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# The Supreme Court of Appeal Limits the Deduction of Expenditure Incurred in the Production of the Income: *The Commissioner for the South African Revenue Service v Spur Group (Pty) Ltd* [2021] ZASCA 145

**Thabo Legwaila***
**https://orcid.org/0000-0002-6915-7853**
*Professor, School of Law, University of the Witwatersrand*

**Abstract**

*The Income Tax Act 58 of 1962 allows for the deductibility of expenditure and losses incurred by a taxpayer in the production of income, provided they are not of a capital nature. This is an important provision that ensures that taxpayers pay tax only on income generated by the application of their capital, and not to tax the return of capital. In 1936 the court in Port Elizabeth Electric Tramway Co Ltd v CIR 1936 CPD 241 interpreted "production of the income" requirement based on the specific facts that the court was faced with. The court further narrowed the interpretation ten years later in Joffe & Co (Pty) Ltd 1946 AD 157 when faced with facts and circumstances that were relatively similar to those in the 1936 case. Unfortunately, subsequent to that, some courts applied that specific circumstances interpretation to other more general cases. This culminated in a rather unfortunate decision in The*

* B Iuris (Venda); LLB; LLM (Wits); PG Dip Tax; LLM (UCT); LLD (Pretoria). Email: thabo.legwaila@wits.ac.za

*Commissioner for The South African Revenue Service v Spur Group (Pty) Ltd [2021] ZASCA 145 eighty-five years later. In this note, it is respectfully submitted that (a) the decisions in PE Electric Tramway and in Joffe were incorrect and inappropriate in the circumstances; (b) that it was wrong for the subsequent cases to follow them; (c) it was also wrong for the court in Spur Group to follow these cases; and (d) besides having wrongly following PE Electric Tramway, the court applied the principles therein incorrectly.*

## 1 INTRODUCTION

Section 11(a) of the Income Tax Act[1] ("the Act") allows for the deduction of expenditure or losses incurred by a taxpayer from any trading during an assessment year, provided such expenditure or losses are not of a capital nature. Section 23(g) limits the deductibility to only monies that are laid out for purposes of trade. South African courts have over time dealt at length with the requirement of the "production of the income" in section 11(a). As business practices evolve and become ever more complex, the interpretation of this requirement hasn't been spared. In the case of *The Commissioner for the South African Revenue Service v Spur Group (Pty) Ltd* [2021] ZASCA 145 the Supreme Court of Appeal considered the "in the production of income" requirement following the precedent set out in earlier cases on facts that were not the same or similar to those in the earlier cases. The note begins with a background to the production of income requirement and case law in this regard leading up to the *Spur* case, highlights and analyses the decision in *Spur* and concludes that the decision was incorrect in substance.

## 2 PRODUCTION OF THE INCOME REQUIREMENT

In this section, I explain the rationale behind the deductibility of expenses incurred in the production of income, the technical aspects of the requirements as well as recent case law on the subject.

### 2 1 The Rationale for the Production of the Income Deductibility

Allowable tax deductions are subtracted from income to reduce taxable income and thereby lowering the amount of tax payable by a taxpayer. However, in actual fact, the rationale behind the deductions of production of income expenses is not merely to reduce taxable income, although in effect it does. The real reason is to ensure that only income derived from business activities is taxed. Put differently, and more succinctly, the reason is to ensure that tax is paid on income and not on return of capital invested in the production of income. In theory, all costs incurred to derive business income should be recognised for the purpose of determining net income, although the timing of recognition may vary for different types of expenses.[2]

There are amounts that would not ordinarily qualify for the deduction because they are not strictly incurred in the production of income, but it is preferred that they be allowed as deductions. In this case, specific provisions are included in legislation to allow for their deductibility.[3] Salient to this discussion are amounts such as legal expenses incurred to protect a taxpayer against incurring of expenses in the production of income.[4]

Many and varied amounts are expended by taxpayers for purposes of producing income. These amounts vary depending on the industry, trade, business activities and operational model of the

1 Income Tax Act 58 of 1962. In this note "the Act" and any references to "section" refer to a section of the Act, unless expressly stated, or the context indicates otherwise.

2 Burns and Krever "Taxation of Income from Business and Investment" in Thuronyi (ed) *Tax Law Design and Drafting* (1998) 597 605.

