General Deductions

S11 (a) Preamble - What may be deducted S23 What may not be deducted

*** NO DEDUCTION MAY BE CLAIMED IF THE TAXPAYER DOES NOT CARRY ON A TRADE!

** Process:

1) Determine whether deduction is prohibited or not

2) If not prohibited, apply the general deduction formula and test whether all requirements are met

Requirements for what can be deducted:

1. Carrying on a trade

2. Expenditure and losses - Jofie v CIR > Losses are involuntarily expenses

3. Actually incurred - Disputes don’t give rise to liability = Not actually incurred

4. During the year of assessment

5. In the production of income - Inevitable concomitant - Joffie v CIR, PE Electric Tramway v CIR

   Expense can be incurred to earn income + exempt income - Nemojin v CIR > Apportioned, deduction not all for expense that produces exempt income.

   >> Must be in the production of income

   >> Cannot be in the production of exempt income!!

6. Not of a capital nature

1. Carrying on a trade

   >> Includes rental income

   - May be once off transaction

   - A venture in the definition of trade
**Requires:**
- Profitable activity
- Active business, NOT passive (Not interest, annuities, dividends etc)
  - Rent and royalties
  - SARS allows interest expense to be set off against income (up to 0)
- Continuity (Not always essential)
- Profit-Motive

**2. Expenditure and Losses**
- Generally accepted as cash or otherwise
- Loss is an involuntary expense, not intentional

**S11A* Pre Trade expenditure and losses**

- Income must be derived from that trade
- Pre trade expenditure and losses are allowed as deductions
- Accumulated over time until business has started
- They are deducted against THAT TRADE INCOME, can’t deduct against any other trade income

**Requirements:**
- Expenditure and losses
  - Actually incurred
  - During the year of assessment
  - In the production of income
  - Not of a capital nature
  - Expended for trade purposes
  - Which were not allowed as a deduction when they were incurred
3. Actually Incurred

- Does not have to be necessarily incurred... just has to be incurred
- Can have paid it or it can be a liability
- **MUST BE AN UNCONDITIONAL LEGAL OBLIGATION**
- There’s no deductions for contingency provisions, transfers to reserves
- NO deductions for items in dispute
- NO deductions for notional losses or opportunity costs
- NO deductions for unrealized losses

**>> Unquantifiable Expenditure**

- Acquire an asset where the amount is unquantifiable = deemed to be incurred in the year it is quantifiable
  
  **>> An amount must be quantifiable**

4. In the year of assessment (Timing of Deductions)

> Actually incurred = earlier of payment or unconditional legal liability

- Only deducted in the year of incurral > Cannot carry forward

5. In the production of income

- Must be an act or business operation for the purpose of earning income
- Expenses must be CLOSELY linked to the operations
  
  - Must be a necessary expense in order to perform
  - Attached to it by chance
  - Bone fide incurred for its more efficient performance

**INEVITABLE CONCOMITANT = GO TOGETHER WITH THE BUSINESS**

> There must be a distinction from the acts that produce income and the expenses that arise from those acts

**>> “In the production of” : Normally rely on several court cases to determine**
Purpose of expenditure

** Expenses incurred which is not related to the income may not be deducted

E.g Dividend income is exempt (Not income) so can’t get a deduction

** The purpose of the expense must be to produce income, even if no income was made.

> If an expense is incurred for revenue and capital purposes, then the expense must be **APPORTIONED**!

Not of a capital nature

Factors which show that an expense is of a capital nature:

- Adds to the income earning structure

  (Distinguish between income earning operation & structure (improvements))

- Once off expense from which future benefits will flow

  (Does not apply to permanent fixed capital assets)

- Creates an enduring benefit/advantage for the taxpayer

- Floating vs. fixed capital

  * Floating (Continuously changing from cash to otherwise = revenue … e.g stock)

>> Cannot be capital and revenue

  * Can be an apportionment

** Income earning structure: Asset used by the taxpayer to produce income:

- E,G Building produces rent income, machine produces products, a lease of an asset which produces income, fishing/mining license

* No single test (Use case law)
Prohibitions: S23

Prohibited from being deducted!

