IN THE COURT OF APPEAL OF THE DEMOCRATIC SOCIALIST

REPUBLIC OF SRI LANKA

In the matter of a Case Stated

under

Section 170 of the Inland

Revenue Act

Judgment in Four Parts,
with summary attached.

No. 10 of 2006.

Samson Sportswear (Pvt) Ltd,
No. 110, Kumaran Ratnam Road, P.
O. Box 778,
Colombo 02.

Appellant

C.A./ Tax/1/2013

Vs.

1. The Commissioner General of Inland Revenue, Sir Chiththampalam A. Gardiner Mawatha, Colombo 02.

Respondent

Before : Hon. D.N. Samarakoon,
Hon. Sasi Mahendran

Counsel: Riad Ameen, with S. Abeygunewardene, instructed by D. L. F. de Saram for the Appellant.

Chaya Sri Nammuni, D. S. G. for the Respondent.

Written Submissions: 08th November 2017 by Appellant

30th November 2017 and 29th June 2022 by Respondent

Date : 26th May 2023

D.N. Samarakoon, J.

PART I

Introduction:-

Basically, the question is about the interplay between the following sections of Inland Revenue Act No. 10 of 2006,

(i) "CHAPTER IV

ASCERTAINMENT OF PROFITS OR INCOME

25. (1) Subject to the provisions of subsections (2) and (4), **there shall be deducted for the purpose of ascertaining the profits or income of any person from any source, all outgoings and expenses incurred by such person in the production thereof,** including.....

(f) interest paid or payable by such person;

(ii) 26. (1) For the purpose of ascertaining the profits or income of any person from any source, no deduction shall be allowed in respect of–

(g) any disbursements or expenses of such person, **not being money expended for the purpose of producing such profits or income**

(h) **any expenditure of a capital nature** or any loss of capital incurred by such person;

(iii) 32 (5) **There shall be deducted from the total statutory income of a person for any year of assessment–** (a) **sums paid by such person for any year of assessment by way of annuity, ground rent, royalty or interest <u>not deductible under section 25.</u>** For the purposes of this paragraph interest does not include the excess referred to in paragraph (x) of subsection (1) of section 26 :

(iv) where any sum is paid by such person by way of interest, no deduction shall be allowed in respect of such interest, unless such interest is paid under any legal or contractual obligation

(B) to any other person recognized by the Commissioner-General for the purposes of this paragraph

What the appellant attempts to deduct or to ask for an exemption of tax is what it paid as "interests" of a loan. The assessor, the Deputy Commissioner and the Tax Appeals Commission referred the Tax Payer to section 26(1)(g), which says, "For the purpose of ascertaining the profits or income of any person from any source, no deduction shall be allowed in respect of–

(g) any disbursements or expenses of such person, not being money expended for the purpose of producing such profits or income"

The TAC in addition cited, section 26(1)(h) which is, "26. (1) For the purpose of ascertaining the profits or income of any person from any source, no deduction shall be allowed in respect of–

(h) any expenditure of a capital nature or any loss of capital incurred by such person;.."

The appellant argues this as a violation of the rule of Audi Alteram Partem, that it was not given an opportunity to explain its stance in respect of that position.

The antecedent circumstances as to why the appellant had to pay interests is as follows,

The appellant "Samson Sportswear (Pvt.) Ltd." is a subsidiary of "D. S. I. Holdings Ltd". In 2005/2006 and 2006/2007 the appellant gave 9 interest free loans to another company of the same Group, "Samson Rajarata Tiles (Pvt.) Ltd". These loans were subsequently taken over by another company of the same Group "D. S. I. Samson Group Ltd"., which thus became the "debtor".

The appellant has also taken loans from 3 Banks which were paid. In 2007 the appellant obtained an interest bearing loan of Rs. 85,000,000/- from the main company "D. S. I. Holdings Ltd". It is the interest of this loan, the appellant wanted to deduct under section 25(1). As already referred to section 25(1) says,

"CHAPTER IV

ASCERTAINMENT OF PROFITS OR INCOME

25. (1) Subject to the provisions of subsections (2) and (4), there shall be deducted for the purpose of ascertaining the profits or income of any person from any source, all outgoings and expenses incurred by such person in the production thereof, including..."

The specific section 25(1)(f) says,

"(f) interest paid or payable by such person;…"

Arguments against the appellant:-

It is stated in paragraph 6 of respondent's "Final Consolidated Written Submissions" dated 29th June 2022, that,

> "It must be stated at the very outset that the judgments in the cases of Tax 1/17, *Geometry Global (Private Limited) vs. Commissioner General of Inland Revenue* decided on 12.11.2021 and the case *Ogilvy Action (Pvt) Ltd vs. Commissioner General of Inland Revenue* Tax 16/13 decided on 12.11.2021, both heard together, were held against the respondent on this matter".

What is meant by "on this matter" above is mainly the interplay of sections 25(1) et seq and 26(1) et seq.

But the respondent states that *CEI Plastics Limited vs. Commissioner General of Inland Revenue* Tax 3/13 decided on 10.07.2018 and *ICICI Bank Limited vs. The Commissioner of Inland Revenue* C. A. Tax 28/2013 decided on 16.07.2015 are in favour of the respondent, although, only some aspects of those cases were considered in the more recent judgments.

As per the judgment in Tax 3/13 decided in 2018, it appears, on page 8 of that judgment, that, the appellant in that case had argued that the word "including" at the end of the main part of section 25(1) has the effect of enlarging the meaning of the previous phrase. *Patrick Alfred Reynolds vs. Commissioner for Income Tax, Trinidad and Tobago (1965) 3 All E R 901* has been cited. The Court of Appeal, then in 3/13 considered the meaning of "including" and having said that the said term was not always given an extended meaning, purported to follow the 2015 judgment in *ICICI Bank Limited vs. The Commissioner General of Inland Revenue,* to say that, the word "thereof" in "incurred by such person in the production thereof" referred to the income generated by expending the said outgoings and

the expenses (page 10) The Court also said (at page 11) that such an interpretive approach is consistent with the approach the Supreme Court took in *Rodrigo vs. The Commissioner General of Inland Revenue* [2002] where Bandaranayake J., (later Chief Justice) held that sections 23(1) and 24 of the Inland Revenue Act No. 38 of 2000 have to be read together as both provisions apply to deductibility from the income and that taking both these sections together in their literal context, it appears that the meaning of words in section 23(1) is restricted by the words given in section 24(1)(g) of the Act. The Court in 3/13 further said that Bandaranayake J., further held (at page 394) that if any part of the expenses could be clearly identified as having being expended for the purpose of deriving money not being profits or income liable to tax, such amount could not be deducted in terms of section 24(1)(g).

Hence it was decided that "includes" cannot be given an extended meaning. It may be noted that sections 23(1) and 24(1)(g) of Inland Revenue Act No. 38 of 2000 are similar to sections 25(1) and 26(1)(g) of Inland Revenue Act No. 10 of 2006.

The Court in 3/13 (at page 11) also considered section 32(5)(a) which read as,

> "32 (5) There shall be deducted from the total statutory income of a person for any year of assessment– (a) sums paid by such person for any year of assessment by way of annuity, ground rent, royalty or interest <u>not deductible under section 25…</u>"

The Court in 3/13 did not accept that the appellant can deduct interest under this section, because,

(i) It says "Not deductible under section 25", but in that case (as per the Court) the interest paid was deductible under section 25 but was prohibited by section 26(1)(g),

(ii) Under 32(5)(a) the proceeds of the loan should be utilized for the specific purposes enumerated thereunder,

(iii) The available documentation not showing that the appellant has raised this question before the Assessor or the Deputy Commissioner,

(iv) The available documentation not showing that the appellant has raised several factual matters referred to in section 32(5)(a) before the Assessor or the Deputy Commissioner (at page 12)

In *ICICI Bank Limited vs. The Commissioner of Inland Revenue,* 28/2013 of 2015 the appellant under Question No. 4 of the Case Stated, in the alternative, suggested that it can deduct interest paid under section 25(1)(f) The Court of Appeal said at page 8, **"My view is that it means the outgoings and expenses incurred for the purpose of generating the taxable Income, and it is the one that can be deducted".**

The 2015 case also referred to *Rodrigo vs. Commissioner of Income Tax* [2002]

In paragraph 18 of the above Written Submissions of the respondent, it is stated,

> "18. Therefore the Appellant argues that this provision [section 25(1)] covers all deductions, those that are expenses and those that may not be recognized as expenses but as outgoings, which may not be incurred in the production of profit or income and that the interest paid and payable on the interest bearing loan taken, is one such expense/outgoing".

It is then argued, for the respondent, that, there is no "dissension" on the definition of the words "expenses" and "outgoings". It is not clear whether what was meant also purportedly included "distinction". Anyway whether it was meant to be "dissension" or "distinction", it is clear that the respondent argues that "incurred by such person in the production thereof" should refer not only to "expenses" but to "outgoings" too.

It is further submitted, that, "**<u>These two sections have to be read together</u>.** It has been held in the Rodrigo's case that any **disbursement or expense which was not spent for the purpose of production of profits and income**

cannot be deducted and all outgoing expenses incurred by a person in the production of income could be concluded as deductions. Court further held that if any part of the expenses could clearly be identified as having been expended for the purposes of deriving money not been profits or income liable to tax such amount could not be deducted in terms of section 26(1)(g)". (paragraph 21) [The emphasis added in the said Written Submissions of the respondent]

It is also submitted, that, the Court of Appeal in Tax 1/17 and 16/13 [*Geometry and Ogilvy, respectively*] has not considered the following paragraph in *Rodrigo vs. The Commissioner of Income Tax* [2002]

> "Page 389 of the judgment refers to section 23(1), which is the same as section 25(1) in the 2006 Inland Revenue Act, where their Lordships' conclude that section 23(1) sets out 3 important elements "(a) the source of profits and income (b) all outgoings and expenses incurred (c) **that such outgoings and expenses should be incurred in the production of such income"**. [The emphasis added in the said Written Submissions of the respondent]

It is also submitted, (paragraph 32), that, *Geometry* and *Ogilvy* have not considered page 392 of *Rodrigo vs. The Commissioner of Income Tax* [2002] which says,

> "Section 24 (1) (g) read with section 23 (1) of the Act, show that –
>
> (a) any disbursement or expenses which was not spent for the purpose of production of profits and income cannot be deducted;
>
> (b) all outgoings and expenses incurred by a person in the production of income from any source could be included as deductions".

It is also submitted,

"Taking both these sections together in their literal context, it appears that the meaning of words in **section 23(1) is restricted by the words given in section 24(1)(g), which spells out the negative or what should not be deducted…"** [The emphasis added in the said Written Submissions of the respondent]

It would appear and in fact the appellant has questioned, the necessity of enacting section 25(1) if it is wiped out by section 26(1)(g). More about this will be said later when it comes to "literally reading both sections together".

Next the respondent questions the purpose for which the loans were taken, that, it is not for the business of the appellant.

It is stated that there is no satisfactory explanation given to why non interest bearing loans were given and an interest bearing loan was taken. The respondent cites *Commissioner of Income Tax vs. PKN (STC (VI)* page 56 at page 117, to say that, "In effect one cannot trade with oneself and claim expenses. The Appellant borrowed the Rs. 85,000,000/- from "D. S. I. Holdings", which owns 97% of the Appellant Company. This is a prime example of dealing with themselves".

Whether a Special Rule on deductions will apply?

Next the respondent purports to refute the argument that section 25(1)(f) is a special rule of deduction which applies even if the expenditure was not incurred in the production of income.

The respondent argues,

"…Thus, the Respondent reiterate that the requirement that all deductions be expenses and outgoings that are incurred in the production of income and profit will apply to section 25(1)(f) and therefore the Appellant is not entitled to claim the deduction for interest paid on the basis that the interest referred to in section 25(1)(f) need not be incurred

in the production of profit and income as in section 25(1)…" (paragraph 49)

It is also submitted, that,

"The Appellant's argument is that section 26(1) should only be interpreted to refer to section 25(1) only and not to the sub sections since it would not make sense to purportedly allow interest to be deducted by 25(1)(f) and prohibit it by 26(1)(g)". (paragraph 54)

It is perfectly true that there is no point in allowing by 25 and prohibiting by 26, but on the other hand, if 26(1) only prohibits 25(1) but not sub sections of 25 then what about sub sections of 26, do not they [sub sections of 26] prohibit sub sections of 25?

Next the respondent refers to *Patrick Alfred Reynolds vs. Commissioner for Income Tax, Trinidad and Tobago (1967) A. C. 1 (1965) 3 All E R 901,* cited by the appellant.

In that case, the Privy Council (Lord Hodson, Lord Upjohn and Lord Wiberforce, delivered by Lord Hodson) had the opportunity to consider an appeal from the Court of Appeal of Trinidad and Tobago. The date of the judgment is 02nd November 1965. It is necessary to obtain an idea about the facts of this case to clearly understand the ratio decidendi of the judgment.

It was concerning the income of Mr. and Mrs. Reynolds. Under the Income Tax Ordinance, it was possible to charge wife's income also in the name of the husband although no assessment has been made upon her. The question arose as to the deductibility of the annual payment made by Mrs. Reynolds to a trustee under a deed of covenant for their four children, which amounted to $ 3,500/- per annum per child aggregating $ 14,000/-, which was disallowed.

The applicable sections were section 10(1)(f) and section 12(1)(b). Section 10(1)(f) read,

"Section 10(1). " For the purpose of ascertaining the chargeable income of any person, **there shall be deducted all outgoings and expenses** wholly and exclusively incurred during the year preceding the year of assessment by such person **in the production of the income, including**-"…

(f) " annuities or other annual payments whether payable within or out of the Colony, either as a charge on any property of the person paying the same by virtue of any deed or will or otherwise, or as a reservation thereout, or as a personal debt or obligation by virtue of any contract;

Provided that no voluntary allowances or payment of any description shall be deducted: "

Section 12(1)(b) read,

"Section 12. **(I)**" For the purpose of ascertaining the chargeable income of any person no deduction shall be allowed in respect of-…

(b) any disbursements or expenses not being money <u>wholly or exclusively laid out or expended for the purpose of acquiring the income;</u>

(f) rent of or cost of repairs to any premises or part of premises **not paid or incurred for the purpose of acquiring the income;**

[The emphasis added in this judgment]

The Privy Council formulated 3 questions, which it said, all should be answered in the affirmative for the appellant to succeed. The first question thus formulated was,

(1) Is an annual payment made by a taxpayer under a deed of covenant deductible in computing his chargeable income by virtue of section 10(1)(f) of the Ordinance read with section 12 thereof, even though it does not constitute an expense incurred in the production of income?

