to have a building. Now the loss which had fallen upon appellant, had not fallen upon him in relation to his trade**

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118 1906 AC 448

119 Cited at 143 of the report.

120 At 144

**or bakery and selling bread; it had fallen upon him as owner of the building in which he carried on the business of the bakery. The legal expenses, therefore, fell upon the appellant in his capacity as owner of the premises responsible for the nuisance, and did not fall on the company in its character as a trader; they were consequently not deductible from income. The damage was not done in the course of trading, the damage was done, it was true, by something incidental to the bakery, but, in the Court's opinion, very remotely connected with the carrying on of the bakery business. The damage cause by a smoking chimney could not therefore be said to be damage caused to another in the production of income.**

With respect, the instant case is clearly distinguishable from the *Strong and Co. of Romsey* case. A falling chimney in a brewhouse is hardly a necessary concomitant of the business of a brewery. On the other hand, a smoking chimney in a bakery is as much part of a bakery business as is a hammering sound in a panel-beating business.

In a leading case, not only in cases grouped under this category but also in the entire area of the law that is subject of discussion in this paper, the court allowed the deduction of damages but not legal costs incurred in defending an action in which such damages were sought. The case was, of course, *Port Elizabeth Electric Tramway Co Ltd v CIR*[121]. The court said that the test to determine whether or not expenditure was incurred in the production of the income involves two inquiries: first, whether the act in question was performed *bona fide* for the purpose of carrying on the trade which earns the income and, second, whether the expenditure attendant thereupon is so closely linked to that act as to be regarded as part of the cost of performing it. Whether or not that expenditure was necessary for the performance of that act is irrelevant.

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[121] 1936 CPD 241

The taxpayer was ordered by a court to pay compensation to the widow of a driver employed by the taxpayer, which driver had been injured while driving the taxpayer's tram in the course of his employment. A costs order was also awarded against the taxpayer. The expenditure incurred in respect of damages was held to be deductible because, the court said, the act (ie the employment of drivers) to which the expenditure was attached was a necessary business operation for taxpayer's type of business. That act carried with it as a natural consequence the potential liability of paying compensation where a driver was injured in the course of his employment. The expenditure was therefore so closely linked to the act of employing drivers that it can be regarded as part of the cost of performing that act. Accordingly, the expenditure was incurred in the production of the income.

The expenditure incurred in paying legal costs was, however, held to be non-deductible as the act to which it was attached (ie the resisting of the claim for compensation) was not performed for the purpose of earning the income. Therefore the expenditure in respect of legal costs was not incurred in the production of income.

It is respectfully submitted that the court's reasoning in excluding expenditure incurred in respect of legal costs in this case is unconvincing. The same argument could, in my view, also be used to exclude the damages from deduction because, strictly speaking, the payment of damages is not an act that is productive of income. In fact it diminishes it. Conversely, however, the same reasoning adopted in allowing a deduction of damages is properly applicable to the legal costs there in question. If the act of employing drivers -- and to which the expenditure in the form of damages is attached -- is a necessary business operation for the taxpayer's type of business, and that act carries with it as a natural consequence the potential liability of paying compensation where a driver is injured in the course of his employment, then the taxpayer has every right to satisfy himself that the driver was injured in the course of his employment before paying the compensation. Any legal costs incurred in defending an action for the payment of such compensation is therefore also closely linked to the act of employing drivers that it can be regarded as part of the cost of performing it. The amount of such costs should therefore also be deductible.

In my view, the approach adopted in *ITC 49*[122] would, with respect, have been preferable. In that case, after allowing the deductibility of damages awarded against the taxpayer for injuries sustained by the plaintiff as a result of the explosion of a petrol lamp sold to the plaintiff by the taxpayer, the court said:[123]

> **Further if the amount awarded as damages was allowed, it seemed only logical to allow the costs.**

Even the Commissioner recognised the unfairness of the disallowance of legal costs in the *P E Electric Tramway* case that the Act was subsequently amended to provide for the deductibility of legal expenses.[124]

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122 2 *SATC* 117

123 At 123

124 s 11(c) of the Act

There appears to be a thin line among some cases in which expenditure was held by the courts to be properly classifiable as having been incurred for the protection of existing income or prevention of its diminution, the protection of a capital asset and the increase of existing income. In *ITC 583*[125] the court held that legal expenses incurred by the taxpayer (a property owner which derived its income from letting property) in respect of an application to the Rent Board for the increase in rent was incidental to the taxpayer's trade and therefore deductible. To the contention that the expenditure was incurred not in the production of income but in the protection thereof, the court said:[126]

