

# The *Port Elizabeth Electric Tramway* case:<sup>1</sup> 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?

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*“Tempora mutantur et nos mutamur in illis.”<sup>2</sup>*

## ABSTRACT

This article analyses the meaning attributed to the phrase “in the production of the income” as used in the present section 11(a) of the Income Tax Act, which provides for general expenses to be allowed as deductions against income. Read together with section 23(g), section 11(a) is commonly referred to as the “general deduction formula”. It has been said that the meaning ascribed to the phrase by Watermeyer AJP (as he was then) in his judgment in the *Port Elizabeth Electric Tramway Company Ltd v CIR* is “too mechanical and contrived”. Consequently, the judiciary, in applying the meaning as attributed to it by Watermeyer AJP in subsequent cases, has sometimes led to inconsistent and conflicting judgments. In fact, the application of the meaning so ascribed takes no account of the economic and other non-economic realities of doing business in the 21st century. The main objective of this article has been to re-ignite the debate surrounding Watermeyer AJP’s interpretation of the phrase, “in the production of the income”, in the *Port Electric Tramway* case and in so doing establish whether the narrow meaning ascribed by him to that phrase has subtly been changed and widened by the judiciary in subsequent cases. It can be concluded from an analysis of the case law discussed in this article that Watermeyer AJP’s interpretation, if strictly adhered to, can and does lead to absurd results.

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1 *Port Elizabeth Electric Tramway Company Ltd v CIR*, 1936 CPD 241, 8 SATC 13.

2 Anonymous old Latin adage meaning “Times change and we change with them.”

However, it is submitted that sanity has finally prevailed. The Supreme Court of Appeal in the comparatively recently decided cases of *C:SARS v Mobile Telephone Networks Holdings (Pty) Ltd* and *Warner Lambert SA (Pty) Ltd v C:SARS*, have considerably widened the ambit of expenses that may now be claimed in terms of section 11(a) of the Income Tax Act. The deduction of expenditure as was allowed in those two cases by the Supreme Court of Appeal, would appear not to have been permissible in terms of Watermayer AJP's interpretation of the meaning of the phrase "in the production of income". It is submitted that the economic realities of doing business in South Africa in the 21st century are now taken into account in determining whether a business expense falls within the ambit of the phrase "incurred in the production of the income".

**Key words:** Section 11(a) of the Income Tax Act, "in the production of the income", "close connection", "necessary concomitant", "ordinary operations", "remoteness", negligence

Early on a rainy morning on 20 July 1932, Piet Jacobs woke up for work. He was employed as a tram driver for the Port Elizabeth Electric Tramway Company Limited – a company that carried on the business of transporting fare-paying passengers in and around Port Elizabeth. That morning, Piet was the driver of a tramcar on the Russell Road route to the city centre but just after 6 o'clock that morning, with only a few passengers on board, Piet lost control of the tramcar while descending the steep Russell Road hill. The tramcar, after a harrowing trip down the hill, finally derailed at the bottom of the hill and ploughed into the Masonic Hotel and the jewellery business next door. It must have been a terrifying experience for those passengers on board. Fortunately, it appeared as if no one was seriously injured in the accident.<sup>3</sup>

Little did Piet know that his claim for damages under the Workmen's Compensation Act<sup>4</sup> against his employer as a result of the tramcar accident would ultimately become one of the leading cases in income tax matters in South Africa on the interpretation of the phrase "in the production of the income" as used in section 11(2)(a) of the 1925 Income Tax Act.<sup>5</sup> This exact same phrase is still used in section 11(a) of the presently in force Income Tax Act<sup>6</sup> ("Income Tax Act").

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3 *Eastern Province Herald*. 1932. *Runaway Tram Dashes into Main Street Shop*. 21 July. Port Elizabeth: Cape of Good Hope at 5.

4 No. 59 of 1934. Today referred to as the Compensation for Occupational Injuries and Diseases Act, No. 130 of 1993, as amended by Compensation for Occupational Injuries and Diseases Amendment Act, No. 61 of 1997.