The Court said,

> "First what is the effect, upon its true construction, of section lO(l)(f), bearing in mind the introductory words " outgoings and expenses wholly and exclusively incurred ... in the production of the income?" If these words as the respondent argues govern all of the following sub-paragraphs (a) to (k), the appellant must fail for it is not and cannot be contended that the covenants in question, including incidentally those entered into by the appellant personally, were entered into in any way that could be covered by the words "in the production of the income". Moreover these words are underlined in section 12(1)(b), supra, where the words " for the purpose of acquiring the income" repeated in section 12(l)(f) reinforces the argument of the respondent.
>
> On the other hand the use of the word " including" in introducing the catalogue enables the appellant to submit, in the language of Lord Watson giving the judgment of the Board in *Dilworth v. Commissioner of*

Stamps [1899] A.C. 99 at page 105, that "the word 'include' is very generally used in interpretation clauses to enlarge the meaning of words or phrases occurring in the body of the statute; and when it is so used these words or phrases must be construed as comprehending not only such things as they signify according to their natural import, but also those things which the interpretation clause declares that they shall include."

In looking at this section as a whole including all its sub-paragraphs, their Lordships have already noticed that not all of the sub-paragraphs appear to be directly aimed at what may be broadly be called trade, business or profession and they are of opinion that the language of sub-paragraph

(f) in particular the reference to a "will" points to the conclusion that,

(f) is looking at something which is not necessarily a business and that the conception of "the production of the income" is inappropriate and certainly not necessary to be regarded as a provision which governs this sub-paragraph.

…….

Further this construction is not inconsistent with section 12 which, read together with section 10, is of limited application and does not take away that which has been expressly provided by section 10 (I) (f)".

Therefore, although the Court finally dismissed Mr. Reynold's appeal, on the basis that "for the purpose of acquiring the income", is repeated in

section 12(1)(f) too, it decided that 10(1)(f) is looking at something which is not necessarily a business and that the conception of "the production of income" is inappropriate and certainly not necessary to be regarded as a provision which governs this sub paragraph.

This shows that *Patrick Alfred Reynolds vs. Commissioner of Income Tax, Trinidad and Tobago,* 02nd November 1965, is not a case that in its entirety supports the appellant in this case. The respondent, albeit not very clearly, says this in paragraph 64 of above Written Submissions, as follows,

> "Although their Lordships' have dealt with this judgment [Patrick Alfred Reynolds vs. Commissioner of Income Tax, Trinidad and Tobago, 02nd November 1965] as being applicable in the recent cases of Tax 1/17 [*Geometry*] and Tax 1/13 [correctly should be Tax 16/13, *Ogilvy,* for Tax 1/13 is this case], with greatest of respect this paragraph has not been highlighted "first, what is the effect upon the true construction of section 10(1)(f), bearing in mind the introductory words, "outgoings and expenses wholly and exclusively incurred…in the production of income"…Moreover these words are underlined in section 12(1)(b)…repeated in section 12(1)(f)…" This clearly firstly demonstrates that even this case, relied upon in the judgments, state that both expenses as well as outgoings are governed by the phrase "incurred in the production of income…and are "introductory words".

It was accepted in Tax 16/13 [*Ogilvy*] that,

> "[78] The Privy Council, however dismissed the appeal on different grounds. The Privy Council was of the view that the payments to the trust for the maintenance and benefits of a taxpayer's children are within the prohibition of Section 12 (1) (b), which prohibits any disbursements or expenses not being money wholly and exclusively laid out or expended for the purpose of acquiring the income".

If one looks at the Question No. 1 formulated by the Privy Council,

(1) "Is an annual payment made by a taxpayer under a deed of covenant deductible in computing his chargeable income by virtue of section 10(1)(f) of the Ordinance read with section 12 thereof, even though it does not constitute an expense incurred in the production of income?",

it would appear that it was not on a different ground, as said in Tax 16/13 [*Ogilvy*] but on the same ground that the Privy Council did dismiss the appeal of Mr. Reynolds.

Hayleys case and Rodrigo's Case:-

The respondent, then, aptly comes to the cases of *Hayley and Company Ltd., vs. Commissioner of Inland Revenue 65 NLR 174* and the case that purportedly followed that judgment, *Rodrigo vs. Commissioner of Income Tax [2002] 1 SLR 384* and says in paragraph 76 of the above Written Submissions, as follows,

"Although their Lordships' have stated that Basnayake C.J.'s decision in Hayleys has been upheld in the Rodrigo's case, the respondent respectfully submits that it is Sinnatamby J's decision that the expenses and outgoings are both limited to those incurred in the production of income that has been, in effect, upheld in Rodrigo's case".

The respondent also submits at paragraph 77 of Written Submissions, as follows,

"The fact that Rodrigo's case had said that section 25(1)(g) [should be 25(1)(f)], similar to section 26(1)(g) limits section 23(1) (25(1) in 2006 Act) states that a specific provision in section 26(1)(g) can and will affect the deductibility provisions, because the sections have to be read together

and the reading does not mean 25(1) vs. 26(1) and 25(1)(a) to (w) vs 26(1)(a) onwards…It means that the sections entirely must be read together".

The mistakes in the syntax in respondent's Written Submissions leaves much to be desired. It foreshadows lack of supervision and makes the Court wonder as to the exact meaning. It basically says that sections 25(1) and 26(1) must be read together. This is what Her Ladyship Shirani Bandaranayake J., (later Chief Justice) said in Rodrigo's case, which if quoted will be as follows,

> "The respondent's argument is that, the appellant should show the expenses that were incurred in earning the taxable income and only those expenses could be allowed as a deduction in terms of section 23 (1). In support of this argument respondent relies on section 24 (1) (g) of the Act. This section states that disbursements or expenses, not expended for the purpose of producing the profits and income will not be allowed as deductions". (page 391)

That case was decided under Inland Revenue Act No. 38 of 2000. What is section 25(1) and 26(1)(g) today were 23(1) and 24(1)(g), respectively, then, which are also similar in main aspects to sections 10(1)(f) and 12 (1)(b) in *Patrick Alfred Reynold vs. Commissioner of Income Tax, Trinidad and Tobago*, 1965.

The Supreme Court continued,

> "Sections 23 (1) and 24 of the Act have to be read together as both provisions apply to the deductibility from the income. While section 23 spells out the permissible expenses, section 24 expressly disallows the whole or part

of certain expenses, which if not so prohibited, would be allowable deductions. The combined effect of sections 23 and 24 therefore is to divide all outgoings and expenses into two categories; outgoing expenses which are deductible and not deductible". (page 391)

"In considering the applicability of sections 23 and 24, the respondent took up the position that section 24 (1) (g) could be applied to disallow amounts expended for the purpose of producing profits and income from the exempt receipts of a source. Section 24 (1) (g) is in the following terms:

"For the purpose of ascertaining the profits or income of any person from any source no deduction shall be allowed in respect of any disbursements or expenses of such person not being money expended for the purpose of producing such profits and income."

Section 24 (1) (g) read with section 23 (1) of the Act, show that –

(a) any disbursement or expenses which was not spent for the purpose of production of profits and income cannot be deducted;

(b) all outgoings and expenses incurred by a person in the production of income from any source could be included as deductions.

Taking both these sections together in their literal context, it appears that the meaning of words in section 23 (1) is

restricted by the words given in section 24 (1) (g) of the Act. Section 24 (1) (g), which spells out the negative or what should not be deducted, uses the words "disbursement or expenses" whereas section 23 (1), which is the positive or the permissible section refers to the words "all outgoings and expenses incurred". The Dictionary meaning of the word "disbursement" explains it as "expenditure" (The Oxford English Dictionary, 2nd edition, volume 4, p. 726) which has a limited meaning than the word "outgoing". If I may repeat Chief Justice Basnayake's reasoning in the Hayley's case (supra) :...(page 392)

> "All outgoings are not expenses incurred in the production of the profits or income; but all expenses incurred in the production of the profits or income are outgoings". (page 393)

If (a) and (b) above referred to by Court as the cumulative effect of sections 24(1)(g) and 23(1) [or sections 23(1) and 24(1)(g)] are written in "reverse" order, for it should work then too and it is the order in the sections, it will read,

"(a) all outgoings and expenses incurred by a person in the production of income from any source could be included as deductions.

(b) any disbursement or expenses which was not spent for the purpose of production of profits and income cannot be deducted;..."

This reminds of a Common saying in the vernacular, which could be translated as, “blooming flowers wiped out by rain”.

The Court finally said,

> “However, it would be necessary to give a meaning to the words in section 24 (1) (g) of the Act. **If any part of the expenses could be clearly identified as having being expended for the purpose of deriving money not being profits or income liable to tax, such amount could not be deducted** in terms of section 24 (1) (g)”. (page 394) [The emphasis added in this judgment]

What is in “bold” letters, is already said, in section 23(1) [section 25(1)] itself and there appears to be no requirement in repeating the same, for section 25(1) reads,

> “**there shall be deducted for the purpose of ascertaining the profits or income of any person from any source, all outgoings and expenses incurred by such person in the production thereof,...”**

Both *Patrick Alfred Reynolds vs. Commissioner for Income Tax, Trinidad and Tobago*, 1965 and *Rodrigo vs. Commissioner of Income Tax* [2002] attempted to read the countervailing sections “together”. But the learned Chief Justice **Hema Henry Basnayake**, in 1961, broke, section 9(1)[1] [as the section was then]

[1] However, the judgment says Chapter 188. Chapter 188 of the 1956 version of Legislative Enactments is Antiquities. But in as much as Chief Justice Basnayake cannot be inaccurate as to the number of the section, there is also a case, Rajapakse vs. Commissioner of Income Tax. 1934, by Daulton J., referring to deductions of travelling expenses under section 9(1). Since, 1956 version of Legislative Enactments were not there in 1934, it is certain that

and it appears to this Court, in right places too.

In *Hayley and Company vs. Commissioner of Income Tax,* 1961, His Lordship said at page 175,

> "Section 9 (1) deals with three classes of deductions. One is " outgoings " , the second is " expenses incurred by the assessee in the production of the profits or income " , and the third is the specific deductions allowed by paragraphs (a)-(i) thereof. The word " outgoings " means what goes out and is a word of wide import. It is the opposite of the equally wide expression " income " , which means what comes in. **In the context the word " expenses " is limited by the words "incurred by such person in the production thereof " while the word " outgoings " is not so limited.** The two words are designed to express two different concepts one of wider import than the other. All outgoings are not expenses incurred in the production of the profits or income; but all expenses incurred in the production of the profits or income are outgoings".

Hence, unlike in *Reynold's case* or *Rodrigo's* case, the Supreme Court under Chief Justice Basnayake classified deductions under section 9(1) to,

(i) Outgoings,

(ii) Expenses incurred by the assessee in the production of the profits or income and

(iii) Specific deductions allowed by paragraphs (a) to (i)

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the reference to Chapter 188, is to a former version of Legislative Enactments, which Chief Justice Basnayake too had used, despite His Lordship decided Hayley's case in 1961.

thereof

His Lordship said, immediately after the above quoted passage,

> "Apart from expenses incurred in the production of the profits or income the section specifically mentions other outgoings. The word " outgoings ' ' in this context must be construed as outgoings other than those specifically mentioned. Whether a particular " outgoing " is deductible for the purpose of ascertaining the profits or income of a business would depend on the circumstances of each case subject to the provision of section 10 (c) which forbids the deduction of any expenditure of a capital nature or any loss of capital. Where an outgoing is not of a capital nature or a loss of capital or where its deduction is not expressly forbidden by the statute, it is deductible under section 9(1) and it is not for the taxing authorities to say that the payment should not have been made". (page 175)

In the same judgment of *Hayleys,* Sinnetamby J., said, at page 177,

> "The imposition of income tax by section 5 of our Ordinance is based upon the profits or income as calculated in accordance with the provisions of the Ordinance. In, therefore, interpreting the expression "outgoings and expenses", one must permit such deductions as may reasonably and in a commercial sense be made, in order to ascertain nett profits. 'The word "outgoings" must not be limited to voluntary payments. It would also include involuntary outgoings such as petty thefts by: Subordinate

officers in the employ of the assessee as well as by outsiders. It was conceded that losses incurred in this way are permissible deductions; for instance, thefts in a grocery store or in a shop by customers as well as minor employees are well recognised as being deductible in ascertaining the nett profits".

As it was said above, the respondents at paragraphs 76 and 77 of their above Written Submissions argue, that,

(i) The Supreme Court personified by Justice Bandaranayake in 2002 upheld not the decision of Basnayake C. J., but the decision of Sinnetamby J., which said that outgoings and expenses are both limited to those incurred in the production of income and

(ii) Sections 25(1) and 26(1)(g) should be read together,

It will be noted, that, as per Basnayake C. J.'s judgment, "outgoings" come in a different head and "expenses" come under another head which has the limitation, "incurred in the production of the income". Did Sinnetamby J., in the same case in his lordship's judgment say that "outgoings" and "expenses" both should be limited by the term "incurred in the production of the income"?

In applying what was said in *Hayley's case* and *Rodrigo's case,* it should also be borne in mind, that, the questions that arose in those two cases are although similar, but not the same as in the present case. In *Hayley's case* the question was whether an amount of money lost due to a burglary was deductible. Hence in that case, the Supreme Court referred to cases, such as, *Charles*

Moore & Co. vs. Federal Commissioner of Taxation, Australian and New Zealand Reports page 739, where "Losses and outgoings and expenses" (page 177, Hayley's) in the particular Tax Act was considered as against, "outgoings and expenses" in the local Enactment. Also, it was the argument of the Commissioner that deductions cannot be made since it is loss of capital. In this case it appears that neither the Assessor nor the Deputy Commissioner took up the position of the payment of interest being an expenditure of capital nature, but the TAC has taken up that position, which the Appellant argues violated audi alteram partem. In *Rodrigo's case*, there was a question of "indivisibility" of the expenditure and it was in that light the Supreme Court said (at page 394, Rodrigo) that it is necessary to give a meaning to the words in section 24(1)(g) by not deducting any part of the expenses, if it could be clearly identified as having being expended for the purpose of deriving money not being profits or income liable to tax. Both these peculiarities do not arise in the present case. This should be appreciated in applying the ratio decidendi of those two cases to the present case.