3 These are mainly contained in ss 11(c) to 11(x).

4 Legal expenses are deductible in terms of s 11(c).

taxpayer. What should make an expenditure deductible is the purpose for which it is incurred. If it is necessary and appropriate to the production of income of the taxpayer, although remote, it should be deductible. Indeed "[m]any outgoings incurred by a business are necessary or appropriate to the operation of the business but not consumed directly in the income-earning process of the business."[5]

The denial of the deduction of expenses incurred in the production of income could have drastic negative implications for businesses. It would serve as an immense disincentive for taxpayers to conduct business activities, for fear of effective double, or even multiple layers of, taxation. Short of being encouraged, the deductibility should be easy, clear, certain and efficient. Courts in other jurisdictions' terminology such as "ordinary and necessary" or "wholly and exclusively" are used basically to discourage tax authorities from second-guessing business decisions and denying a deduction for what is regarded as ineffective or inappropriate outgoings.[6]

A tax deductible expense is any expense that is considered "ordinary, necessary, and reasonable" and that helps a business to generate income. It is usually deducted from a taxpayer's income before taxation. This position is not unique to South Africa. For example, according to the US Internal Revenue Service (IRS): "[t]o be deductible, a business expense must be both ordinary and necessary. An ordinary expense is one that is common and accepted in your industry. A necessary expense is one that is helpful and appropriate for your trade or business. An expense does not have to be indispensable to be considered necessary."[7]

The applicability of the general deduction is often mired in the potential for abuse where excessive deductions or those that are not in the production of income are claimed, purely because of the benefit of the reduction of the taxable income, alluded to earlier. However, courts should read the provisions creatively and refrain from applying the interpretation that denies taxpayers deductions for genuine business expenses merely because the taxpayer used methods that are not ordinary.

### 2 2 Interpretation and Application of "in the Production of the Income"

Hitherto two oft-quoted cases, and therefore the leading cases, on the interpretation of the production of the income requirement are the Cape Provincial Division (as it then was) case of *Port Elizabeth Electric Tramway Co Ltd v CIR*[8] and the Appellate Division (as it then was) case of *Joffe & Co (Pty) Ltd.*[9] I hasten to mention that the decisions in these cases were handed down by the same judge, Watermeyer J. Ten years after handing down *PE Electric Tramway* in the CPD, when he handed down *Joffe,* he was Chief Justice of South Africa. In both cases, the taxpayer had incurred losses on compensation for an employee as well as legal expenses defending the compensation claim.[10] The main difference in the cases was that in *Joffe* the employee had been negligent and in *PE Electric Tramway* negligence was not at issue.

Whether expenditure has been incurred in the production of income is determined by examining the act which produces the income and then judging whether the attendant expenditure can be said to be sufficiently close to that act to be regarded as having been incurred in the production

5 Burns and Krever 606.

6 Burns and Krever 606.

7 Publication 535, Business Expenses (2021) at 3 https://www.irs.gov/pub/irs-pdf/p535.pdf (accessed 29-07-2022).

8 1936 CPD 241, 8 SATC 13.

9 1946 AD 157, 13 SATC 354.

10 Please note that the cases of *Joffe* and *PE Electric Tramway* were decided in terms of s 11(2)(a) of the Income Tax Act 40 of 1925. However, the provision in that Act was reproduced in the 1962 Act.

of income.[11] Expenditure is regarded as being incurred in the production of income if it is an inevitable concomitant of the taxpayer's income-producing operations.[12]

As to how closely the expenses must be linked to the business operation, the court in *PE Electric Tramway* stated that:[13]

> all expenses attached to the performance of a business operation *bona fide* performed for the purpose of earning income are deductible whether such expenses are necessary for its performance or attached to it by chance or are *bona fide* incurred for the more efficient performance of such operation provided they are so closely connected with it that they may be regarded as part of the cost of performing it.

Based on the above reasoning, the court found that compensation paid in *PE Electric Tramway* was deductible but not in *Joffe*, because the employee's negligence was not an inevitable concomitant of the taxpayer's income-producing operations. In both cases Justice Watermeyer found that the legal costs were not deductible.

A multitude of cases also dealt with this requirement, mainly following Justice Watermeyer's precedent. In *ITC 224*[14] the taxpayer company incurred interest on a loan which was taken in order to advance the funds to a purchaser of shares in the taxpayer company. The court held that the intention of the company in this regard was to effect a change in the shareholding of the company and not to produce income for the company. In *Sub-Nigel v Commissioner for Inland Revenue*[15] the Commissioner for Inland Revenue contended that the use of the word "the" before income, in "in the production of the income" in section 11(a) meant that there should be a direct link between the expenditure and the income derived by the taxpayer. The Appellate Division, as it then was, disagreed with this proposition and stated that "the court is not concerned with whether a particular item of expenditure produced any part of the income: what it is concerned with is whether that item of expenditure was incurred for the purpose of earning income" and that "the fact that no income has actually resulted is, in my view, irrelevant: the purpose was to obtain income…".[16]

## 3 LESSONS FROM *PE ELECTRIC TRAMWAY*

It should be noted that the "close connection" and "inevitable concomitant" tests are not one and the same and should not necessarily both be met for the production of income requirement to be met. Thus, *PE Electric Tramway* did not consider whether the expenditure was an inevitable concomitant of the production of income. Yet, in *Joffe* the inevitable concomitant requirement was the deciding factor.