S23(a) Personal/Family maintenance (clothes, food)

S23(b) Domestic or Private Expenditure (includes rent)

Except portion of private residence used for trade

- Specially equipped for trade
- Regularly and exclusively used for trade

Except income earned from work carried on outside of employer’s office (commission)

Home Study/Offices > Included in s11(b)

- May be deductible >> Apportionate according to requirements

Requirements to be met:

- The study must be used regularly and exclusively, and specifically equipped for the purposes of trade
- If earn commission duties must be mainly performed in study or office provided by employer

S23(c) Insured Losses > “Insurance”

- If an expense is recoverable from someone else, it is either:
  1. Not deductible in the first place
  2. Deductible, but then the amount recovered included in gross income

S23(d) Taxes

- Normal tax, Donations tax
- All penalties
- All interest on late tax

S23(e) Provisions

- This section prohibits the deductions of any provision unless it is specifically allowed in either S24C (the provision for future expenditure) or S11j (the provision for doubtful debts)
**S23(f) Expenses to produce exempt income**

Any expense incurred for the purpose of earning an amount that is exempt income or not included in gross income, is NOT deductible. Nemojim v CIR

NB: Only deduct full cost of trading stock when it is taken into account fully either as closing stock or gross income.

**S23(g) Non - Trade expenditure**

Expenses incurred that aren’t for the purposes of trade are not deductible.

**23(h) Notional Interest**

Prohibits the deduction of interest which might’ve been earned if money was invested.

**S23(k) Limitation on Labor Brokers**

Restraint of trade payments are prohibited from being deducted. Considered to be capital.

**S23(l) Restraint of trade payments**

Restraint of trade payments are prohibited from being deducted. Considered to be capital.

**S23(m) Employment expenses to employees**

Not applicable to agents or reps earning commission.

**S23(o) Fines and Corrupt activity**

Prohibits the deduction of any fine or penalty from any unlawful or corrupt activity.
Prohibition of Double deductions S23B

Expense cannot be deducted twice!

Choose which section you will use to deduct it by

SAICA SYLLABUS INCLUDES S23C!!!

Acquisitions or disposal of trading stock S23F

Prohibits the deduction of the cost of trading stock until such time that he takes delivery of it.

S23H Prepaid Expenditure

BUT S23H can delay deduction for certain future goods and services: PREPAID EXPENSES

Goods purchased

- Only deducted for goods actually received in the current year
- Doesn’t apply to trading stock

Services

- Only deducted for time served in the current year (based on months) = Apportioned. >> If there is no time, it must be estimated based on similar services.

Deductions that CANNOT or AREN’T delayed

- Goods or services supplied within 6 months of the year end
- Where the aggregate of the amount does not exceed R80 000.
- Expenses paid on any liability imposed by legislation (Property Tax)

Variable Expenses S7B

If there is a variable renumeration (Commission, bonuses, leave pay) then it is only deducted when the amount is paid.

Therefore it is also only a deduction for the employer (person paying) when paid

VAT

If VAT vendor claims input tax, then amount must be excluded for tax purposes

Expenses paid EXCL VAT if VAT vendor
Specific Transactions

* These items must also comply to the general deduction formula requirements. Due to SARS practice and case law the deductibility has been established.

Advertising Expenditure

Revenue - Usually a short term benefit

EXCEPT FOR:

- Initial launch costs of a new product (knowledge = enduring benefit)
- Permanent advertising purchasing of billboards (structure = enduring benefit)
- Production costs incurred for the production of an ad for television or radio (Ongoing ‘airing’ costs will be deductible)

Damages and Compensation

Is it in the production of income???

- Be inevitable concomitant, risk related to business (Is the risk closely related to business)

> PE Electric Tramways v CIR

> Joffe v CIR

Is it of a capital nature??