Of particular relevance are the following observations by Professor Brumbaugh[2]:

> Decisions are not primarily made that they may serve the future in the form of precedents, but rather to settle issues between litigants. Their use in after cases is an incidental aftermath. A decision, therefore, draws its peculiar quality of justice, soundness and profoundness from the particular facts and conditions of the case which it has presumed to adjudicate. In order, therefore, that this

[2] Brumbaugh, Legal Reasoning and Briefing 172 (1917).

> quality may be rendered with **the highest measure of accuracy**, it sometimes becomes necessary to **expressly limit its application to the peculiar set of circumstances out of which it springs**.

To the question, whether Sinnetamby J., decided that "incurred in the production of the income" applied for "outgoings" and "expenses" both, the following is the answer.

His lordship said at page 176-177,

> "Both the Authorised Adjudicator and the Board of Review held against the assessee, on the basis that this loss was a loss of capital and not a loss which, in terms of section 9 (1) of the Income Tax Ordinance, was **an outgoing or expense "incurred by such person in the production of profits or income.** The question referred to this court for its opinion is whether, in the circumstances of this case, the loss of Rs. 36,150 is **a loss of capital or an outgoing incurred in the production of profits"**.

In the above passage Sinnetamby J., implied that the term "outgoing" is also covered by the words "incurred in the production of the income".

His lordship further said at page 177,

> "It seems to me that the word " outgoings " is wide enough to cover losses, for a loss, after all, is an involuntary outgoing. I may add that learned Crown Counsel did not

seek to support the decision of the Board of 'Review on this ground. **The " outgoings " , however, must be outgoings of such a nature as would come within the meaning of the expression " incurred in the production of profits".**

Hence Sinnetamby J., unlike Chief Justice Basnayake, who categorized "outgoings" under a different head and "expenses" limited by the words "…incurred by the assessee in the production of the profits or income" separately, thought that "outgoings" should be qualified by the words "incurred in the production of profits".

His Lordship the Chief Justice Basnayake clearly said at page 175,

> "Where an outgoing is not of a capital nature or a loss of capital or where its deduction is not expressly forbidden by the statute, it is deductible under section 9(1) and it is not for the taxing authorities to say that the payment should not have been made".

Referring to the Australian case of *Alliance Assurance Co. Ltd., vs. Federal Commissioner of Taxation, 29, Commonwealth L. R. 424 at 430,* His Lordship said,

> "In that case the Court was called upon to construe sub-clause (a) of Section 18 (1) of the Income Tax Assessment Acts 1915 (34 and 47 of 1915) which reads— " in calculating the taxable income of a taxpayer the total income derived by the taxpayer from all sources in Australia shall be taken as a basis, and from it there shall be deducted (a) all losses and

outgoings, not being in the nature of losses and outgoings of capital, including commission, discount, travelling expenses, interest, and expenses actually incurred in Australia in gaining or producing the gross income." Knox C.J., Gavan Duffy, Rich and Starke J.J., with whose judgment Higgins J. expressed his agreement in a separate judgment, stated—

"In our opinion **the words 'all losses and outgoings' which occur at the beginning of sub-clause (a), extend to all losses and outgoings of the business not being in the nature of losses and outgoings of capital and are not qualified by the words 'incurred in Australia in gaining or producing the gross income. We think these latter words refer either to the word "expenses" only, or at most to the words 'commission, discount, travelling expenses, interest, and expenses".**

Although there is a reference to "interest" that is because it contained in section 18(1)(a) of that particular statute and not because of a general reference that would extend to the facts of this case. **But what is important is that the Australian Court thought that the words "incurred in Australia in gaining or producing the gross income" only applicable to the word "expenses" and not to "outgoings".** This exactly was what His Lordship the Chief Justice Basnayake decided in categorizing "outgoings" as one and "expenses incurred by the assessee in the production of the profits or income" as two.

It was this decision of Chief Justice Basnayake and not the decision of Sinnetamby J., that was followed in 2002 in

Rodrigo's case **by Justice Shirani Bandaranayake (later Chief Justice) when she said at page 390,**

> "It is obvious that section 23 focuses on all aspects of expenses as it refers not only to "expenses", but also to the "outgoings". **The word "outgoings" gives a wider meaning than the word "expense".** "Outgoings" incurred by a person carrying out a profession, could include a wide variety of items, which would not come within the meaning of "expenses".

All expenses are outgoings, but not all outgoings are expenses.

Her ladyship further said at page 390 itself,

> "On the other hand, **in addition to the outgoings** a taxpayer would also rely on the expenses that incurred in the production of the income to be claimed as deductions".

With regard to the word "disbursement", because, section 24(1)(g) does not permit the deduction of "disbursements or expenses" not incurred in the production of profits, she said, at page 392,

> "**The Dictionary meaning of the word "disbursement" explains it as "expenditure"** (The Oxford English Dictionary, 2nd edition, volume 4, p. 726) **which has a limited meaning than the word "outgoing"**.

Hence, what the Supreme Court said in *Rodrigo vs. Commissioner of Income Tax,* 2002 shows that "outgoings" has an independent

standing from "expenses". There can be an "outgoing" which is not an "expense". **Since "disbursements and expenses" in section 24(1)(g) [present 26(1)(g)] is therefore relating to "expenses", there can be "outgoings" which are not covered by section 26(1)(g).** This is one of the arguments of the appellant.

Therefore it appears that a payment of "interest", which is the question in this case, can come under "outgoings" not coming within the purview of "expenses", or under the separate heading "(f) interest paid or payable by such person;…" in section 25(1)(f).

It was seen, that, if it comes under "outgoings" but not within the meaning of "expenses", it will not be limited by the words, "**incurred by such person in the production thereof,"** that is, profits or income of the assessee. But if it comes under "expenses", it is limited by those words in the first part of section 25(1) itself and also by the words, "not being money expended for the purpose of producing such profits or income", in section 26(1)(g).

It is in this second sense, that, the respondents argue, that, the purpose for which the loans were taken, was not for the business of the Company (assessee)

The argument is that, if the said loan was taken not for the business of the assessee, then, it is not an expense "incurred in the production of profits or income" of the assessee.

It is stated, in the above Written Submissions of the respondent, that, "the reason for obtaining the loan and therefore, the reason for paying interest, is NOT as a result of the needs of the business, but to cover the shortfall they created by lending money to a sister company". (paragraph 41)

It is further submitted, that, "Thus, the respondents reiterate that the requirement that all deductions be expenses and outgoings that are incurred in the production of income and profits will apply to section 25(1)(f) and therefore

the appellant is not entitled to claim the deduction for interest paid on the basis that the interest referred to in section 25(1)(f) need not be incurred in the production of profits and income as in section 25(1)". (paragraph 49)

It is in this backdrop, that, what was examined by her ladyship Justice Shirani Bandaranayake in *Rodrigo vs. Commissioner of Income Tax* [2002] with regard to the meaning of the phrase "incurred in the production of the [profits] and income" becomes relevant.

PART II

Port Elizabeth Electric Tramways Co. Ltd., case:-

At page 390 of the case, her ladyship referred to the South African case of *Port Elizabeth Electric Tramways Company Ltd. vs. Commissioner of Income Tax, (1936) CPD (Cape Provincial Division) 241, 8 S. A. T. C. 14.*

It is a case of the Supreme Court of South Africa from the Cape of Good Hope Provincial Division.

The facts of the case are as follows,

> "It appears that in 1932 the driver of one of company's trams lost control on a steep gradient. The tram ran into a building and the driver was injured. He claimed compensation under the Workmen's Compensation Act, the company resisted the claim and legal proceedings were taken. In the end, by a judgment of this Court the company was compelled to pay a sum of 664 as compensation to the driver's widow (the driver having died in the course of the case). The costs incurred by the company amounted 774. In its return for income tax purposes the company claimed to deduct the amount of 1,412 (the sum of the aforementioned amounts) from its gross income. The Commissioner disallowed the deduction and on appeal to the Special Court his decision was upheld. The company now appeals to this Court and the question before us is whether the deduction is

permissible in terms of the Income Tax Act No. 40 of 1925". (page 242-243)

"The sections which govern the matter are 11(2) (a) and 13(b) which provide as follows: "11(2) The deduction allowed shall be: (a) expenditure and losses actually incurred in the Union in the production of income, provided such expenditure and losses are not of a capital nature. 13. No deduction shall, as regards income derived from any trade, be made in respect of any of the following matters: (b) any moneys not wholly or exclusively laid out or expended for the purpose of trade". (page 243)

The Court said at page 244,

"The matter of expenditure, however, requires to be examined a little more closely. In the first place it must be noted that there are three qualifications: (a) the expenditure must be actually incurred; (b) it must not be of a capital nature; (c) it must be incurred in the production of income".

In respect of the third head, the Court said,

"There remains the third qualification. Was it incurred in the production of income? This third qualification seems to me the same one as is dealt with negatively in section 13(b), which prohibits a deduction unless the expenditure is made "wholly and exclusively for the purpose of trade…" (page 244-245)

It may be noted, that, in the local sections 25(1) and 26(1)(g) the same provision is again negatively dealt with, which made this Court to refer to the saying, "Flowers blooming in rain". The judgment continued,

"…The matter can therefore be put thus: if expenditure is incurred "in the production of income" and "wholly and exclusively for the purposes of trade" it is deductible, otherwise not. Now, as pointed out above, income is produced by the performance of a series of acts and attendant upon

them are expenses. Such expenses are deductible expenses provided they are so closely linked to such acts as to be regarded as part of the cost of performing them". (page 245)

It continued,

"A little reflection will show that two questions arise (a) whether the act to which the expenditure is attached is performed in the production of income and (b) whether the expenditure is linked to it closely enough. Now at first sight it would appear that only acts necessary to earn the income and expenditure necessarily attendant upon such acts and should be deducted; but this is not so". (page 245)

"As pointed out above businesses are conducted by different persons in different ways. The purpose of the act entailing expenditure must be looked to. If it is performed for the purpose of earning income then the expenditure attendant upon it is deductible. This is illustrated by cases such as *Commissioner for Inland Revenue v. Thompson* (1935, T.P.D. 166, see particularly p.171) and *Usher's Wiltshire Brewery v. Bruce* (1915,A.C. 433). The latter case was a decision under the English Income Tax Acts which contains a provision corresponding to sec.13 (b) of our Act but not one corresponding to 11 (2) (a). In that case a brewery company, in order to improve its trade, acquired the ownership of certain tied houses which were leased to tenants. The company (a) expended money on repairing the tied premises, (b) let them at a lower rental because of the tie, (c) paid insurance premiums, rates and taxes, etc., on them and (d) incurred legal charges in respect of them. **The House of Lords decided that the company could make deductions under all these heads on the ground that such expenses were incurred wholly for the purposes of trade.** It will be noted that these expenses were all attendant (some necessarily; some not) upon the ownership of the houses and the acquisition of the ownership was an act done for the purpose of more efficiently selling the

beer brewed by the company. It follows that provided the act is *bona fide* done for the purpose of carrying on the trade which earns the income the expenditure attendant on it is deductible. It seems, however, that this statement may require qualification in one respect. If the act done is unlawful or negligent and the attendant expense is occasioned by the unlawfulness or possibly the negligence of the act then probably it would not be deductible. (page 245,246)

There are two English cases which point that way. In the case of *Commissioner of Inland Revenue v. Van Glehn and Co. Ltd.* (1920, 2 K.B. 553) a trader in the course of his business traded with the enemy and became liable to a fine, it was held that he could not deduct such fine. In the case of *Strong and Co. of Romsey v. Woodifield* (1906, A.C. 448) an innkeeper incurred liability towards a guest in his inn owing to the collapse of a chimney and it was held that this expense could not be deducted. In this case the Judges differed in their reasons and the judgments are not very helpful, but the LORD CHANCELLOR suggested that possibly a railway company which had to compensate injured passengers could deduct such compensation – presumably on the ground that payment of compensation in such cases was an expense attendant upon the operations of railway transport, and because no amount of care could prevent it arising from time to time, it was so closely connected with such operations as to form part of the cost of preforming them. There is in fact a decision of the Special Court to that effect in the case of a tramway company reported at (1 S.A.T.C. 57). I shall not, however, deal further with the question of unlawfulness of a business operation or negligence in carrying it out because they do not arise in this case. (page 246)

The other question is what attendant expenses can be deducted? How closely must they be linked to the business operation? **Here, in my opinion, all expense attached to the performance of a business**

operation *bona fide* performed for the purpose of earning income are deductible whether such expenses are necessary for its performance or attached to it by chance or are bona fide incurred for the more efficient performance of such operation provided they are so closely connected with it that they may be regarded as part of the cost of performing it. There is certainly one type of expenditure which must be excluded, and that is expenditure payable out of income after it has been earned. An example is a tax upon profits. In a sense such expenditure might be said to be attendant upon business operations, but there is a real distinct between "a charge against profits and an appropriation of profits after they have been earned". See *Van Rhyn Deep Ltd. V. C.I.R.* (1922, W.L.D. 22) (page 246)

In the present case, the employment of the drivers is necessary in carrying on the business of the tramway company, and the employment of drivers carries with it as a necessary consequence a potential liability to pay compensation if such drivers are injured in the course of their employment. This compensation is not in any way a penalty for an infraction of the law, it is payable even if the driver is injured through no fault of his own or of the tramway company. It is due to him in a sense as a part of his contract of employment: it partakes of the nature of a sick benefit (such as payment of wages while ill) or of a pension. **There is a possible ground upon which it may be contended that the payment of compensation is not deductible, viz , that the occurrence of the expense is fortuitous and dependent upon an accidental injury; and in that sense not sufficiently closely connected with the employment of drivers, to allow of its deduction. But many business expenses stand on the same footing. Bad weather, for instance, must cause numerous additional expenses to trades such as transport by sea or land. Chance, in other words, increases the expenses, or make additional expenses, but though chance causes them to arise they**

nevertheless remain expenses so closely linked to a necessary business operation that they can be regarded as part of the cost of performing such operation. In this case the potential liability is there all the time and is inseparable from the carrying on of the business. Moreover, it is a potential liability that is bound, human nature being what it is, to become at intervals in greater or lesser degree an actual liability by the occurrence of accidents". (page 247)

The learned Judge continued,

"The view which I have expressed seems to me to be supported by a number of English cases which provide an analogy. In the case of Smith vs. The Lion Brewery (1911, A. C. 150) it was held by the House of Lords after a remarkable conflict of judicial opinion that brewers who owned tied houses for the purpose of increasing their trade could deduct from their income an amount which they had indirectly to pay as their contribution towards a fund which was created by statute and contributions towards which were levied annually on the tied houses, the purpose of the fund being to provide compensation to licensed houses whose licences were taken away. The tied house in that case can be compared to the workman in this, but the compensation was not payable in a lump sum by the "employer" of the tied house but by way of an annual contribution towards a fund which was used for the purpose of compensating "Injured" tied houses. There is, of course, the distinction that in that case the amount deducted was an annual contribution in the nature of an insurance premium, whereas in the present case the employer has not paid an annual premium but has had to bear the whole expense in a lump sum. But if the premium of insurance against an expenditure is deductible why in principle should the expenditure itself not be deductible save in those cases in which it is of a capital nature? (page 247,248)

For instance, in *Hancock vs. General Reversionary and Investment Co. Ltd., (1919, 1 K. B. 25)* it was held that the payment of a lump sum, the value of an annuity, to a servant on his retirement from service was a deductible expense. By analogy payments under the Workmen's Compensation Act are sometimes periodical payments and are made in respect of incapacity by injury, whereas a pension is usually paid on account of incapacity by reason of age. In principle it is difficult to see any distinction. (page 248)

For these reasons I am of opinion that the amount paid as compensation under the Workman's Compensation Act to the widow of the driver are deductible under section 11(2) of the Income Tax Act of 1925". (page 248)

Hence it appears that as per *Port Elizabeth case,* if it is an expense attached to the performance of a business operation bona fide performed, even if attached to it by chance, expenses attached to such performance can be deducted, if there is a potential liability of incurring such an expense. It must be an incidence with a close link.