According to Goldswain and Swart [17] the court in *Joffe* erred in disallowing the legal expenses incurred by the taxpayer as they were only incurred because of the claim against the taxpayer

11 *PE Electric Tramway* 245.

12 *Joffe* 163.

13 246.

14 *ITC 224* 6 SATC 156.

15 1948 4 SA 580 (A).

16 At 588; see also *ITC 224* 6 SATC 156; *CIR v Hickson* 1960 1 SA 746 (A); *ITC 247* 6 SATC379; *COT v Rendle* 1965 1 SA 59 SRA; *ITC 815* 20 SATC 487; *CIR v Genn & Co (Pty) Ltd* 1955 3 SA 293 (A); *CIR v Rand Selections Corporation Ltd* 1956 3 SA 124 (A); *ITC 1274* 40 SATC 185; *CIR v Nemojim (Pty) Ltd* 1983 4 SA 935 (A); *CIR v De Beers Holdings (Pty) Ltd* 1984 3 SA 286 (T).

17 Goldswain and Swart "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?" (2015) *Southern African Business Review Special Edition − Tax Stories* 71 79–80.

for compensation to which the taxpayer was entitled and properly did resist. The authors argue that there was no other purpose for the expenditure. Because the legal expenses incurred were an essential and integral part of the compensation claim, logic dictates that if the compensation paid should be regarded as being closely connected to the operations of the taxpayer in transporting taxpayers for reward, then the attendant legal expenses incurred are solely in connection with resisting the compensation claim and should also meet the closeness of the connection.

The decisions in *PE Electric Tramway* and *Joffe* raise a number of questions as regards the legal expenses being incurred in the production of income. Could a business adequately run without legal expenses? It could, but for a limited period. But would it be efficient to run a business without protecting its revenue, its income? Surely not. At the same time, perhaps a question never asked is: would the taxpayer have incurred the legal expenses if they were not conducting business to produce income? This question would almost always be answered in the negative, hence the law was changed subsequent to *PE Electric Tramway* and *Joffe* to allow legal expenses that are attributable to the production of income to be deductible. In allowing legal expenses in terms of section 11(c) the legislature adopted the words of Mason J in *Lockie Bros Ltd v CIR*[18] to describe the circumstances in which the legal costs would be allowed. Section 11(c) allows the deduction of legal expenses incurred by a taxpayer in respect of any claim, dispute or legal action arising in the course of or by reason of the ordinary operations undertaken by the taxpayer in the carrying on of his trade.[19] This is a clear legislative correction of the decisions in *PE Electric Tramway* and *Joffe* cases.

Watermeyer has been criticised in his interpretation of the production of the income requirement in disallowing the expense.

What is interesting about Watermeyer J in *Joffe* is that the judge did not stick to the "precedent" he himself set in *PE Electric Tramway*, regardless of the fact that the issues involved both compensation and legal expenses. He came up with a new standard in *Joffe*, that he perhaps had not applied his mind by the time he decided *PE Electric Tramway*. He managed to distinguish the two cases on the basis of the value of negligence in the two cases, which is alarming. As Kruger *et al*[20] gaily put it: "the taxpayer's representative must have been delighted when he arrived in Bloemfontein to find that the presiding Judge of Appeal was none other than the self-same Mr. Justice Watermeyer who had decided the *Port Elizabeth Electric Tramway* case, who was now the Chief Justice of South Africa. His joy was short-lived."

Regardless of the shift, the tests in *PE Electric Tramway* and *Joffe* were overly complex and should have been confined to the specific cases dealing with the deductibility of compensation and legal expenses. As Kruger *et al* concur:[21]

> … the tests suggested in these two cases are too mechanical and contrived to be applied in the hard reality of commerce and industry. A far better test was the one laid down by Mason J in Lockie Bros Ltd v CIR (1922 TPD 42, 32 SATC 150). The learned judge there suggested that an expense would be allowed as a deduction if it was incurred in the course of or by reason of the ordinary operations undertaken by the taxpayer in the carrying on of his trade. If this test had been applied, the taxpayers in both *Port Elizabeth Electric Tramway* and *Joffe & Co Ltd* would have qualified for the deduction; and that does seem to be the appropriate answer.

The interpretation of the production of the income requirement is flexible and has been applied dynamically relative to the specific transactions and facts, for example in cases involving

18 1922 TPD 42, 32 SATC 150.