> **The company was not seeking in its application for a reduction thereof. Its application was for *an increase of rent* and any opposition thereto was against such increase. *No costs were incurred in maintaining its rentals at the existing levels.* (My italics)**

The court also held that inasmuch as the taxpayer acquired no new real right by the expenditure, and the source of the increase in income was the same as before, namely the productive employment of the taxpayer's capital invested in the flats, and no further capital asset was created by the expenditure, the expenditure was not of a capital nature.[127]

In *ITC 585*[128], and on similar facts other than the fact -- which is insignificant in

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125 14 *SATC* 111

126 At 114

127 At 115

128 14 *SATC* 120

my view -- that in this case the taxpayer incurred expenditure in the form of legal costs in an application to the Rent Control Board and the Rent Board for the restoration of the rents, which had been reduced, to their original amounts, the same judge held that the expenditure[129]

> **in no way added to or increased the income so produced, it merely had the effect of protecting and preventing its diminution. It did not contribute to the earning of this income, or if did so, it is too remote to be permitted as a deduction.**

The court found it unnecessary to decide whether or not the expenditure was of a capital nature, having found that it was not incurred in the production of income. Although the court indeed did not have to decided on the question of the capital nature of the expenditure, it nonetheless thereby effectively avoided having to find, as it did in *ITC 583*, that the taxpayer had acquired no new real right by the expenditure and the source of its income was the same as before, namely the productive employment of its capital invested in the flats.

In the *Cadac Engineering Works* case[130] the Appellate Division had held that expenditure incurred in order the better to exploit the taxpayer's existing capital assets is more closely related to the taxpayer's income-earning structure than to its income-earning operations.[131] In my view, the expenditure in both *ITC 583* and *ITC 585* was incurred in

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129 At 122 - 123

130 See 44 above

131 At 523E

order the better to exploit the taxpayers' capital assets.

In *ITC 817*[132], dealing with the dismissal in *P E Electric Tramway* of a claim for the deduction of legal costs on the ground that they were not incurred in the production of income but in resisting a claim for compensation which is not an operation entered upon for the purpose of earning income, the court said:

> **That is all that is said about the question of costs in that case. No argument was advanced to the effect that *the minimizing of expenditure is part of the normal operation of earning the income, and there are scores of instances to show that where money is expended in order to reduce expenses without the direct object of earning income it can be deducted, and is always deducted from gross income in order to arrive at the taxable income.* (My italics)**

On the other hand, the court in *ITC 650*[133] held that legal expenses incurred by the taxpayer for the prevention of the diminution of his income in the form of maintaining the cost of his production at low levels were not incurred in the production of income and were therefore inadmissible as a deduction.

Further cases which give contrary dicta on the deductibility of expenditure incurred for the purpose of preventing the diminution of existing income include *CIR v Stellenbosch Farmers' Winery*[134], *Weinberg v CIR*[135] (obiter at 437) and *ITC 793*[136], where it was

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[132] 20 *SATC* 501 at 505

[133] 15 *SATC* 365

[134] 1945 CPD 377

held that such expenditure is, or in the case of *Weinberg could in a proper case be, an admissible* deduction. On the contrary, the courts in *African Greyhound Racing Association (Pty) Ltd v CIR*[137], *ITC 632*[138] and *ITC 725*[139] took the opposite view.

### 5.3 Expenditure Incurred to Eliminate Competition

Cases classifiable under this sub-category are fairly consistent. The facts of a case, however, may lend themselves to the court's fancy to elect an approach that is most consistent with its disposition at a particular time. The *Stellenbosch Farmers' Winery* case is, in my view, one such case. In *ITC 304*[140] the court had held that payment made to a competitor to close down its business was expenditure of a capital nature and therefore not admissible as a deduction. In *ITC 359*[141] the court ruled that expenditure incurred in compensating a competitor, thus inducing it not to manufacture and compete on products similar to those of the taxpayer, was of a capital nature and therefore not deductible. In *ITC 725*[142] the court held that expenditure incurred by a taxpayer in litigation seeking to prevent the owner of the premises in which the taxpayer carried on business from letting

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135 1946 CPD 429

136 20 *SATC 100*

137 1945 TPD 344

138 15 *SATC* 102

139 17 *SATC* 500

140 8 *SATC* 85

141 9 *SATC* 182

142 17 *SATC* 500

certain adjoining premises to a competitor, and opposing the granting of a trading licence to such competitor, was not incurred in the production of the taxpayer's income and was therefore not deductible. In *Cadac Engineering Works* the court viewed such expenditure as being incurred in order the better to exploit the taxpayer's existing capital asset and therefore more closely related to the taxpayer's income-earning structure than to its income-earning operations.