Is Port Elizabeth Electric Tramways case still religiously followed today?

But, this is not all. *Port Elizabeth case* was decided on 26th November 1935. Eighty years later, in 2015, it is written in the *Southern African Business Review Special Edition Tax Stories,* 2015, by G. K. Goldswain[3] and O. Swart, the Article, "**The Port Elizabeth Electric Tramway case:- Is the meaning ascribed to the phrase "in the production of the income" by Watermeyer AJP in the Port Elizabeth Electric Tramway case still religiously followed today?**"

The Article says, closer upon its commencement itself, as follows,

"It is submitted, for the reasons advanced later on in this article, that perhaps even the Lockie Bros test, as advocated by Kruger, et al, is still

[3] Prof. G.K. Goldswain is Chair of the Department of Taxation, University of South Africa. Ms O. Swart is Head: Tuition and Learning Support in the College of Accounting Sciences, University of South Africa. E-mail: goldsgk@unisa.ac.za; swarto@unisa.ac.za

not wide enough to take into account the economic and other non-economic realities of how business and trade is conducted in the 21st century. For example, is it possible under either interpretation to take into account the moral, common law and statutorily imposed restrictions, obligations and responsibilities of taxpayers to incur expenditure – or even to submit to the requirements of shareholders (in the case of companies), to other stakeholders (employees, creditors, debtors, customers) and to all the organs of state, to incur expenditure – and still be able to claim such expenditure as a deduction taking into account Watermeyer AJP's interpretation of the phrase "in the production of the income"? Unfortunately, there has been little debate in this area for a considerable period of time because it has been assumed, erroneously, it is submitted, that the matter has long since been settled and needs no further debate. **The reality, however, is that the manner in which business and trade is now conducted has changed considerably since the 1930s when the Port Elizabeth Electric Tramway case was decided".**

In this regard, *Lockie Bros Ltd., vs. Commissioner for Inland Revenue, 1922 TPD 42, 32 S. A. T. C. 150* is important. In that case, "the appellant company employed a manager who had full power to operate on the company's banking account. During the company's financial year ending 31st August 1918 it was discovered that large defalcations had been made by the manager totalling 12,625…The defalcations consisted of funds withdrawn from the bank by the manager to cover bogus purchases, misappropriation of petty cash and charges for transport expenses which had never been incurred".

"In assessing the company for normal income tax and for excess profits duty for the year ending 30th June 1918, the Commissioner declined to allow the defalcations or any portion thereof to be deducted in the calculation of the company's taxable income. The Special Court upheld the

Commissioner's ruling and at the request of the company, stated a special case for decision by the Supreme Court". (page 42)

In the Transvaal Province Division, Mason J., said,

"The deduction is claimed under the provisions of section 17(1)(a) of the Act which authorizes deductions "for losses and outgoings actually incurred in the Union in the production of the income provided such losses and outgoings are not of a capital nature". (page 43,44)

"**The first question is as to the meaning of the words "in the production of income": patently they cannot be taken in their literal sense, because a loss cannot produce income and because if the whole year's business resulted in a loss, not even the outgoings could be said to be incurred in the production of a non existent income, yet by sub section 2 of this section the loss on a year's business is to be assessed and may be deducted in subsequent years. <u>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.</u>** No decision on the construction of these words of the statute have been discovered by counsel; it will be convenient to refer to the English decisions upon analogous provisions in their Income Tax Acts after considering the words of our statute which are copied not from England, but from a New South Wales Act". (page 44)

Mason J., having considered whether the embezzlement was due to the operations, with reference to several cases, said,

"Now the English Acts are, perhaps, more favourable in their language to the trader than ours in respect of losses and outgoings, though the

differences are slight and these cases seem to me to tell strongly against the appellants". (page 46)

"I am satisfied that our Act 41 of 1917 does not include amongst losses which can be deducted the sums embezzled under the present circumstances. It is not necessary to determine whether or not they are of capital nature, though there is much to be said for that view". (page 46)

What is important is not Mason J., dismissing the appeal, but the words he used to describe the term, "incurred in the production of income", was used in section 11(c) of the Income Tax Act to statutorily negate the disallowance by Watermeyer AJP in *Port Elizabeth Electric Tramways case* of the deduction of legal expenses incurred in resisting the claim of the driver.

Watermeyer AJP in 1932 said in *Port Elizabeth Electric Tramways case,* that,

"With regard to the amount paid in legal costs no ground for allowing these as deductions has been advanced in argument save that they stand upon the same footing as the compensation. In my opinion they do not. Legal costs can sometimes be deducted, as was done in the case of Usher's Wiltshire Brewery Ltd., vs. Bruce (1915, A. C. 433); but they must be closely connected with the earning of the income as to be regarded as part of the cost of earning it. In the present case they were expended in resisting a demand for compensation, this is not an operation entered upon for the purpose of earning income". (page 248)

Although Watermeyer AJP in 1935 did not follow what Mason J., said in 1922, the latter came into section 11(c) of the statute to negate the decision to disallow the deduction of legal expenses. Goldswain and Swart says about this,

"The disallowance of the legal expenses, in effect, meant that tax was being levied on the legal expenses that were incurred with the sole purpose of protecting its bottom line profits. This part of the judgement, it is submitted, apart from being illogical and absurd, was unfair to the

taxpayer and became indefensible with the legislature being forced to remedy the situation by later introducing legislation to permit the deduction of legal expenses that statutorily negated Watermeyer AJP's judgment in this respect. Section 11(c) of the Income Tax Act now specifically caters for the deduction of legal expenses. **The wording in section 11(c) is very interesting. It steers clear of the phrase "in the production of the income" and instead uses virtually the same words that Mason J used in the Lockie Bros case to interpret and ascribe a meaning to that phrase, namely, that the phrase must be given the meaning that the expenditure must be "actually incurred in the course of and by reason of the ordinary operations undertaken for the purpose of conducting the business".** If section 11(c) had been in operation at the time of the decision given in the Port Elizabeth Electric Tramway case, or if Watermeyer AJP had followed the interpretation ascribed to the phrase by a fellow judge (Mason J) in an earlier decision, albeit from a different division of the then Supreme Court, it is submitted that the legal expenses would have been deductible. It is further submitted with a word of caution that the meaning attributed to the phrase "in the production of the income" by Mason J in the Lockie Bros case, prima facie, may appear to have a wider ambit than the meaning ascribed to it by Watermeyer AJP. However, as will be seen from the discussion later on in this article, the decision of Mason J, if the facts of the case are closely analysed, indicates that the ambit of the meaning that he attributed to the phrase, although appearing to be considerably wider than Watermeyer AJP's interpretation, is not as wide a meaning as commentators such as Kruger et al contend".

The orbiter dicta in *Port Elizabeth Electric Tramways case,* that, when there is negligence by the taxpayer, no deduction could be made, as per Goldswain and Swart, placed Watermeyer, now the Chief Justice of South Africa in an

unenviable position in the case of *Joffe & Co., (Pty) Ltd., vs. Commissioner for Inland Revenue, 1946 AD 157, 13 S. A. T. C. 354,* ten years later.

Goldswain and Swart says about Joffe, as follows,

> "He presided in the Joffe case where the taxpayer carried on business as engineers in reinforced concrete. A concrete cantilever hood for a power station in Durban, the building of which the taxpayer was supervising, collapsed and a plumber employed by another contractor was killed by the falling material. It was later established that the reinforcing steel rods had become displaced from their proper position while the concrete was being poured. This displacement had weakened the structure and caused it to collapse. In a delictual court action brought against the taxpayer, it was established that the taxpayer had been negligent in supervising the construction work and, accordingly, it was required to pay compensation to the relatives of the deceased workman. The compensation and legal expenses directly related to resisting the compensation action were claimed as a deduction incurred "in the production of the income". The Commissioner disallowed both the compensation awarded and the attendant legal expenses incurred in resisting and defending the claim as a deduction.
>
> The facts in the Joffe case, prima facie, appear to be very similar to the facts in the Port Elizabeth Electric Tramway case, negligence notwithstanding. The economic consequences to the taxpayer were the same as for the taxpayer in the Port Elizabeth Tramway case. In both cases compensation had to be paid as a result of an accident occurring while carrying on a business. So a similar result could have been expected. But that was not to be. Watermeyer CJ not only disallowed the legal expenses claimed – to be expected since he had made the same decision on this very point in the Port Elizabeth Electric Tramway's case – but also the compensation paid. He held that the taxpayer failed to prove that the

negligent construction was a "necessary concomitant" of, and was "closely linked" to the trading operations of a reinforced concrete engineer".

In *Joffe,* Watermeyer C. J., said,

> "All expenditure, therefore, necessarily attached to the performance of the operations which constitute the carrying on of the income earning trade, would be deductible and also all expenditure which, though not attached to the trading operations of necessity, is yet bona fide incurred for the purpose of carrying them on, provided such payments are wholly and exclusively made for that purpose and are not expenditure of a capital nature".
>
> The damages paid out in this case do not pass that test. They were paid out to discharge a debt or legal liability to the plumber's dependants; arising out of appellant's negligence in performing a trading operation. There is nothing in the stated case to suggest that such negligence and the consequent liability which such negligence entailed, were necessary concomitants of the trading operation 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, according to the interpretation which I have suggested above, the payment of damages was not made for the purpose of trade".

His lordship also said,

> "Mr. Rosenberg [N. E. Rosenberg K. C., who appeared for the appellant] further contended that, even if the expenditure in question was not the necessary concomitant of the business of a reinforced concreate 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. It is possible that this argument can be refuted upon more grounds than one, but I shall only mention the following one: there 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 disappears and it cannot be supported".

"Mr. Rosenberg's next contention was that, if the damages were not deductible, as an expenditure, they were deductible as a loss. The word "loss" has several meanings and its meaning in section 11(2)(a) is somewhat obscure. In relation to trading operations the word is sometimes used to signify a deprivation suffered by the loser, usually an involuntary deprivation, whereas expenditure usually means a voluntary payment of money. When trading operations cause damage to third parties and this damage has to be made good, then the payment which is made in satisfaction of such damage (and possibly even the pre existing liability to make such payment) may properly be called a loss, but when the payment has been made then it can also properly be called an expenditure. Consequently, it is not clear to me that the word "losses", if used in this sense in section 11(2) of the Act, means anything different from "expenditure". The word "loss" is also sometimes used as the antonym of "profit", but then it denotes the final result of a trading operation after the expenditure has been deducted and it seems inappropriate to speak of a loss, in that sense, in conjunction with expenditure, as something which is incurred in the production of income. If any income at all (i.e., any return) is produced by a trading operation, then clearly the expenditure and the loss, in that sense, cannot both be deducted from the income in order to arrive at taxable income, because it would entail a double

deduction of so much of the expenditure as is a loss. A trading operation may, however, sometimes produce no income at all. In such a case a loss is incurred in attempting to produce income and not "in the production of income". Such a loss would, however, be deductible from income earned by the taxpayer in other trading operations and it may be that the word "losses" was inserted in section 11(2)(a) in order to sanction such a deduction. If the taxpayer earned no other income his loss could probably be set off in future years as an "assessed loss" in terms of section 11(3)".

The local section does speak of "outgoings and expenses" [section 25(1)] and "disbursements or expenses" [section 26(1)(g)] It was decided in *Hayley's* case by Sinnetamby J.,

> "**It seems to me that the word "outgoings " is wide enough to cover losses, for a loss, after all, is an involuntary outgoing.** I may add that learned Crown Counsel did not seek to support the decision of the Board of Review on this ground. The "outgoings " , however, must be outgoings of such a nature as would come within the meaning of the expression "incurred in the production of profits". (page 177)

Hence, the Supreme Court of Ceylon regarded a "loss" too as an "outgoing", but an involuntary one. But in the above quote from Joffe, Watermeyer C. J., said,

> "Consequently, it is not clear to me that the word "losses", if used in this sense in section 11(2) of the Act, means anything different from "expenditure"".

Here his lordship has failed to appreciate the difference between an "outgoing" and an "expense", probably because section 11(2)(a) did not use the word, "outgoing" but said, "expenditure and losses actually incurred". It is clear on the construction of these concepts, "loss", "outgoing" and "expense", as per the judgment of Chief Justice Basnayake in Hayley's case, that, an "outgoing" is the widest concept that includes a "loss" [Sinnetamby J., too accepted this] and when

it comes to "expenses" they are limited by the concept. "incurred in the production of income". Shirani Bandaranayake J., (later Chief Justice) interpreted "disbursements" in Rodrigo's case, to be also "expenses".

"Incurred in the production of income":-

As per the said writers, Goldswain[4] and Swart, "The narrow meaning attributed to the phrase "in the production of the income" by Watermeyer in both the *Port Elizabeth Electric Tramway* and the *Joffe cases,* was followed in subsequent cases **where the expenditure incurred was not related to damages and compensation paid.** It is submitted that there is clear evidence from the discussion that follows in this paragraph that by slavishly following Watermeyer AJP's narrow interpretation, some rather absurd decisions were given".