- Does the compensation payment produce an enduring benefit
- If the compensation paid creates no long term advantage or enduring benefit it is seen to be of a revenue nature

Conditional/Contingent Expense

- Not actually incurred
- Not deductible
- Until future event has occurred or condition met
Employment Costs

**Employee Benefits**: Remuneration, Fringe benefit, etc is FULLY deductible

- Termination lump sums

- If part of a service contract = deductible

- If it’s for past services & not normal practice of employer = NOT deductible

- Restraint of trade = NOT deductible

Excessive Expenses

- NOT deductible as not incurred for the purpose of trade

- Person receiving it will still be taxed in full

Acquisition of plant, machinery or factories by manufacturing business

- Allowed wear and tear allowances

- Therefore not deductible

Cost of acquiring share capital

- Not deductible

Goodwill

- Capital, therefore not deductible

Intellectual Property

- Royalty paid for use of property (e.g. trademarks)

- Revenue in nature if used in the production of income

License Fees

- Deductible if incurred in the course of trade and does not produce an enduring benefit beyond the end of the year
**Interest**

- Normally revenue BUT depends on purpose (Why were the funds borrowed)
- The actual use of the funds is the main indication
- Interest paid to acquire shares is not deductible as dividend income is exempt
  - Unless the purchase of shares is trading stock (In the business of purchasing shares)
- Interest is only deductible if taxpayer is trading or item is used in trade

**Losses and compensation in respect of theft or damages**

- Depends on nature of asset, whether it is capital or revenue.
- Inevitable risk of the business entity (In the production of income)

**Theft**

- Employees, robbers, burglars = deductible
- Managing director or owner, not an inherent risk, therefore not in the production of income, NOT deductible

**Recurring expenditure.**

- Audit fees, insurance premiums, maintenance
- Not directly attributable to performance
- deductible due to practice established over time

**Warranties and Guarantees**

- Provision not allowed as a deduction
- Cost deductible in warranty period even if income was earned prior (The risk of warranty claim is part of the business)

**Education and Training**

- Deductible if it is to maintain a level of knowledge or expertise in the trade
- Not deductible if it is for a qualification (capital nature - enduring benefit)
Share dealers: Buys and sells shares, therefore treated as trading stock, included in gross income when sold.

UNLESS S9C applies - If there was a change of intention

Exemption is on income

Deduction is on expenses

Dividend = Exempt for individual

NOT exempt for companies.

NB CASES:

1. Joffe v CIR
   - Company manufactures buildings, and the employees are employed to build the building
   - The building falls down and kills a worker
   - The company must pay compensation
   - Court held that it was not an inevitable concomitant for the building to fall down
   - Therefore cannot claim a deduction for the compensation paid.

2. PE Electric Tramway v CIR
   - Company was to deliver goods (delivery company)
   - Driver was killed/injured in a car accident while working
   - The company had to pay compensation
   - The court held that there was an inevitable concomitant. There is a close link to the car accident and the way in which the company produces its income.
   - The compensation was therefore deductible

3. Nemojim v CIR
   - Individual bought R1M shares and obtains full control
   - Causes the company to declare a dividend of R1M
   - Then he sells the shares for R100
   - Court held that he was not allowed a deduction from income which is exempt.
**Burgess v CIR**

The word “trade” must be very widely interpreted

Court held that any profitable activity is carrying on a trade even if it was a single activity

A person can carry on a trade irrespective of his motive for doing so: even if his purpose is to gain a tax advantage, that could still amount to carrying on a trade

**MTN Holdings (Pty) Ltd v CSARS**

Trade usually implies some active occupation as opposed to merely earning passive income

However the court accepted that the trade carried on by the holding company in this case was to earn interest from its subsidiaries

The company could therefore deduct expenses in connection with the earning of this interest income. Rental and royalty income (passive income) is specifically included in the definition of trade

Audit fees disallowed as wasn’t in the production of income

> Their production of income was to hold and receive interest and dividends