In *Stellenbosch Farmers' Winery*, however, the court was not so inclined and elected an approach that favoured the taxpayer. It is conceded that the facts of that case are such that it is difficult to fault the court's approach, and this illustrates further in my view the danger of relying on precedents in this area of income tax law. In that case the taxpayer company carried on the business of wine and spirit merchants. Among its achievements it had marketed sherry which became popularly known as "Ship Sherry" although the taxpayer did not so name it. A competitor, seeking to take advantage of this opportunity, entered the trade with sherry labelled "Ship Sherry". The taxpayer's sales of its sherry consequently declined. When the competitor applied for registration of its "Ship Sherry" trademark the taxpayer successfully opposed the application. Thereafter, the taxpayer's sales of its sherry increased. It sought to claim the legal expenses incurred by it in opposing the competitor's trademark application as a deduction.

To the Commissioner's argument that the taxpayer's opposition of the registration proceedings amounted to steps taken to protect its own label and as such that the expenditure was incurred in the protection of a trade asset, the court said[143] that the opposition was not aimed at protecting an own label because that was not threatened and could not have been threatened even if the competitor had succeeded in registering its "Ship Sherry" label. What the taxpayer sought to nullify, said the court, was the competition consequent upon the establishment of a rival's asset which would have led to a slump in the taxpayer's sales of its sherry, which indeed was the case. The court held further that the expenditure was incurred in order to maintain and *increase the taxpayer's profits.*[144]

In my view, the facts of this case are similar to those of *ITC 1370*[145] where the court dismissed an appeal for the deduction of expenditure incurred by the taxpayer in interdict proceedings brought against a competitor for passing off certain blades as being those of the taxpayer. The court said:[146]

> **I ... have no doubt that ... the overall objective was the increasing of the [taxpayer's] profits by the elimination of the unfair competition ... . However, having regard to the nature of the expenditure, there is not, in the view of this court, a sufficient link between that expenditure and the taxpayer's income-earning operations to warrant the conclusion that it formed part of [the taxpayer's] income-earning operation as distinct from the cost of expanding it income-producing structure, namely its business.**

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143 At 383

144 At 388 - 389

145 45 *SATC* 55

146 At 57

These two cases are clearly irreconcilable although their respective facts are materially similar.

Comparatively, in *Walker (Inspector of Taxes) v Joint Credit Card Co Ltd*[147] the court held that payment made by a company to a competitor thereby effecting a total closure of the competitor's business was expenditure of a capital nature and therefore not claimable as a deduction.[148]

### 5.4 Expenditure Incurred to Increase Existing Income

Generally the courts have found that such expenditure is deductible.[149] The Australian cases, however, appear to be leaning towards a contrary view. In the recent case of *Vodafone Cellular Ltd and Others v Shaw (Inspector of Taxes)*[150] the court held that expenditure incurred to cancel an onerous contract so that the taxpayer could trade more profitably and increase its income was of a capital nature and therefore not deductible. Much

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147 [1982] STC 427 (ChD)

148 Compare *ITC 359* (supra)

149 *ITC 583* (14 *SATC* 111) on the basis that it is incidental to the taxpayer's trade; *CIR v Stellenbosch Farmers' Winery* on the basis that it is closely connected with the production of the taxpayer's income; *ITC 390* (9 *SATC* 473) on the basis that it removed an obstacle to the increase of the taxpayer's revenue; *ITC 1267* (39 *SATC* 146) on the basis that it was incurred to utilize the taxpayer's capital asset to best advantage; *SIR v John Cullum Construction Co (Pty) Ltd* 1965 (4) SA 697 (A) on the basis that it enabled the taxpayer to conduct its business on more economical basis; *ITC 1600* ( *SATC* 131).

The list is not exhaustive.

150 [1995] STC 353 (ChD)

earlier, in *Mallett (Inspector of Taxes) v Staveley Coal and Iron Co Ltd*[151] the court held that a lump sum payment made to modify the conditions of a burdensome mining lease, which was considered to be a capital asset, thus increasing the taxpayer income from mining constituted expenditure of a capital nature. In *Tucker v Granada Motorway Services Ltd*[152], where the taxpayer had paid a consideration to the landlord in order to modify the terms and conditions of a 50 year lease which effectively limited the taxpayer's borrowing powers against its own assets and curtailed its profit margins, the court held that the expenditure was *one of once and for all on a capital assets and designed to make it more advantageous*[153] and that it was incurred *to make a capital asset* (the lease) *more advantageous to the taxpayer*[154]. Thus the House of Lords held that the expenditure was not deductible. In *Whitehead v Tubbs (Elastics) Ltd*[155] the court found that expenditure incurred for the release of the taxpayer from an onerous loan agreement, which effectively constrained its borrowing powers and encumbered its assets, was of a capital nature and therefore not admissible as a deduction.