It was said IN THE TAX COURT OF SOUTH AFRICA (GAUTENG SOUTH DIVISION), in XYZ HOLDINGS (PTY) LTD vs. THE COMMISSIONER FOR THE SOUTH AFRICAN REVENUE SERVICE, decided on 15th March 2010 that,

> "Schreiner J said in CIR v Drakensberg Garden Hotel (Pty) Ltd, 1960 (2) SA 475 (A) at 479H–480A that – "To be deductible the expenditure must have been actually incurred in the production of income, it must not be of a capital nature and it must have been wholly or exclusively laid out for the purpose of trade. **It need not, however, have been causally related to the income which is the subject of the assessment in question." (page 07)**
>
> "In Joffe & Co Ltd v Commissioner for Inland Revenue, 1946 AD 157, Watermeyer J held (at 163) that – "All expenditure, therefore, necessarily

[4] Prof. G.K. Goldswain is Chair of the Department of Taxation, University of South Africa. Ms O. Swart is Head: Tuition and Learning Support in the College of Accounting Sciences, University of South Africa. E-mail: goldsgk@unisa.ac.za; swarto@unisa.ac.za

attached to the performance of the operations which constitute the carrying on of the income-earning trade, would be deductible and also all expenditure which, though not attached to the trading operations of necessity, is yet bona fide incurred for the purpose of carrying them on, provided such payments are wholly and exclusively made for that purpose and are not expenditure of a capital nature." (page 09)

"I will first consider whether the professional fees were expenditure of a capital nature. It was held by Ogilvie Thompson JA in Secretary for Inland Revenue v Cadac Engineering Works (Pty) Ltd, 1965 (2) SA 511 (AD) at 521H, that expenditure "of a capital nature" eludes precise and comprehensive definition. The learned judge quoted the following dictum of Watermeyer CJ in New State Areas Ltd v Commissioner for Inland Revenue, 1945 AD 610 at 627 as a general guide:

"The conclusion to be drawn from all of these cases, seems to be that the true nature of each transaction must be enquired into in order to determine whether the expenditure attached to it is capital or revenue expenditure. Its true nature is a matter of fact and the purpose of the expenditure is an important factor; if it is incurred for the purpose of acquiring a capital asset for the business, it is capital expenditure, even if it is paid in annual instalments; if, on the other hand, it is in truth no more than part of the cost incidental to the performance of the income-producing operations, as distinguished from the equipment of the income-producing machine, then it is revenue expenditure, even if it is paid in a lump sum." (page 21,22)

Absurdity of "Close Connection" test:-

Goldswain and Swart states that the re analysis of Kruger, D, Stein, M, Dachs, P and Davey, that, the "close connection" test as laid down by Watermeyer AJP for the interpretation of the phrase, "incurred in the production of income" is too

'mechanical and contrived" is supported and cites the case of *ITC 1058 (1963) 26 S.A.T.C. 305,* as an example. It is as follows,

> "…the judge in ITC 1058, it is submitted, took a backward step and erred when holding that the compensation paid as a result of a negligent or perhaps only a stupid act on the part of the taxpayer, was not deductible. The South African Railways had parked a trailer in front of the entrance to the taxpayer's factory. The employees of the taxpayer, unfortunately for some reason not mentioned in the case, partially moved the trailer onto a tarred portion of the road. During the night, a motorist crashed into the trailer and both the taxpayer and the Railways had to pay damages to the motorist as a result of the accident. The court reasoned, somewhat absurdly it is submitted, that a third party who happens to drive past the factory at night is not essential to the taxpayer's trade and did not, therefore, produce income".

It is submitted, that, the narrow view taken in *Joffe,* that an accident is not arising out of the business methods employed by the appellant, was the reason that resulted in such narrow interpretations. Watermeyer C. J., in *Joffe* said,

> "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".

The real spirit of the argument was identified by Mason J., in Lockie Bros when he said,

> "**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".

An accident is such and an interest payment of a loan obtained is also similar.

The writers state,

> "Furthermore, by 2003 the judiciary, unlike SARS, [South African Revenue Services] appeared to have recognised the absurdity of some of its previous decisions and had subtly begun to widen the ambit of the phrase to take into account the economic, social, statutory and even the requirements of its shareholders and other stakeholders that have emerged over the past 40 years or so".

Scribante Case:-

They cite, *Commissioner for South African Revenue Services vs. Scribante Construction (Pty) Ltd., 2001 (2) SA 601(E). 62 S. A. T. C. 443.*

> "C:SARS v Scribante Construction (Pty) Ltd is a useful guide as to the judicial meaning of the phrase "in the production of the income" in a situation when a dividend declared to a shareholder is converted to a loan account on which interest is payable. Half of the dividend declared by the company was credited to the shareholder's account as an interest-bearing loan. The other half was credited to the same account as an interest free loan. On appeal against the Commissioner's decision not to allow the deduction for the interest incurred on the interest bearing portion of the loan account, the court held that the purpose of the loan to the company by its shareholders was to further enhance the already healthy position of the taxpayer. In addition, the company's financial profile improved. This enabled it to obtain future business and earn interest for the taxpayer. The loan in issue had, therefore, produced income to the advantage of the company and the interest incurred was held to be "in the production of the income" and thus deductible in the determination of its taxable income".

The above is a decision dated 14th May 2002 by The Supreme Court of Appeal of South Africa. The Court said,

> "The declaration of a dividend is a commercial decision regulated by the terms of the company's statutes and the rules which have been developed in practice: see the authorities referred to in Commissioner for Inland Revenue v Dirmeik 1996 (2) SA 736 (C) at 740 C – I. I find nothing in the evidence to suggest that the declaration and distribution concerned in this case were motivated by anything but bona fide commercial considerations".

It further said,

> "There is no doubt that the interest paid by the company enabled it to secure (even if only temporarily) the shareholders funds which could otherwise have been moved elsewhere. Equally it is certain that the availability to the company of the funds substantially increased its competitiveness and, temporarily, its income in the form of the interest which it retained. Those two considerations simply stated provide the sufficiently close link between the expenditure and the income earning operations having regard to the purpose of the expenditure and what it actually effects, Commissioner for Inland Revenue v Genn & Co (Pty) Ltd 1955 (3) SA 293 (A) at 299 G. The fact that the company could have operated quite adequately without the funds is not the only pertinent factor. It was enough that they served for the more efficient performance of its 12 operations: Port Elizabeth Electric Tramway Co v Commissioner for Inland Revenue 1936 CPD 241 at 246. The interest paid to the shareholders on their loan accounts was plainly an actual expense which enabled the company to produce income both in the form of its allocation of the interest earned and through the commercial advantages which possession of the loan funds generated. Section 11(a) was thereby satisfied".

Warner Lambert SA (Pty) Ltd., case:-

Expenditure incurred at the behest of its holding company was considered in Warner Lambert SA (Pty) Ltd., vs. Commissioner for South African Revenue Services, 2003 (5) SA 344 (SCA), 65 S. A. T. C. 346.

> "In Warner Lambert SA (Pty) Ltd v C:SARS, the taxpayer, an American-owned company operating in South Africa during the apartheid regime, was a voluntary signatory to the Sullivan Code[5]. During the height of apartheid, an Act was promulgated in America to force American companies and its subsidiaries operating in South Africa to comply with the Sullivan Code principles. If not complied with, fines and even the imprisonment of the directors of the participating American companies could be imposed. **The South African subsidiary company claimed the social responsibility expenses that it was forced to incur to comply with the Sullivan Code principles, as deductions in the determination of its income. These expenses were disallowed by the Commissioner on the basis that the expense had not been incurred in the production of the taxpayer's income. In effect, the expenses were incurred at the behest of the American holding company and therefore, could never actually produce income**. On appeal to the Supreme Court of Appeal, Conradie JA (the other four judges concurred with his judgment) found a link, which was not regarded as too remote, between the continued trade of the taxpayer and the expenditure at the behest of its holding company. It was held that the Sullivan Code expenses were bona fide incurred for the performance of the South African taxpayer's income-producing operation, and formed part of the cost of performing it. If the company had

[5] The Reverend Sullivan, an American citizen, was a critical activist against the former South African apartheid government. The Sullivan Code principles provided for the non-segregation of races in the workplace, equal and fair employment for all employees, equal pay, development of training programmes, increasing the number of disadvantaged persons in management and supervisory positions and improving the quality of employees' lives outside the work environment (Warner Lambert SA (Pty) Ltd v C:SARS, 2003(5) SA 344 (SCA), 65 SATC 346 at 346 and 348).

not followed the dictates of its holding company, disagreeable consequences were a possibility which would almost certainly have translated to a loss of income. The social responsibility expenditure was therefore held to be incurred for the purposes of trade and in the production of its income. In addition, this expenditure reduced the risk that the taxpayer might lose its privileged subsidiary status, it benefitted the underprivileged and it pleased its American parent".

The Supreme Court of Appeal said on 30th May 2003,

"It is true that the link between the appellant's trade and the social responsibility expenditure is not as close and obvious in the second category as in the first, **but that does not mean that the connection is too remote.** To qualify as moneys expended in the course of trade, an outlay[6] does not itself have to produce a profit.

'It is true, as I have already indicated, that the absence of a profit does not necessarily exclude a transaction from being part of the taxpayer's trade; and correspondingly monies laid out in a non-profitable transaction may nevertheless be wholly or exclusively expended for the purposes of trade within the terms of s 23(g). Such monies may well be disbursed on grounds of commercial expediency or in order indirectly to facilitate the carrying on of the taxpayer's trade…' (per Corbett JA in *De Beers Holdings (Pty) Ltd v Commissioner for Inland Revenue* **1986 (1) SA 8** (A) at 36 I – J".

It was also said,

"The appellant's income earning structure had been erected long ago. It was now a question of protecting its earnings. Periodic payments were

[6] An amount of money spent on something.

required to preserve it from harm, or at least to avert the risk of harm. I regard these payments as similar to insurance premiums. If they are anything like that, they were payments of a revenue nature. There is support for this approach in England. In *Morgan (Inspector of Taxes) v Tate & Lyle Ltd* **[1954] 2 All ER 413** (HL) it was held that expenditure incurred in a propaganda campaign against nationalising the sugar industry was revenue in nature. In *Lawson (Inspector of Taxes) v Johnson Matthey plc* **[1992] 2 All ER 647** (HL) a payment by the appellant to avert a threat to its business due to the collapse of a banking subsidiary was held to be an expense of a revenue nature".

Part III

Solaglass and the question of "expenditure of capital nature":-

In *Solaglass Finance Limited vs. Commissioner for Inland Revenue, 1991 (2) SA 257, 53 S. A. T. C. 1,* the facts were similar to the present case. Goldswain and Swart says about this case,

> "See also Solarglass Finance Limited v CIR where a similar decision was given in regard to loans made by a subsidiary company to other companies in the group at the behest of its holding company".

This judgment is important, not only to define the term, "incurred in the production of income", but also to the argument of the expenses being "capital in nature", which was taken up by the TAC, albeit without notice to the appellant and hence the respondent cannot rely upon, on the basis of the violation of the rule audi alteram partem, which is addressed in the next section of this judgment, but adverted to here, to err on the side of caution.

Like in the present case, there was a Holding company and subsidiary companies. One such company was acting as the "Financier" of the group. The matter arose due to loans given. But the question was not in respect of interest

payments. It was regarding losses caused due to the non payment of certain loans.

A. S. Botha J, wrote the leading judgment, Nicholas and Nienaber JJ., agreeing disallowing the appeal of the taxpayer, though their lordships agreed with the minority, on the basis that the expenditure was revenue in nature, they held that the expenses cannot be deducted as they were not incurred wholly or exclusively in the production of income. G. Friedman J., dissented, with whom concurred, E. M. Grosskopf J., allowing the appeal on the basis that it is floating capital and hence revenue (with which the majority too agreed) and it can be allowed under section 23(g). The decision of *Solaglass Finance Company (Pty) Limited vs. Commissioner for Inland Revenue,* on capital expenditure or no capital expenditure itself will not apply to this case, because, this case is about deducting the interests, however, the authorities cited in the judgment of Friedman J., in this regard will be relevant.

The other question referred to by Friedman J., is on the construction of an English section similar to section 23(g) of South African Income Tax Act, which says, "…no sum shall be deducted in respect of any disbursement or expenses, not being money wholly and exclusively laid out or expended for the purpose of trade, profession, employment or vocation…", which is similar to the local section 26(1)(g) which says, "…not being money expended for the purpose of producing such profits or income…" and authorities cited in this regard.

Furthermore, what Botha J., himself said about the capital would show, that, what is in question in this case is not capital. Botha J., commences his judgment dated 30th November 1990 saying,

> "I have had the benefit of reading the judgment of my Brother FRIEDMAN. In his judgment it is held (a) that the capital which the appellant lost as a result of being unable to recover the loans in question was not fixed, but circulating capital, and therefore of a revenue nature, and that the losses in question were accordingly deductible in

terms of section 11(a); and (b) that the losses were not disqualified from deduction by reason of the provisions of section 23(g). **I agree with (a),** but I respectfully differ on (b)[7]. In my judgment section 23(g) precludes the deductions claimed by the appellant, and the appeal should fail on that ground. My reasons for this view follow.

Section 23(g) does not refer in terms to "losses", as does section 11(a). Counsel for the appellant based an argument on the difference, in this respect, between the two sections. He said that it showed that the Legislature did not intend section 23(g) to apply to the deduction of "losses" at all; and, since the appellant was clearly claiming a deduction of "losses", and nothing else, its claim could not be barred by section 23(g). I do not agree.

It seems to me that the argument does violence to the plain meaning and effect of the language used in section 23(g), particularly when it is contrasted with the wording of section 11(a), and more especially when it is considered in the context of the other paragraphs of section 23, as I shall now endeavour to show".

But it may be noted, that, the argument of the appellant's counsel in that case was correct. Like "losses" were not mentioned in section 23(g) but on section 11(a)(2), the local section 25(1) mentions "outgoings" but not section 26(1)(g), which section mentions "disbursements" and "expenses". The word "disbursements" was also interpreted as "expenses" in Rodrigo's case. This shows that the same principle has been followed world over and hence when an expense is an "outgoing" under section 25(1), it is not covered under section 26(1)(g) and only "expenses" in section 25(1) are covered by section 26(1)(g).

[7] A. S. Botha J, Nicholas and Nienaber JJ., G. Friedman J. and E. M. Grosskopf J., that means, the Whole Court agreed that the expense is revenue in nature.