19 See also Kruger, Stein, Dachs & Davey *Broomberg on Tax Strategy* (2012) 252.

20 Kruger *et al.* 251.

21 252.

deductibility of audit fees in *C:SARS v Mobile Telephone Networks Holdings (Pty) Ltd*,[22] misappropriated funds in *ITC 1221*,[23] and *COT v Rendle*,[24] as well as funds stolen by junior and senior staff members of the taxpayer in *ITC 1242*[25] and *ITC 1383*[26] respectively. The principles laid out in these cases are not to be applied strictly in all other general cases. So too should the principles in *PE Electric Tramway* and *Joffe* be limited to facts and circumstances similar to the facts and circumstances in those cases.

## 3 RECENT DEVELOPMENTS *SPUR* CASE

### 3 1 Facts

In the case of *The Commissioner for The South African Revenue Service v Spur Group (Pty) Ltd*[27]the taxpayer, Spur Group (Pty) Ltd ("Spur") was the chief operating arm of a group of companies. The taxpayer was a wholly owned subsidiary of the group's holding company ("HoldCo"). During 2004 the group adopted and implemented a share incentive scheme, the purpose of which was to incentivise key managerial staff of the taxpayer by providing them with an indirect interest in the listed shares of HoldCo. To that end, HoldCo established a discretionary trust (the trust) in which HoldCo was the sole beneficiary until 13 December 2010. The trust acquired a shelf company ("NewCo") in which employees of the taxpayer were offered ordinary shares at par value in proportions determined by HoldCo. The taxpayer contributed R48 million to the trust which the trust utilised to subscribe for NewCo preference shares. NewCo thereafter applied the funding received from the preference share issue to purchase HoldCo shares. The employees, as shareholders of NewCo, became entitled to the incremental value of the HoldCo shares by virtue of NewCo's investment in HoldCo.

At the expiry date after five years, the HoldCo shares had appreciated in value to the extent that the investment (and hence the value of NewCo) significantly exceeded the preference share liability. NewCo redeemed some of the preference shares and paid out R22.5 million to the trust leaving the employees as the only shareholders of NewCo. NewCo sold some of the shares in HoldCo and paid a dividend to the employees. The taxpayer's contribution of R48 million was not repaid by the trust. The preference share dividends of R22.5 million received by the trust in December 2009 vested in HoldCo as sole beneficiary. After termination of the scheme NewCo was de-registered on 10 December 2012. The taxpayer sought to deduct the R48 million that was contributed to the trust as expenditure incurred in the production of the taxpayer's income.

### 3 2 Judgment

The SCA disallowed the deduction of the expenditure on the basis that it was not directly and closely connected to the production of income. The court started off by acknowledging and contextualising the authorities mentioned above and held that deductibility of an expense was dependent upon two criteria that must be considered on the particular facts of the case.[28]The taxpayer must show an adequate closeness between the expenditure and the production of income by first determining the purpose of the taxpayer in incurring the expenditure in question and whether the purpose was to produce income. Second, it should be determined whether a

22 2014 ZASCA 4

23 1974 36 SATC 233.

24 1965 1 SA 59 (SRAD), 26 SATC 326

25 1975 37 SATC 306.

26 1978 46 SATC 90.

27 2021 ZASCA 145.

28 Paragraph 27.

close nexus or link exists between the expenditure and the ultimate production of income.[29]

According to the SCA, and correctly so, the contribution of R48 million by the taxpayer to the trust was central to the scheme.[30] However, the participants did not benefit directly, and even indirectly for that matter, from the making of the contribution. The court garnered this from the testimony of a Ms van Dyk, testifying for the taxpayer, that as at the date of hearing in the court below, the R48 million in the form of now HoldCo shares was still being held in the trust with the result that the participants have not benefited directly from the 48 million.[31]

The court criticised the Tax Court decision, holding that the majority in that court erred in finding that the expenditure directly served the purpose of incentivising the participants, and that a sufficiently close nexus existed between the expenditure and the production of income by Spur. The court concluded that the contribution did not itself serve to incentivise the participants because it was an amount that would never accrue to the participants. Instead, it was for the benefit of Spur HoldCo as the beneficiaries of the trust.