However, in *Walker v Cater Securities Ltd*[156] the director of the best customer to

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151 [1928]2 KB 405

152 [1979] STC 393 (HL)

153 per Lord Wilberforce at 397h

154 per Lord Fraser of Tullybelton at 403h - 404d

155 [1984] STC 1 (CA)

156 [1974] STC 390 (ChD)

the taxpayer company in terms of the taxpayer company's gross earnings held an option which, if any disagreement were to arise between that director and one of the directors of taxpayer company, the customer's director could exercise to withdraw the customer's business with the taxpayer. In seeking to release the option of the said director the taxpayer company paid a consideration to him thereby warding off the risk of losing the customer's business. On advice the taxpayer's auditors the payment was charged to the revenue account. It was however capital income in the hands of the payee. When the taxpayer sought to deduct the payment, the court said the following after accepting that the payment was capital in the hands of the payee:[157]

> **I am not persuaded that because compensation for the destruction or removal of an important part of a trader's trading structure is rightly treated as a capital receipt, it follows that expenses paid to maintain an existing trading structure necessarily have the quality of capital expenditure.**

### 5.5 Expenditure Incurred on Traffic Fines

In determining whether or not expenditure of this nature is deductible it appears that the courts adopt policy considerations. In *ITC 1199*[158] the court said, without more, that the nature and character of a fine as a punishment exacted by the state is such that it could not properly, naturally or reasonably be regarded as part of the cost of performing the business operation.[159] In *ITC 1490*[160] the facts afforded the court, in my view, a

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[157] At 401

[158] 36 *SATC* 16

[159] At 21

basis other than public policy to dismiss the taxpayer's claim for the deduction of a fine. The taxpayer that carried on the business of transporting goods on behalf of customers had been fined for overloading. In conducting its business the taxpayer routinely agreed to carry overloads for its customers provided that the customer would be responsible for the charge of a fine if it were imposed. The amount of the fine would then be built into the fee charged by the taxpayer for conveyance of goods.

In dismissing the taxpayer's appeal the court said that to allow fines imposed for an infraction of the law to be deducted as an expense would be contrary to public policy in that it would frustrate the legislative intent and allow a punishment imposed to be diminished or lightened.[161] In my view, the court applied public policy considerations in dismissing the taxpayer's appeal because on an application of the established principles the outcome of the case might well have been different. In *CIR v Genn & Co (Pty) Ltd*[162]*, for example, the court, amplifying the test as expressed in P E Electric Tramway*, said what is deductible are:

> **all expenses attached to the performance of a business operation bona fide performed for the purpose of earning income ... 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 it would be proper, natural or reasonable to regard the expenses as part of the cost of performing the operation.**

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160 53 *SATC* 108

161 At 114

162 1955 (3) SA 293 (A) at 299

Upon application of this test to the facts of both *ITC 1199* and *ITC 1490* the court would, in my view, have found it difficult to hold that the respective expenditure was not incurred bona fide for the more efficient performance of the taxpayers' operations and therefore closely connected with the earning of the income.

The Australian and English courts appear to adopt an approach similar to that of our courts.[163]

## 6. CONCLUSION

In this paper I have sought to point out some of the difficulties that arise in the area of income tax law that has been the subject of discussion herein. I have also attempted to give my own perspective in some instances where I considered the courts could have adopted a different and more apposite approach. It is clear in my view that the area of the deductibility of expenditure and losses incurred as a result of defalcations, negligence and liability for compensation and damages (together with the legal costs attendant thereupon), particularly the last-mentioned, owes much of its jurisprudence, both in South Africa and seemingly in Australia and England, to judicial activism. In the interest of enriching and intriguing debates among barristers on the one hand and between the bench and bar on the other, perhaps such is not a bad thing. However, for the sake of consistency and clear

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[163] *CIR v Warnes* 12 TC 227 (KB); *CIR v Alexander vo Glehn & Co Ltd* 12 TC 232 (CA); *Herald & Weekly Times Ltd v Federal Commissioner of Taxation* 2 ATD 169; *Mayne Nickless Ltd v Federal Commissioner of Taxation* 15 ATR 732; *Madad (Pty) Ltd v Federal Commissioner of Taxation* 15 ATR 1118.

guidance for the taxpayer to enable him or her to better conduct his or her affairs, perhaps the price for intriguing debates is too high.

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