The facts of the case, as per the judgment of Friedman J., was as follows,

> "The facts are not in dispute and may be summarised as follows. PGSI is the holding company of a group of companies known as the Plate Glass Group (the Group). PGSI's subsidiaries are of the order of 20Ó, most of which are wholly owned by the parent company. The Group is involved in the manufacture, processing, wholesaling and retailing of timberwood and glass products. Until about 1973 the finances of each company in the Group were largely the responsibility of the particular company itself. In 1973 PGSI decided that the financial affairs of the Group would be best served by a finance company which would secure and arrange the funds required by all the companies in the Group. It would also monitor the use of those funds in the hands of the subsidiaries. In order to give effect to this decision a dormant subsidiary, previously called Plate Glass and Shatterprufe Industries Finance Company (Pty) Ltd, but whose name was subsequently changed to Solaglass Finance Company (Pty) Ltd (the present appellant), was utilised. One of appellant's objects, in terms of its memorandum of association, is to lend money to any person or company and to borrow such money as it deems fit. This object was not changed when the decision was taken to utilise appellant for the purposes contemplated. Henceforth, subsidiary companies requiring funds would apply to appellant which would, having regard to the budget of the subsidiary concerned, provide the necessary funds by way of loans. Security was not required on such loans. The subsidiaries were, however, required to pay interest on their loans. The rates varied, depending on the financial position of the subsidiary concerned, but generally the rates of interest charged were approximately 1% higher than appellant itself paid for moneys borrowed by it. Surplus funds in the hands of the subsidiaries were required to be placed with appellant on a daily basis. Appellant did not, however, rely solely on the surplus funds received from its fellow subsidiaries. It borrowed moneys from PGSI as well as from commercial

banks, in the case of the latter by means of overdrafts and acceptance credit facilities. Loans obtained by appellant from banks would generally be guaranteed by PGSI".

Botha J., said,

> "So, in the case of a loan which has become irrecoverable, the amount of which is sought to be deducted, important considerations are that it is not the "expenditure" incurred in advancing the loan which is sought to be deducted, but the loss of the loan capital by reason of its having become irrecoverable; and in that regard, for the purposes of applying the section, it is relevant to observe that were it not for the loss of the loan capital there would be no question of any deduction and that the real issue in such a case is the deductibility of the loss (see Stone' s case supra at 593E-F) . But in my view considerations such as these are confined to the context of section 11(a); they have no bearing on the application of section 23(g). Section 11(a) provides positively for what may be deducted, and section 23(g) negatively for what may not, but there is no direct correlation between the one and the other. **So, for instance, the question whether or not expenditure is of a capital nature is vital to the enquiry under section 11(a), but it plays no role in the application of section 23(g).** The enquiries under the two sections are notionally and logically discrete. That this is so is demonstrated by the fact that the Legislature did not transpose the descriptive expression "expenditure and losses" from section 11(a) to section 23(g); instead, it used in the latter section the colourless expression "any moneys". Section 11(a) is concerned with the deduction of "expenditure" qua expenditure and the deduction of "losses" qua losses, while section 23(g) focusses on the deduction of "moneys" qua moneys".

It was said that section 11(a) is concerned with an expenditure of capital nature, whereas section 23(g) is not. This is not the situation in local sections. Section

25(1) is not concerned with expenses of capital nature whereas section 26(1)(h) deals with expenditure of capital nature.

Friedman J., addressed the question of the distinction between losses of a capital and those of a revenue nature and quoted from Watermeyer C. J., in *New State Areas Ltd., vs. Commissioner of Inland Revenue 1946 AD 613 at 620 et seq.*

What authorities say on "expenditure of capital nature" – New State Areas Ltd., case:-

What Watermeyer C.J. discussed about the said distinction is important and hence it will be quoted.

His lordship said[8],

> "The two relevant provisions are :-
>
> "1. The deductions allowed shall be expenditure and losses actually incurred in the Union in the production of the income provided such expenditure and losses are not of a capital nature.
>
> 2. No deduction shall in any case be made in respect of any moneys, claimed as a deduction from income derived from trade, which are not wholly or exclusively laid out or expanded for the purpose of trade."
>
> It has been pointed out before (see Port Elizabeth Electric Tramway Co. v. Commissioner general Inland Revenue (1936, C.P.D. 241)) **that in a literal sense expenditure and losses do not produce income[9].** Save in the case of the leasing or the loan of capital in some form or other, income is produced by work or service or activities or operations and as a rule expenditure is attendant upon the performance of such operations sometimes necessarily, sometimes not. Expenditure may also occur in the

[8] IN *New State Areas Ltd., vs. Commissioner of Inland Revenue 1946 AD 613 at 620 et seq. case.*

[9] This was pointed out by Mason J., in Lockie Bros Ltd., vs. Commissioner for Inland Revenue, 1922 TPD 42, 32 S. A. T. C. 150.

acquisition by the taxpayer of the means of production. i.e., the property plant, tools, etc. which he uses in the performance of his income earning operations and not only for their acquisition but for their expansion and improvement. Both these forms of expenditure can be described as expenditure in the production of the income but the former is, as a rule, current or revenue expenditure and the latter is, as a rule, expenditure of a capital nature. As to the latter, the distinction must be remembered between floating or circulating and fixed capital. When the capital employed in a business is frequently changing its form from money to goods and vice versa (e.g., the purchase and sale of stock by a merchant or the purchase of raw material by a manufacturer for the purpose of conversion to a manufactured article), and this is done for the purpose of making a profit, then the capital so employed is floating capital. The expenditure of a capital nature, the deduction of which is prohibited under sec. 11 (2), is expenditure of a fixed capital nature, not expenditure of a floating capital nature, because expenditure which constitutes the use of floating capital for the purpose of earning a profit, such as the purchase price of stock in trade, must necessarily be deducted from the proceeds of the sale of stock in trade in order to arrive at the taxable income derived by the tax payer from that trade. **The problem which arises when deductions are claimed is, therefore, usually whether the expenditure in question should properly be regarded as part of the cost of performing the income earning operations or as part of the cost of establishing or improving or adding to the income earning plant or machinery.** In the case of Commissioner for Inland Revenue v. George Forest Timber Co., Ltd. (1924, A.D. 516), INNES, C.J., at p. 525, said;

"In the absence of any authoritative and comprehensive definition of capital expenditure, it is well to bear in mind the characteristic quality of capital; that it is wealth employed in creating fresh wealth, invested to produce income. As already pointed out the proceeds of merchandise sold

in the course of trade are included in the gross income of the trade, because they are not receipts of a capital nature, within the meaning of sec. 6. Similarly, the cost of merchandise thus disposed of would be an outgoing not of a capital nature within the meaning of sec.17 (1) (a) and having been incurred in producing the income would be properly deducted under that clause.

Now, money spend in creating or acquiring an income- producing concern must be capital expenditure. It is invested to yield future profit; and while the outlay does not recur the income does. **There is a great different between money spent in creating or acquiring a source of profit, and money spent in working it.** The one is capital expenditure, the other is not. The reason is plain; in the one case it is spent to enable the concern to yield profits in the future, in the other it is spent in working the concern for the present production of profit." [The emphasis was added in this judgment]

These remarks have been applied to furnish a test in several subsequent cases, e.g., *Rhodesia Railways v. Commissioner of Taxes* (1925, A.D. 438); *Baikie* v. C.I.R. (1931, A.D. 496) *; Port Elizabeth Electric Tramway Co*, v. *C.I.R.* (1936, C.P.D. 241).

In ordinary cases it is not difficult to distinguish between capital expenditure and revenue expenditure, but there are many cases on the border line, some of which, such as repairs and wear and tear of the means of production, are specially provided for in sec. 11 (2) of the Act. Several tests for determining the doubtful cases have been suggested in English cases which were useful in some circumstances, but many of them have turned out to be insufficient and inconclusive when applied to other circumstances. One such test suggested by **Lord DUNEDIN** in the **Vallambrosa case (1910, S.C. 519)** and often quoted, viz., that in a rough way a payment made once for all is capital expenditure and a recurrent

expenditure is revenue expenditure, had regard only to the form and not to the essential character of the transaction and is of little value in those cases where capital expenditure is given the appearance of revenue expenditure because it is paid in instalments and where revenue expenditure is given in the appearance of capital expenditure because it is commuted and paid in one lump sum. **It has now been recognized by the English courts that the true character of the transaction and not its form must be looked at to the determine whether it is a capital or a revenue expenditure.** As to this, the Master of the Rolls (Sir WILFRED GREENE as he then was) said, in the case of I.R.C. v. Mallaby-Deeley (1938, 4 A.E.R. 818 at p. 823) :

"**The distinction which is to be drawn for the purposes of the Income Tax Acts between payments of an income character and payments of a capital nature; is sometimes a very fine and rather artificial one.** It may – in fact, it does – depend upon the precise character of the transaction. To take a simple case, if the true bargain is that a capital sum shall be paid, the fact that the method of the payment which is adopted in the document is that of payment by instalments will not have the effect of giving to those installments the character of income. Their nature is finally determined by the circumstance that the obligation is to finally determined by the circumstances that the obligation is to pay a capital sum and instalments are merely a method of effecting that payment. **On the other hand, to take another simple case, where there is no undertaking to pay a capital sum and no capital obligation in existence, and all that exists is an undertaking to pay annual sums, those may, in the absence of other considerations, be annual payments of an income nature for the purpose of the Income Tax Acts.**" [The emphasis added in this judgment]

In 1926 the English cases were reviewed by the House of Lords in the case of *British Insulated & Helsby Cables v. Atherton* (1926, A.C. 205). **Lord CAVE** in his judgment said:

"But there remains the question, which I have found more difficult, whether, apart from the express prohibition, the sum in question is (in the words used by Lord SUMNER in Usher's case) a proper debit item to be charged against incomings of the trade when computing the profits of it; or in other words, whether it is in substance a revenue or a capital expenditure. This appears to me to be a question of fact which is proper to be decided by the Commissioners upon the evidence brought before them in each case; but where, as in the present case, there is no express finding by the Commissioners upon the point, it must be determined by the Courts upon the materials which are available and with due regard to the principles which have been laid down in the authorities".

"Now in *Vallambrosa Rubber Co. vs. Farmer*, **Lord DUNEDIN**, as Lord President of the Court of Session, expressed the opinion that "in a rough way" it was "not a bad criterion of what is capital expenditure – as against what is income expenditure – to say that capital expenditure is a thing that is going to be spent once and for all and income expenditure is a thing that is going to recur every year"; and no doubt this is often a material consideration. But the criterion suggested is not and was obviously not intended by Lord DUNEDIN to be, a decisive one in every case; for it is easy to imagine many cases in which a payment, though made "once and for all", would be properly chargeable against the receipts for the year. Instances of such payments may be found in the gratuity of 1,500 paid to a reporter on his retirement, which was the subject of the decision in Smith vs. Incorporated Council of Law Reporting for England and Wales and in the expenditure of 4,994 in the purchase of an annuity for the benefit of an actuary who had retired, which, in Hancock vs. General Reversionary

and Investment Co. was allowed and I think rightly allowed, to be deducted from profits. But when an expenditure is made, not only once and for all, but with a view to bringing into existence an asset or an advantage for the enduring benefit of a trade, I think that there is very good reason (in the absence of special circumstances leading to an opposite conclusion) for treating such an expenditure as properly attributable not to revenue but to capital. For this view there is already considerable authority. Thus, moneys expended by a brewing firm with a view to the acquisition of new licensed premises, Southwell vs. Savill Brothers; "flitting expenses" incurred in transferring a manufacturing business to new premises, Granite Supply Association vs. Kitton; costs incurred in promoting a Bill which was dropped on the desired facilities being obtained by agreement, A. G. Moore & Co. vs. Hare; and expenditure incurred by a ship building firm in deepening a channel and creating a deep water berth (not on their own property) to enable vessels constructed by them to put out to sea, Ounsworth vs. Vickers, Ltd., have been held to be in the nature of capital expenditure and not to be deductible under the Income Tax Acts; and Rowntree & Co. vs. Curtis is to the same effect. I think that the principle to be deduced from this series of authorities rests on sound foundations and may properly be adopted by this House".

"With regard to that judgment of Lord CAVE, the remarks of ROMER, L.J., in the case of Anglo Persian Oil Co. vs. Dale (1932, 1 K. B. D. 124 at p. 145) are of sufficient importance to be repeated here. After referring to the lack of certainty as to permissible deductions furnished by the terms of the Act and to numerous and not easily reconcilable tests suggested by the Judges in past cases, he continued:

"At the end of the year 1925, however, all these authorities were considered by the House of Lords in *British Insulated & Helsby Cables vs. Atherton* and the law applicable to such cases at the present was, as it

seems to me, placed beyond the realms of controversy. The boundary line between deductions that were permissible and those that were not had previously been uncertain and difficult to follow. As regards the large majority of deductions, there was and could be no conceivable doubt. They were clearly on one side of the line to the other. But as regards a comparatively small number, it was difficult to say on which side of the line they fell. This was particularly the case where, as in the present one, an expenditure is not a recurring one, but is made once and for all. It was pointed out by Lord CAVE in *Atherton's case,* that an expenditure, though made once and for all may, nevertheless, be treated as revenue expenditure and he then added this: "But when and expenditure is made not only once and for all but with a view to bringing into existence an asset or an advantage for the enduring benefit of a trade, I think that there is very good reason (in the absence of special circumstances leading to an opposite conclusion) for treating such an expenditure as properly attributable not to revenue but to capital". It should be remembered, in connection with this passage, that the expenditure is to be attributed to capital if it be made "with a view" to bringing an asset or advantage into existence. It is not necessary that it should have that result. It is also to be observed that the asset or advantage is to be for the "enduring" benefit of the trade. I agree with ROWLATT, J., that by "enduring" is meant "enduring in the way that fixed capital endures". An expenditure on acquiring floating capital is not made with a view to acquiring an enduring asset. It is made with a view to acquiring an asset that may be turned over in the course of trade at a comparatively early date. Nor, of course, need the advantage be of a positive character. The advantage may consist in the getting rid of an item of fixed capital that is of an onerous character, as was pointed out by this Court in Mallett vs. Staveley Coal & Iron Co. (1928, 2 K. B. 405)".

"Wholly" or "Exclusively" not being a part of local law:-

Coming back to the case of *Solaglass Finance Company (Pty) Ltd., vs. Commissioner for Inland Revenue, 1990,* Freidman J., said the following on considering section 23(g) which is similar to the local section 26(1)(g).

> "It remains to be considered whether the losses are disqualified from deduction by reason of the provisions of sec 23(g). According to that section no deduction shall be made in respect of 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".**
>
> .....
>
> "There is a similarly worded provision in the English tax legislation which reads as follows:
>
> "... in computing the amount of the profits or gains to be charged .... no sum shall be deducted in respect of (a) any disbursements or expenses, not being money wholly and exclusively laid out or expended for the purposes of trade, profession, employment or vocation ...."