## 3 3 Critique

### 3 3 1 Missing the Link?

The test of whether expenditure was incurred in the production of income entails a two-pronged approach: a subjective purpose test and an objective nexus test.[32] The subjective test looks at the purpose of the expenditure while the objective test concerns itself with the closeness of the connection between expenditure and the production of income. The objective test is also referred to as the "closely connected" test or, as later described in *Joffe*, as the "inevitable concomitant" test.[33]

Should the close link be between the expenditure or the purpose of the expenditure and the production of the income? If the close link is between the purpose of the expenditure and the production of the income, then what matters is therefore not the actual expenditure, but the purpose as contained in the intention of the taxpayer. It was held in *Sub-Nigel* that "the Court is not concerned whether a particular item of expenditure produced any part of the income: what it is concerned with is whether that item of expenditure was incurred for the *purpose* of earning income."[34] The court in *SG Taxpayer v Commissioner for the South African Revenue Service*[35] emphasised that if the taxpayer can show that the purpose of the expense was to produce income, any incidental benefit to a third party or the realisation of other possibilities does not serve to preclude the legitimate deduction of the expense.[36]

In applying *PE Electric Tramway*, the SCA in *Spur Group* found that[37]

> the purpose of Spur in incurring the expenditure was not to produce income, as required by s 11(a) of the ITA, but to provide funding for the scheme, for the ultimate benefit of Spur HoldCo. There was only an indirect and insufficient link between the expenditure and any benefit arising from the incentivisation of the participants. The contribution was therefore

29 Paragraph 27.

30 Paragraph 30.

31 Paragraph 30.

32 See Williams *Income Tax in South Africa* (2009) 446.

33 Goldswain and Swart 71 78.

34 592; emphasis added.

35 2018 SATC 1. This was the case that was later appealed to the SCA and reported as *The Commissioner for The South African Revenue Service v Spur Group (Pty) Ltd* 2021 ZASCA 145.

36 Paragraph 38.

37 Paragraph 38.

> not sufficiently closely connected to the business operations of Spur such that it would be proper, natural and reasonable to regard the expense as part of Spur's costs in performing such operations.

The court placed some weight on the fact that HoldCo would benefit from the contribution of the R48 million. And indeed, HoldCo did benefit from the contribution. In this regard, Spur submitted that although it (Spur) foresaw that HoldCo would potentially also benefit from the redemption of the NewCo preference shares, this did not negate Spur's purpose and intention.[38] Spur explained that such purpose and intention "was actually effected by the scheme insofar as the value of NewCo shares increased significantly and this benefit, together with the dividends declared by NewCo on the remaining Spur HoldCo shares following the redemption of the preference shares, actually accrued to the participants."[39] In response to this, the court placed emphasis on the fact that the participants, as at the date of the hearing, had not received the benefit. It is submitted that the fact that the participants had not received the benefit is totally irrelevant to the inquiry. It is the intention at the inception of the scheme that is important. In fact, even whether any income was actually produced as a result of the scheme or that the actual benefit did or did not materialise is irrelevant.

In this regard the courts have found that the relevant considerations are the purpose for which expenditure is incurred and what the expenditure actually effects and that it is not a requirement that income actually be produced at all. It is sufficient that the expenditure was incurred for the purpose of producing income.[40] It is respectfully submitted that the court in *Spur Group* seems to have incorrectly required the link to be between the R48 million and the receipt by the participants. Hence the court ignored the link between the purpose of the expenditure and the fact that in the end the participants received a dividend as a result of the expenditure. They did not need to receive the actual R48 million. It is, therefore submitted that the court did not apply the principles laid out in *PE Electric Tramway* correctly. The court took a narrow interpretation in *PE Electric Tramway*, applied it to a case it should not have been applied to, and worse still, applied it in an ever narrower fashion.

### 3 3 2 No Basis for SCA to Overturn the Decision of the Tax Court

The SCA did not provide satisfactory detail to the basis on which it overturned the decision of the Tax Court. The SCA did not engage with, nor rebut, the following definitive aspects of the decision of the Tax Court:

- The Tax Court distinguished the decision in the *Solaglass Finance Co (Pty) Ltd v Commissioner for Inland Revenue*[41] ("*Solaglass*") on the basis that in the *Solaglass* case the expenditure was incurred for purposes of benefitting the group of companies to which the taxpayer in that case belonged.[42] In *Spur Group* the purpose of the expenditure was specifically to incentivise the key management staff of the taxpayer, and was therefore closely connected to the production of the income of the taxpayer.

- The Tax Court held, in particular, reference to the purpose of the scheme, that: "the dominant purpose in the establishment and implementation of the scheme was to protect and enhance the business of the taxpayer and its income, by motivating its key staff to be

38 Paragraph 29.

39 Paragraph 29.

40 See *Nemojim* and *Sub-Nigel*; see also Legwaila "'Close' in the Closeness of the Connection between Expenditure and the Production of Income for Tax Deductibility *SG Taxpayer v Commissioner for the South African Revenue Service* (IT 14264) 2018 SATC 1 (9 May 2018) 2018" *Tydskryf vir die Suid-Afrikaanse Reg* (2018) 948 951.

41 1991 2 SA 257 (A).