In this regard, Freidman J., cited 3 cases, 2 English cases and one South African case. They are as follows,

(i) The English Court of Appeal had occasion to consider the meaning of the words "wholly and exclusively laid out or expended for the purposes of trade ...." in Bentleys, Stokes and Lowless v Beeson (H M Inspector of Taxes) **[1952] 33 TC 491**; **[1952] 2 All ER 82** (CA) . The issue in the Bentleys case was whether the taxpayers, who were members of a firm of solicitors, were entitled to a deduction in respect of expenses incurred in entertaining clients.

ROMER LJ, in delivering the judgment of the court, said the following at 503-4 (33 TC) ([1952] 2 All ER at 84G-85B):

"The relevant words .... 'wholly and exclusively laid out or expended for the purposes of the profession' - appear straightforward enough. It is conceded that the first adverb- 'wholly' -is in reference to the quantum of the money expended and has no relevance to the present case. The sole question is whether the expenditure in question was 'exclusively' laid out for business purposes, that is: What was the motive or object in the mind of the two individuals responsible for the activities in question? It is well established that the question is one of fact: and again, therefore, the problem seems simple enough. The difficulty however arises, as we think, from the nature of the activity in question. Entertaining involves inevitably the characteristic of hospitality. Giving to charity or subscribing to a staff pension fund involves inevitably the object of benefaction. An undertaking to guarantee to a limited amount a national exhibition involves inevitably supporting that exhibition and the purposes for which it has been organised. But the question in all such cases is: Was the entertaining, the charitable subscription, the guarantee, undertaken solely for the purposes of business, that is, solely with the object of promoting the business or its profit earning capacity?

(ii) The words "wholly and exclusively laid out or expended for the purposes of the trade " were

subsequently considered by the House of Lords in Mallalieu v Drummond (Inspector of Taxes) **[1983] 2 All ER 1095.** The taxpayer was a female barrister who claimed, as a deduction, the expenditure incurred by her on the replacement, cleaning and laundering of certain items of clothing which she wore in court. In considering the words of the tax provision, LORD BRIGHTMAN said at 1099e-f that they mean "expended to serve the purposes of the trade ...." or "for the purpose of enabling a person to carry on and earn profits in the trade ...". His Lordship proceeded, at 1099g-h, to state:

"The effect of the word 'exclusively' is to preclude a deduction if it appears that the expenditure was not only to serve the purposes of the trade, profession or vocation of the taxpayer but also to serve some other purposes. Such other purposes, if found to exist, will usually be the private purposes of the taxpayer."

(iii) In Commissioner for Inland Revenue v Pick n Pay Wholesalers (Pty) Ltd 1987(3) SA 453(A) this Court adopted the analysis of ROMER LJ in the Bentleys case, and referred also to the distinction between the object of expenditure and its effect as outlined in LORD BRIGHTMAN's speech in Mallalieu's case. **Applying the principles thus enunciated, this Court held that the taxpayer who had made a large charitable donation which it sought to deduct from its income as an "advertising" expense, had not shown that, in making the donation, it did not have a dual purpose, namely a philanthropic as well as a business purpose; the deduction was therefore disqualified by the provisions of sec 23(g).** [The emphasis was added in this judgment]

In the local section 26(1)(g) there are no words as "wholly" or "exclusively" and it appears to this Court, that, the local section is more in favour of the taxpayer.

It simply says,

> "26. (1) For the purpose of ascertaining the profits or income of any person from any source, no deduction shall be allowed in respect of–
>
> (g) any disbursements or expenses of such person, not being money expended for the purpose of producing such profits or income".

It does not say "not being money wholly or exclusively expended for the purpose of producing such profits".

As the great ROWLATT J., once said and quoted again and again,

"In the words of the late Rowlatt, J., whose outstanding knowledge of this subject was coupled with a happy conciseness of phrase: " In a taxing Act one has to look merely at what is clearly said. "There is no room for any intendment. There is no equity about a tax. " There is no presumption as to a tax. Nothing is to be read in, nothing is to "be implied. One can only look fairly at the language used" —Cape Brandy Syndicate v. Commissioners of Inland Revenue, [1921] 1 K.B. 64, at page 71; 12 T.C. 358, at page 366". [Canadian Eagle Oil Company Ltd., vs. The King (Petition of Right – on Demurrer only) 30th July 1945, House of Lords]

On the basis of the realities, that has come into existence, after nearly a century, the definition of the phrase, "incurred in the production of the profits or income" has become widened. Hence, even if it is considered that the payments of interests in this case is not an "outgoing", that is not coming under the purview of the "expenses" and hence not limited by the said phrase, but it is an "expense" limited by the said phrase, it appears that the appellant is entitled to deduct the amount paid as interests. Mason J's test in *Lockie Bros* made in 1922, a century ago, with a test of non remoteness, instead of "close connection" holds the ground.

The words, "wholly or exclusively incurred in the production of income" was used in *Reynolds case* too. The same provision was referred to in *Joffe.* What Mason J., said in *Lockie Bros vs. Commissioner of Income Tax* was,

(1) **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,**

What Watermeyer C. J., said in *Port Elizabeth Electric Tramways Co., case* was,

(2) **Chance, in other words, increases the expenses, or make additional expenses, but though chance causes them to arise they nevertheless remain expenses so closely linked to a necessary business operation**

that they can be regarded as part of the cost of performing such operation.

In *Warner Lambert SA (Pty) Ltd., case,* Conradie JA, with the concurrence of four other judges found,

(3) a link, which was not regarded as too remote, between the continued trade of the taxpayer and the expenditure

Hence, the principle emanating from the cursus curiea is "in the course of ordinary operations" (Mason J.) caused sometimes by "chance" (Watermeyer AJP) and "a link which is not too remote" (Conradie JA)

Part IV

Violation of audi alteram partem rule:-

In the reasons given by the Assessor or the Deputy Commissioner of Inland Revenue, there was no reference to capital expenditure or to section 26(1)(h). Hence as the appellant argues it is a violation of the rule audi alteram partem. In this regard, the appellant has cited the cases,

(i) *D. M. S. Fernando vs. Mohideen Ismail (1982) 1 SLR 222* at page 242, which says,

"The object of this Amendment appears to be **to make a taxpayer** who has, according to him, made a correct return and is therefore reasonably entitled to expect his return to be accepted, **aware, if the Assessor does not accept his return, of the reasons for the non-acceptance of his return so as to enable him to demonstrate the untenability of the said reasons at the hearing of any appeal that may be preferred by him against the assessment.** The return referred to is the return required by section 82 of the Inland Revenue Act. Under the Amendment, what **the taxpayer should be informed of are only the reasons in writing for non-acceptance of his return,** but not the ground or basis

of the estimate of the assessable income made by the Assessor". [The emphasis added in this judgment]

(ii) *Jayawardena vs. Dharani Wijayatilake, Secretary, Ministry of Justice and Constitutional Affairs and others [2001] 1 SLR 132 at page 150,*

"The legal principles are clear. In Cooper vs. Wandsworth Board of Works141 it was, laid down that "although there are no positive words in a statute, requiring that the party shall be heard, yet the justice of the common law will supply the omission of the legislature." In a passage which has repeatedly been cited with approval, Lord Loreburn, LC, referred to the duty of public bodies and officers when called upon to decide questions, even involving discretion: "In the present instance, as in many others, what comes for determination is a matter to be settled by discretion, involving no law. It will, I suppose, usually be of an administrative kind; but sometimes it will involve matter of law as well as matter of fact, or even depend on matter of law alone. In such cases [they] will have to ascertain the law and also to ascertain the facts. I need not add that in doing either they must act in good faith and listen fairly to both sides, for that is a duty lying upon everyone who decides anything. But I do not think they are bound to treat such a question as though it were a trial. They have no power to administer an oath, and need not examine witnesses. They can obtain information in any way they think best, always giving a fair opportunity to those who are parties in the controversy for correcting or contradicting anything prejudicial to their view." Board of Education v Rice, [1911] AC 179. Professor Wade (Administrative Law, 5th ed, p 444) refers to the picturesque judicial dictum in R. v. University of Cambridge, "I remember to have heard it observed by a very learned man upon such an occasion, that even God himeself did not pass sentence upon Adam, before he was called upon to make his defence." Adam, says God, where art thou? Hast thou not eaten

of the tree, whereof I commanded thee that thou shouldst not eat?, And the same question was put to Eve also."

Wade's observations (p 442) are apposite: "As the authorities will show, the courts took their stand several centuries ago on the broad principle that bodies entrusted with legal power could not validly exercise it without first hearing the person who was going to suffer. This principle was applied very widely to administrative as well as to judicial acts, and to the acts of individual ministers and officials as well as to the acts of collective bodies such as justices and committees. The hypothesis on which the courts built up their jurisdiction was that the duty to give every victim a fair hearing was just as much a canon of good administration as of good legal procedure. **Even where an order or determination is unchallengeable as regards its substance, the court can at least control the preliminary procedure so as to require fair consideration of both sides of the case. Nothing is more likely to conduce to good administration.** [The emphasis added in this judgment]

The decision reached by the TAC that interest paid is capital expenditure and cannot be allowed under section 26(1)(h) is therefore a nullity ***ab initio usque ad finem,*** i.e., from the beginning to the end.

Since this judgment is somewhat long, if salient points of it are summarized it would be as follows,

(1) What is relevant to the question in this case is the interplay between section 25(1) and 26(1)(g), mainly, of the Inland Revenue Act No. 10 of 2006,
(2) It was decided in *Rodrigo vs. Commissioner of Income Tax [2002]* that these two sections have to be read together,
(3) However, the mere reading of these two sections would bring about a situation, that, what is given in section 25(1) is taken away by section 26(1)(g),

(4) The material part of section 25(1) says, "there shall be deducted for the purpose of ascertaining the profits or income of any person from any source, all **outgoings** and **expenses incurred by such person in the production thereof,** including…",

(5) In certain decided cases, it has been argued; and the appellant in this case, tries to argue, that, several enumerations after the word "including" in section 25(1) are especial deductions (this part has been called the "catalogued" deductions) which will not be taken away by section 26(1)(g),

(6) Section 26(1)(g) says, "For the purpose of ascertaining the profits or income of any person from any source, no deduction shall be allowed in respect of- (g) any **disbursements** or **expenses** of such person, **not being money expended for the purpose of producing such profits or income",**

(7) This Court does not accept the argument, that, what is stated after the word "including" in section 25(1) are especial deductions,

(8) This Court is of the view, that, *Patrick Alfred Reynolds vs. Commissioner of Income Tax, Trinidad and Tobago (1965) 3 All E R 901,* does not assist the appellant,

(9) In *Hayley and Company Ltd., vs. Commissioner of Income Tax 65 NLR 174,* [decided on 10th July 1961] Chief Justice Hema Henry Basnayake, broke the section similar to section 25(1) then, in correct places, such as, "outgoings", "expenses incurred by the assessee in the production of profits and income" and "the specific deductions allowed by paragraphs (a)-(i) thereof",

(10) This division makes "outgoings" not subject to the words, "incurred by the assessee in the production of income" and the words, "not being money expended for the purpose of producing such profits or income",

(11) Thus, the interests on loans, which the appellant attempts to deduct in this case, though especially mentioned under section 25(1)(f), also comes under the head "outgoings" and hence not covered by the words referred to in (10) above,

(12) It was not Sinnetamby J', decision in Hayley's case, which implied that "outgoings" are also subjected to the words "incurred in the production of income", but the judgment of Basnayake C. J., that was followed in the later case of *Rodrigo vs. Commissioner of Income Tax [2002],*

(13) His Lordship Basnayake, C. J.'s decision, not to cover the word "outgoing", by the words "incurred in the production of income", or words of similar import, is supported by the Australian case His Lordship cited, *Alliance Assurance Co., Ltd., vs. Federal Commissioner of Taxation, 29 Commonwealth L. R. 424 at 430,* where Knox C. J., Gavan Duffy, Rich and Starke JJ., with whose judgment Higgins J., expressed his agreement in a separate judgment, stated- **"In our opinion the words "all losses and outgoings", which occur at the beginning of sub clause (a) extended to all losses and outgoings of the business not being in the nature of losses and outgoings of capital and are not qualified by the words "incurred in Australia in gaining or producing the gross income.** We think these latter words refer earlier to the word "expenses" only, or at most to the words "commission, discount, travelling expenses, interest and expenses",

(14) In *Rodrigo vs. Commissioner of Income Tax [2002],* the Supreme Court followed this decision of Basnayake C. J., when it said, "It is obvious that section 23 focuses on all aspects of expenses as it refers not only to "expenses" but also to the "outgoings". The word "outgoings" gives a wider meaning than the word "expense". "Outgoings" incurred by a person carrying out a profession, could include a wide variety of items, which would not come within the meaning of "expenses", (page 390)

(15) In *Rodrigo vs. Commissioner of Income Tax [2002]* the Supreme Court decided that the word "disbursements" also refer to expenses and it has a limited meaning than the word "outgoings", (page 392)

(16) The Case *Rodrigo vs. Commissioner of Income Tax [2002]* referred to the South African decision of *Port Elizabeth Electric Tramways Company Ltd.,*

vs. Commissioner of Income Tax, (1936) CPD (Cape of Good Hope Province Division) 241, 8 S. A. T. C. 14

(17) This Court having obtained the Law Report of this case, has examined the decision of Watermeyer AJP in detail. The Court held that, all expenses attached to the performance of a business operation bona fide performed for the purpose of earning income are deductible whether such expenses are necessary for its performance or attached to it by chance or are bona fide incurred for the more efficient performance of such operation provided that they are so closely connected with it that they may be regarded as part of the cost of performing it.

(18) The Article by G. K. Goldswain and O. Swart, "The Port Elizabeth Electric Tramways case:- In the meaning ascribed to the phrase "in the production of the income" by Watermeyer AJP in the Port Elizabeth Electric Tramways case still religiously followed today?" refers to *Lockie Bros Ltd., vs. Commissioner for Inland Revenue, 1922 TPD 42, 32 S. A. T. C. 150,* which is a decision of Mason J. It was said, ""**The first question is as to the meaning of the words "in the production of income": patently they cannot be taken in their literal sense, because a loss cannot produce income and because if the whole year's business resulted in a loss, not even the outgoings could be said to be incurred in the production of a non existent income, yet by sub section 2 of this section the loss on a year's business is to be assessed and may be deducted in subsequent years. <u>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".</u>**

(19) What is important is not only that Mason J., previous to Port Elizabeth Electric Tramways case, had a wider definition for the term, "incurred in the

production of income", but it was used in section 11(c) of the Income Tax Act to negate the disallowance by Watermeyer AJP in Port Elizabeth Electric Tramways case of the deduction of legal expenses incurred in resisting the claim of the driver.