42 Paragraph 39–44.

efficient and productive and remain in the taxpayer's employ."[43]

• The Tax Court found that the incidental benefit to other members of the group of the Spur companies did not detract the purpose of the expenditure. In this regard the court found that the fact that the incentive was offered to, and in fact received by, the employees was the financial benefit that would flow from the success of the taxpayer's business and the growth in the value of the shares in HoldCo, cannot detract from a finding that the expenditure was incurred by the taxpayer for the purpose of earning income.[44]

• The Tax Court held that the purpose of the expenditure was to incentivise the taxpayer's key staff through a scheme which facilitated the acquisition of an indirect investment in the shares of HoldCo for scheme participants.

• The Tax Court concluded that the purpose of this incentivisation was to: (a) encourage the particular employees to grow or increase the value of their investment in HoldCo by contributing to the success and profitability of the taxpayer's business; (b) encourage employees to remain in the taxpayer's employ; (c) facilitate, for the taxpayer, the retention of staff members with the skills and experience to maximise the profitability of its business and prevent crucial knowledge and experience being lost to the taxpayer through staff turnover; and (d) preserve and enhance the income-earning capacity of the taxpayer's business.[45]

### 3 3 3 What Severed That Link in the Spur Group Case?

In *PE Electric Tramway*, what is it that further separated the legal expenses from the production of income? Put differently, what compromised the closeness of the connection between expenditure and the production of income on legal expenses which did not exist with regards to the actual compensation? The anticipated outcome of the expenditure is to be taken into account in determining the closeness of the expenditure and the production of income. In fact, the court has to take into account what the expenditure effects, in determining whether it is sufficiently closely connected to the production of income. Incidentally, Schreiner JA stated in *Commissioner for Inland Revenue v Genn and Co (Pty) Ltd*[46] that "[i]n deciding how the expenditure should properly be regarded the Court clearly has to assess the closeness of the connection between the expenditure and the income-earning operations, having regard both to the purpose and to what it actually effects." The court in *PE Electric Tramway* found that the close link existed with regards to the compensation but not the legal expenses incurred to protect the taxpayer against compensation claims.

In *SG Taxpayer* the court expounded on the enquiry as follows:[47]

> What is thus required is an assessment of the closeness of the connection between the expense and the income. Where there is a clear and close causal connection, the assessment should be relatively simple. What is important for present purposes is that the causal connection is not necessarily established by reference only to the incurring of the expense and the initial use to which it is put. It is the purpose of the expenditure – from the taxpayer's perspective – that must be considered, together with what that expenditure actually effects, i.e. causes to happen or brings about.

In support of its conclusion, the SCA in *Spur Group* cited among other cases, the decision in *Solaglass*. In this case, the court ruled that the deduction of expenditure in relation to monies

43 Paragraph 46.

44 Paragraph 46.

45 Paragraph 47.

46 299G.

47 Paragraph 34.

spent for the purposes of advancing the interests of the group of companies to which the taxpayer belongs is precluded. The Appellate Division (as it then was) found that the losses incurred by the taxpayer did not pass the requirement in section 23(g), namely that the losses are deductible only if they are wholly and exclusively laid out for purposes of the taxpayer's trade. The court in *Solaglass* did indeed find that the losses passed the production of the income test.[48] In the *Spur Group* case the trade requirement was not at issue since the Commissioner accepted that the expenditure incurred by Spur had been laid out for purposes of Spur's trade.

In *Warner Lambert SA (Pty) Ltd v C:SARS*[49] the taxpayer incurred expenditure discharging its social responsibility as required by law. The Supreme Court of Appeal allowed the deduction of that expenditure although it was not obviously close to the production of income. The court stated that "[i]t 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 does not itself have to produce a profit".[50] Regardless of acknowledging *Warner Lambert*, the court in *Spur Group* did not consider this liberal application of the production of income requirement.

The court in *Spur Group* seems to have been blurred by the fact that the actual R48 million was not paid to the key managerial staff that was supposed to be incentivised. The general deduction formula and indeed the production of income requirement do not require that direct link. The court seems also to have been confused further by the fact that another person, ie the holding company, actually benefitted from the actual expenditure. But both these facts do not matter. What matters is the intention behind and purpose of the expenditure. The purpose was to incentivise the employees. That this was achieved as planned was evidenced by a MsVan Dijk who was one of the eligible employees who participated in the scheme. She testified that the incentive contributed significantly to her desire to remain employed, working and travelling the extensive hours that she did. She further testified that she ultimately beneited materially upon the dissolution of the scheme. According to Van Dijk,the incentive changed the mindset of the participants in their decision-making, in that they started making business decisions with a bigger vision in mind.[51]