(20) The Article then discusses about *Joffe & Co., (Pty) Ltd., vs. Commissioner for Inland Revenue, 1946 AD 157, 13 S. A. T. C. 354,* which was decided ten years after Port Elizabeth Electric Tramways case, saying that Watermeyer, now the Chief Justice of South Africa was in an unenviable position.

> Watermeyer C. J., said, ""Mr. Rosenberg [N. E. Rosenberg K. C., who appeared for the appellant] further contended that, even if the expenditure in question was not the necessary concomitant of the business of a reinforced concreate 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. It is possible that this argument can be refuted upon more grounds than one, but I shall only mention the following one: there 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 disappears and it cannot be supported".

(21) As an example of the fact that the "close connection" test laid down by Watermeyer AJP for the interpretation of the phrase, "incurred in the production of income" is too "mechanical and contrived", Goldswain and Swart cites *ITC 1058 (1963) 26 S. A. T. C. 305,* in which it was decided, that,

"a third party who happens to drive past the factory at night is not essential to the taxpayer's trade and did not, therefore, produce income".

(22) The writers state that by 2003 the judiciary, unlike SARS [South African Revenue Services] appeared to have recognized the absurdity of some of its previous decisions and had subtly begun to widen the ambit of the phrase to take into account the economic, social, statutory and even the requirements of its shareholders and other stakeholders that have emerged over the past 40 years or so.

(23) *South African Revenue Services vs. Scribante Construction (Pty) Ltd., 2001 (2) SA 601 (E). 62 S. A. T. C. 443,* is a case that dealt with payment of interests. It was said, "There is no doubt that the interest paid by the company enabled it to secure (even if only temporarily) the shareholders funds which could otherwise have been moved elsewhere. Equally it is certain that the availability to the company of the funds substantially increased its competitiveness and, temporarily, its income in the form of the interest which it retained. Those two considerations simply stated provide the sufficiently close link between the expenditure and the income earning operations having regard to the purpose of the expenditure and what it actually effects, Commissioner for Inland Revenue v Genn & Co (Pty) Ltd 1955 (3) SA 293 (A) at 299 G. The fact that the company could have operated quite adequately without the funds is not the only pertinent factor. It was enough that they served for the more efficient performance of its 12 operations: Port Elizabeth Electric Tramway Co v Commissioner for Inland Revenue 1936 CPD 241 at 246".

(24) Expenditure incurred at the behest of its holding company was considered in *Warner Lambert SA (Pty) Ltd., vs. Commissioner for South African Revenue Services, 2003 (5) SA 344 (SCA), 65 S. A. T. C. 346.* It was said, "**The South African subsidiary company claimed the social responsibility expenses that it was forced to incur to comply with the Sullivan Code principles, as deductions in the determination of its income. These expenses were**

disallowed by the Commissioner on the basis that the expense had not been incurred in the production of the taxpayer's income. In effect, the expenses were incurred at the behest of the American holding company and therefore, could never actually produce income. On appeal to the Supreme Court of Appeal, Conradie JA (the other four judges concurred with his judgment) found **a link, which was not regarded as too remote,** between the continued trade of the taxpayer and the expenditure at the behest of its holding company".

(25) In *Solaglass Finance Limited vs. Commissioner for Inland Revenue, 1991 (2) SA 257, 53 S. A. T. C. 1,* the facts were similar to the present case. Goldswain and Swart says about this case,

"See also Solarglass Finance Limited v CIR where a similar decision was given in regard to loans made by a subsidiary company to other companies in the group at the behest of its holding company".

This judgment is important, not only to define the term, "incurred in the production of income", but also to the argument of the expenses being "capital in nature", which was taken up by the TAC, albeit without notice to the appellant and hence the respondent cannot rely upon, on the basis of the violation of the rule audi alteram partem, which is addressed in the next section of this judgment, but adverted to here, to err on the side of caution.

(26) Like in the present case, there was a Holding company and subsidiary companies. One such company was acting as the "Financier" of the group. The matter arose due to loans given. But the question was not in respect of interest payments. It was regarding losses caused due to the non payment of certain loans.

A. S. Botha J, wrote the leading judgment, Nicholas and Nienaber JJ., agreeing disallowing the appeal of the taxpayer, though their lordships agreed with the minority, on the basis that the expenditure was revenue in nature, they held that the expenses cannot be deducted as they were not incurred wholly or exclusively in the production of income. G.

Friedman J., dissented, with whom concurred, E. M. Grosskopf J., allowing the appeal on the basis that it is floating capital and hence revenue (with which the majority too agreed) and it can be allowed under section 23(g).

(27) The authorities referred to in *Solaglass Finance Limited vs. Commissioner of Inland Revenue* are relevant to this case.

With regard to deductions under section 23(g), which is akin to section 26(1)(g) in the local section, Botha J., refusing the argument of the counsel for the appellant said, "**Section 23(g) does not refer in terms to "losses", as does section 11(a). Counsel for the appellant based an argument on the difference, in this respect, between the two sections. He said that it showed that the Legislature did not intend section 23(g) to apply to the deduction of "losses" at all; and, since the appellant was clearly claiming a deduction of "losses", and nothing else, its claim could not be barred by section 23(g). I do not agree".**

(28) The argument of the appellant's counsel in that case was correct. Like "losses" were not mentioned in section 23(g) but on section 11(a)(2), the local section 25(1) mentions "outgoings" but not section 26(1)(g), which section mentions "disbursements" and "expenses". The word "disbursements" was also interpreted as "expenses" in Rodrigo's case. This shows that the same principle has been followed world over and hence when an expense is an "outgoing" under section 25(1), it is not covered under section 26(1)(g) and only "expenses" in section 25(1) are covered by section 26(1)(g).

(29) Friedman J., in Solaglass addressed the question of the distinction between losses of a capital and those of a revenue nature and quoted from Watermeyer C. J., in *New State Areas Ltd., vs. Commissioner of Inland Revenue 1946 AD 613 at 620 et seq.*

(30) Watermeyer C. J., said, "**The problem which arises when deductions are claimed is, therefore, usually whether the expenditure in question should properly be regarded as part of the cost of performing the**

income earning operations or as part of the cost of establishing or improving or adding to the income earning plant or machinery".

(31) It was said, "**There is a great different between money spent in creating or acquiring a source of profit, and money spent in working it".**

(32) It was said, ""**The distinction which is to be drawn for the purposes of the Income Tax Acts between payments of an income character and payments of a capital nature; is sometimes a very fine and rather artificial one".**

(33) It was said, ""At the end of the year 1925, however, all these authorities were considered by the House of Lords in *British Insulated & Helsby Cables vs. Atherton* and the law applicable to such cases at the present was, as it seems to me, placed beyond the realms of controversy. The boundary line between deductions that were permissible and those that were not had previously been uncertain and difficult to follow. As regards the large majority of deductions, there was and could be no conceivable doubt. They were clearly on one side of the line to the other. But as regards a comparatively small number, it was difficult to say on which side of the line they fell. This was particularly the case where, as in the present one, an expenditure is not a recurring one, but is made once and for all. It was pointed out by Lord CAVE in *Atherton's case,* that an expenditure, though made once and for all may, nevertheless, be treated as revenue expenditure and he then added this: "But when and expenditure is made not only once and for all but with a view to bringing into existence an asset or an advantage for the enduring benefit of a trade, I think that there is very good reason (in the absence of special circumstances leading to an opposite conclusion) for treating such an expenditure as properly attributable not to revenue but to capital".

(34) "**Wholly or exclusively laid out or expended for the purposes of trade",** in section 23(g), is not part of section 26(1)(g) and hence the latter section is more in favour of the tax payers.

Therefore, the Questions of Law are answered in favour of the appellant.

(1) Is the interest paid by the appellant during the year of assessment 2007/2008 on the loan of Rs. 85,000,000 taken from Messrs. DSI Holdings Ltd and utilized to meet the working capital requirements of the appellant deductible in the computation of its profits for the year of assessment 2007/2008 as an expenditure incurred in the production of profits and income of the business of the appellant?

Yes. It can also be an "outgoing", to which "incurred in the production of income", does not apply.

(2) Is the interest referred to in the previous question of law deductible in terms of section 25(1)(f) of the said Act, which is a special rule of deduction even if it is held that such interest cannot be treated as expenditure incurred in the production of income?

There are no special rules of deduction. The sections must be read together [Rodrigo vs. Commissioner of Inland Revenue, 2002] But the said interest is either an "outgoing" or an "expenditure incurred in the production of income and hence deductible.

(3) Is the interest referred to previously deductible in terms of section 32(5)(a)(ii) of the said Act as interest paid on a loan the proceeds of which are utilized in any trade, business, profession or vocation carried on by the appellant?

Does not arise in view of the answers to (1) and (2) above.

(4) Did the Commission err in law in arriving at the conclusion that the interest in question is not deductible, for the reasons that such conclusion

is arrived at on the basis of inferences drawn from primary facts established or admitted in the case, which inferences are, it is submitted perverse such inferences being the following:

(i) That the loan given by the appellant to Samson Rajarata Tiles (pvt) Ltd during the year of assessment 2005/2006 and 2006/2007 were loans given by the appellant to DSI Samson Group (Pvt) Ltd., a company different from Samson Rajarata Tiles (Pvt) Ltd (Please see page 2 of the determination of the Tax Appeals Commission)

The statement in (i) is correct, but that is not a reason to hold that the interest paid was not deductible, due to reasons given in this judgment.

(ii) That the appellant had no obligation whatsoever to grant such loan to DSI Samson Group (pvt) Ltd., (a loan which the appellant never gave to DSI Samson Group (pvt) Ltd (Please see page 3 of the determination);

DSI Samson Group (pvt) Ltd., has been substituted as the "debtor", but this is not relevant to the question of deducting interest payments.

(iii) That the shortfall created in the capital base of the appellant company was due to the grant of a loan of Rs. 97.500,000 the appellant never gave to DSI Samson Group (pvt) Ltd (Please see page 3 of the determination)

This is not relevant. Even if there was a question of "floating capital", that applies to the loan and not to the interest, which is a recurrent revenue expenditure.

(iv) That the loans amounting to Rs. 97,500,000 given by the appellant to Samson Rajarata Tiles (pvt) Ltd during the year of assessment 2005/2006 and early part of the year of assessment 2006/2007 taken by the appellant from DSI Holdings Ltd on 31.3.2007 (Please see pages 3 and 7 of the determination)

Not relevant to the question of deducting interest payments.

(5) Did the Commission err in law by impliedly holding that the expenditure referred to in the special provisions of section 25 of the Act an expenditure, which should have been incurred in the production of income?

Section 25 is not an especial provision. The appellant has incurred an expenditure (if it is not an "outgoing", which was incurred in the production of income.

(6) Did the Commission err in law in its refusal to apply a judicial decision of highest persuasive authority namely the decision of the Privy Council in the case of Patrick Alfred Reynolds vs. Commissioner for Income Tax, Trinidad and Tobago for the alleged reason that the decision was made in 1967 and that the law has undergone much development since 1967 without indicating any such development?

Yes. The said decision was made in 1965. However, for the reasons mentioned in the judgment that decision is not helpful to the appellant.

(7) Did the Commission err in law in the interpretation of the word INCLUDING which occurs at the end of the general rule of deduction in section 25(1) is not a definitional clause acted on the basis of the meaning of the word INCLUDING occurring in definitional clause (see reference to Bindra on Interpretation of Statutes at page 8 of the determination) and disregarding the meaning of the word occurring in a non definitional

clause as explained by Maxwell Interpretation of Statutes page 270. Which was cited on behalf of the appellant?

This Court has decided taking the sections referred to at the beginning of this judgment as a whole and reading them together [as per the decision of Shirani Bandaranayake J., (later Chief Justice) in Rodrigo vs. Commissioner of Income Tax, 2002, to which decision Sarath N. Silva C. J. and Ismail J., agreed] and not on any artificial construction in terms of arguments that "catalogued" provisions are special or on the meaning of the term "including". For example, if the first part of section 26(1) can negate only the first part of section 25(1) but not the "catalogued" part, what about the effect of the specific parts in section 26(1) such as section 26(1)(g) or section 26(1)(h) or "catalogued" part of section 25(1) ?

(8) Did the Commission err in law in holding at page 7 of the determination (even without any reference to either a judicial or a statutory definition of the expression) that the interest claimed by the appellant is CAPITAL EXPENDITURE?

Yes.

(9) Did the Commission err in law in holding that the interest claimed is prohibited by section 26(1)(g) and section 26(1)(h) even where the claim for deductions is made in terms of section 25(1)(f)?

The appellant can succeed because payment of interest is an "outgoing" or an "expense" incurred in the production of income, which arises on section 25(1) and which cannot be vitiated under section 26(1)(g) or 26(1)(h)

(10) Did the Commission err in law in violating the principle of natural justice audi alteram partem in holding that the interest claimed by the appellant is capital expenditure without providing an opportunity to the appellant to make submissions in that regard and in circumstances that neither the Commissioner General of Inland Revenue nor his representatives before the Commission claimed that such expenditure is capital expenditure?

Yes and hence Commission's decision in this regard is a nullity. But this Court has addressed that issue too, err on the side of caution.

(11) Did the Commission err in law by allowing itself to be guided by irrelevant and extraneous considerations when it said at page 5 of the determination that ISSUE TO BE RESOLVED IN THE FIRST INSTANCE IS WHETHER THE GRANT OF A LOAN BY THE APPELLANT COMPANY TO ANOTHER COMPANY (WHETHER IN THE SAME GROUP OR NOT) COULD BE CONSIDERED AS PART AND PARCEL OF THE BUSINESS ACTIVITY OF THE DONOR COMPANY?

Yes. If deductions can be allowed under section 26(1)(g) and 26(1)(h) the Commissioner General cannot question the propriety of granting loans or taking the loan.

(12) Did the Commission err in law in not annulling the assessment under appeal on the basis of its own finding that the loan of Rs. 85,000,000 was taken to fill the deficit in the capital base of the appellant company (whatever may have been the causes for the creation of the deficit) since the existence of a deficit in the capital base is always the reason for raising credit or obtaining loans to be utilized in any business relief for which is

provided in the revenue legislation in the form of granting deductions for interest costs involved?

Yes.

The appeal in the form of a Case Stated is allowed.

Judge of the Court of Appeal

Hon. Sasi Mahendran J.

I agree.

Judge of the Court of Appeal