Based on the above, there is no sufficient reason to explain why the court found that the link in *Spur Group* was not direct enough to satisfy the production of the income requirement. In effect, the court failed to "assess the closeness of the connection between the expenditure and the income-earning operations, *having regard both to the purpose and to what it actually effects*" as stated by Schreiner JA *Genn and Co (Pty) Ltd* (emphasis added).[52]

### 3 3 4 Spur Group's Unfitting Application of the Law

Pertaining to the closeness of the connection between the purpose of the expenditure and the production of income, a simple question should be asked, namely: what is the purpose of the expenditure? Without complicating a simple inquiry, in *Spur Group*, the purpose of the expenditure was to incentivise key management staff, increase productivity and therefore the taxpayer's income. As to how that purpose was achieved is immaterial. I go further to say that incentivising staff was the direct purpose of the expenditure. The fact that the means of achieving these involved measures that resulted in the actual expenditure being applied to

48 Paragraph 51.

49 2003 5 SA 344 (SCA), 65 SATC 346.

50 349.

51 27.

52 299G.

various other measures or players remains immaterial. It is not that to what the expenditure was applied that matters, but what its purpose was. So, the argument that the key management staff did not receive the money expended or the benefit thereof is a total misapplication of the purpose requirement. Proximity of the purpose of the expenditure means that one has to look at the purpose and the actions that seek to achieve that. The actions taken that support the achievement of the purpose would be in the production of income.

In the first place, 11(a) refers to expenditure incurred in the production of income. It does not refer to the closeness of the connection between expenditure and the production of income. Also, where does the requirement that the expenditure should be directly, and not indirectly, connected to the production of income come from? Did Watermeyer J in *PE Electric Tramway* make the law as opposed to interpret it? Or, have the courts and the legal fraternity been blindly following a rhetoric that cannot be justified, and that has not been adequately pondered? If the legislature wanted the expenditure to be direct, it would have included the expression in legislation. The lack of reference to the word "direct" means that it is not a requirement that the expenditure be direct.

Perhaps Watermeyer J did not create a law of general application in all production of income inquiries. He interpreted the provision in respect of legal expenses, because ordinarily, legal expenses would need to somehow be connected to the production of income in order to be deductible. Pertinently, the purpose of the expenditure needs to be determined, as the connection is not obvious — it is obscure. This connection therefore needed to be created and clarified. That is not necessary where the purpose of the expenditure is clearly to incentivise employees, increase productivity and therefore the taxpayer's income.

The conclusion, however, that the legal expenses were not closely connected to the production of income, is nevertheless still incorrect, in my view. This test, I submit is apposite for legal expenses, but should not be applied as a yardstick for all production of income inquiries. The determination of different types of expenses would vary and be applied on a case by case basis. For example, there is no need whatsoever to apply the "closeness of the connection" or the "inevitable concomitant" tests to remuneration of employees or data costs to connect the business to the internet, although both tests would still be passed. Objectively, looked at through the eyes of a reasonable man, remuneration and data costs are incurred in the production of income. Along the same lines, expenditure whose purpose is to incentivise employees, and that actually results in employees being incentivised as attested to by Van Dijk, is incurred in the production of income.

Goldswain and Swart also condemn this approach. They state that "the apparent narrow interpretation of the phrase "in the production of the income" by Justice Watermeyer in both these decisions was later used as a basis or guide for determining the deductibility for all types of general business expenditure and losses."[53] It is indeed unfortunate that the courts, especially in *Spur Group*, applied the interpretation that was used with respect to legal expenses to an instance where the expenditure did not involve legal expenses and was not as obscure as legal expenses.

Is there any value that the phrase "closeness of the connection between expenditure and the production of income" adds to the expenditure being part of the cost of producing income? In my view it only serves to exclude expenditure that a tax administrator (not an entrepreneur) would think might be for other purposes. What matters is that the expenditure must be for purposes of producing income. The closeness of the connection between expenditure and the production of the income needs to be looked at in context. Is it the closeness of the connection or the effect, time, cost and outcome or purpose? If it is in purpose, then the directness or otherwise

53 Goldswain and Swart 84.

is not relevant. It also then gets semantically convoluted: the test is then the closeness of the connection of the (or in) purpose between the purpose of the expenditure and the production of income?

The same goes for "inevitable" in "inevitable concomitant". Business is not run on the basis of inevitability of expenses. Some expenses are "evitable". Hence incurral does not require the amount to be necessarily incurred.[54] Requiring the expense to be inevitable could potentially negatively impact on the liberal interpretation of incurral. How often would an amount that is not necessarily incurred be an inevitable concomitant? Indeed, in *KBI v Van der Walt*,[55] Eloff AJP stated that that the requirement is that the taxpayer must show a nexus between the incurral of the expenditure and the receipt of his salary and that he does not have to prove a causal factor in the form of an absolute *sine qua non*. The spirit of the dedications is only that there should be a connection between incurring the expense and generating income.

Van Dyk further testified that the R48 million in the form of Spur Corporation shares was still being held in the trust so directly the participants have not benefited from the 48 million. It has, however, been confirmed that a dividend was paid to the employees after HoldCo disposed of shares, following an increase in the value of the HoldCo's shares. The court *a quo* confirmed that "[t]he dividend declared by NewCo of some R28 627 million was paid to the employees as participants in the scheme in accordance with the resolution. In April 2011 a further dividend of R635 000 was similarly declared and paid to them (further dividends were also declared and paid thereafter outside the period of the disputed assessments)."[56] It appears to me that the Commissioner and the Court concerned themselves with the R48 million as the amount that should be paid to the employees and not any other benefit that would arise therefrom (for the expenditure to be deductible). This is a result of fixation on the word "direct" which as I state earlier, does not exist in section 11(a).

The fact that the R48 million would never itself accrue to the participants does not mean that the contribution did not benefit them or would not have benefitted them. The contribution was the source of the incentive scheme. But for the contribution, there would have been no share incentive scheme and hence, no benefit to the participants. The contribution was an absolute *sine qua non* of the incentive scheme, and the purpose of the latter was clearly to incentivise the participants, and therefore to benefit Spur. Thus, the link between the contribution and the business operations of Spur was sufficiently close for the contribution to be in the production of Spur's income and the Court should have concurred with the judgment of the majority in the Tax Court.[57]

## 5 CONCLUSION

While an item of expenditure that meets the "closeness of the connection" and the "inevitable concomitant" test could satisfy the "production of the income" test, these two tests, combined or in the alternative should not be applied dogmatically or be made peremptory. They cannot be the be-all and end-all of the simple legislative expression: "in the production of the income." As Goldswain and Swart state; "[t]he reality, however, is that the manner in which business and trade is now conducted has changed considerably since the 1930s when the *Port Elizabeth*

54 See *PE Electric Tramway* 244; *Concentra (Pty) Ltd v CIR* 1942 CPD 509; *Caltex Oil (SA) Ltd v SIR* 1975 1 SA 665 (A); *Nasionale Pers Bpk v KBI* 1986 3 SA 549 (A); *Edgars Stores Ltd v CIR* 1988 3 SA 876 (A).

55 1986 4 SA 303 (T) 309.

56 Paragraph 11.

57 Warneke "The SCA Decides on the Deductibility of a Contribution to a Share Scheme and Prescription: Analysis of the Spur Case" BDO https://www.bdo.co.za/en-za/insights/2021/tax/the-sca-decides-on-the-deductibility-of-a-contribution (accessed 04-08-2022).

*Electric Tramway* case was decided."[58] Unfortunately, courts that followed Watermeyer's decisions in *PE Electric Tramway* and *Joffe* have ignored the fact that the legislature sought to correct the error, and the fact that the principles laid therein were specific to expenditure incurred in compensation and legal expenses.

It is respectfully submitted that:

- the decisions in *PE Electric Tramway* and in *Joffe* were incorrect and inappropriate in the circumstances;
- that it was wrong for the subsequent cases that did not involve deductions for amounts paid in compensation and legal expenses to follow them;
- it was also wrong for the court in *Spur Group* to follow *PE Electric Tramway* and *Joffe*; and
- besides having wrongly following *PE Electric Tramway*, the court applied the principles therein incorrectly.

Warneke opines that if the scheme in *Spur Group* were structured in such a way that it was the participants and not Spur Holdco that would share in the amount contributed to the trust, the contribution would likely have been allowed as a deduction. However, he further submits that the court should still have found that the contribution was in the production of Spur's income.[59] This opinion sheds light on the impact that the SCA decision is likely to have on the structuring of incentive schemes, incorrect as the decision might be. It would be safer for taxpayers to structure their schemes in such a way that it is clear beyond doubt that there is a direct visible benefit to the schemes participants (employees).

There is no empirical evidence on whether industry practices are stifled by the interpretation of laws, for instance that new and essential transactions are not entered into for fear of this narrow, restrictive and negative application of the law. Suffice it to say that applying a 1925 interpretation of the law to simplistic transactions entered into prior to and immediately after that date, can not be further removed from the realities of well-intended transactions that are entered into now (over 80 years later). This is more so especially with transactions influenced by the fourth industrial revolution, such as artificial intelligence, crypto currencies, digitalisation and so forth. Could it be a case of tax tail wagging the business dog catastrophe?

58 74.

59 Warneke "The SCA Decides on the Deductibility of a Contribution to a Share Scheme and Prescription: Analysis of the Spur Case" 2021 BDO.