5 No. 40 of 1925.

6 No. 58 of 1962.

When the Commissioner for Inland Revenue (“Commissioner”) disallowed as a deduction both the compensation paid to the widow of Piet Jacobs (Piet had unfortunately passed away before the compensation claim was finally settled in court) as a result of the accident and the ensuing legal fees incurred in resisting the compensation claim, the directors of the Port Elizabeth Electric Tramway Company Limited appealed to the then Cape Provincial Division of the Supreme Court against the decision after also having lost its stated case in the Special Court for Hearing Income Tax Appeals (“Special Court”). The decision by the Cape Provincial Division of the Supreme Court was reported in 1936 as *Port Elizabeth Electric Tramway Company Ltd v CIR*.<sup>7</sup>

Although the *Port Elizabeth Electric Tramway’s* case never went on appeal to the then Appellate Division, the general meaning ascribed to the phrase “in the production of the income” in that case by Watermeyer AJP is still referred to today by certain academics as correctly stating its meaning.<sup>8</sup> Contrary to this view is the opinion of Kruger, D, Stein, M, Dachs, P and Davey, T<sup>9</sup> that the South African law relating to the deduction of expenditure incurred by a taxpayer who is conducting a trade has never really recovered from the test laid down by Watermeyer AJP. Kruger, *et al*<sup>10</sup> regard the test as “too mechanical and contrived”. Instead they postulate that the possibly wider meaning ascribed to the phrase by Mason J in *Lockie Bros Ltd v CIR*,<sup>11</sup> a decision given some 12 years prior the *Port Elizabeth Electric Tramway* case, namely, 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”,<sup>12</sup> is a far more practical interpretation and should rather be used.

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*,<sup>13</sup> is still not wide enough to take into account the economic and other non-economic realities of how business and trade is conducted in the 21<sup>st</sup> 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

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7 1936 CPD 241, 8 SATC 13.

8 Williams, RC. 2009. *Income Tax in South Africa*, 3rd edition, Durban: LexisNexis at 444 and De Koker, A and Williams, RC. 2013. *SILKE on South African Income Tax*, Volume 1, service 49, Durban: LexisNexis, para 7.8.

9 Kruger, D, Stein, M, Dachs, P & Davey, T. 2012. *Broomberg on Tax Strategy*, 5th edition. Durban: LexisNexis at 252.

10 *Supra*.

11 *Lockie Bros Ltd v CIR*, 1922 TPD 42, 32 SATC 150.

12 *Supra* at 152.

13 Kruger, D, Stein, M, Dachs, P & Davey, T. 2012. *Broomberg on Tax Strategy*, 5th edition. Durban: LexisNexis at 252.

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.

Thus, this article will endeavour to reignite the debate in this area and attempt to answer the question of whether either Watermeyer AJP’s or Mason J’s interpretation of the phrase “in the production of the income” should prevail or even if both their interpretations should be discarded and reinterpreted in the light of two comparatively recently decided Supreme Court of Appeal cases, namely, *C:SARS v Mobile Telephone Networks Holdings (Pty) Ltd*<sup>14</sup> and *Warner Lambert SA (Pty) Ltd v C:SARS*.<sup>15</sup> It is submitted these two judgements, *prima facie*, appear to have considerably widened the ambit of expenses that may now be deducted as being incurred “in the production of the income” by taking into account the manner in which business was conducted in the latter part of the 20<sup>th</sup> century against, *inter alia*, the social background of apartheid and how it is now conducted in the 21<sup>st</sup> century. The conclusion reached as to whether Watermeyer AJP’s interpretation of the phrase “in the production of income” is still a valid interpretation for the 21<sup>st</sup> century, and if not valid, what is the interpretation that should be used, is the main contribution that this article will make to the body of knowledge in the field of taxation.

In line with one of the overall objectives of this Special Edition of Tax Stories, namely, to make a pedagogical contribution to the teaching and learning of tax principles by telling the story behind the story, it is considered appropriate to place the *Port Elizabeth Electric Tramway* case in its historical and social context. It is hoped that telling the story behind the story will contribute to and enable a more accessible and interesting journey of discovery for the tax scholar.

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14 [2014] ZASCA 4.

15 2003(5) SA 344 (SCA), 65 SATC 346.

## The story behind the story

The Port Elizabeth Tramway Company Limited was founded in 1879 as a subsidiary of the Cape Town Tramway company.<sup>16</sup> Two years later, on 14 May 1881,<sup>17</sup> the Port Elizabeth network of transporting passengers by tram commenced. Initially the tram network operated with five horse-drawn tramcars that were imported from America. In 1895 the Cape Parliament passed an Act allowing the Port Elizabeth municipality to construct an electric tram system to replace the horse-drawn tram carriages. Ten electric trams were ordered from Philadelphia, America. The first electric tram in Port Elizabeth was driven on 16 June 1897 from the Market Square to Prince Alfred's Park where the Nelson Mandela Bay Stadium is now located.

Shortly after the introduction of the electric tram system, a double-decker tram was successfully tested both up and down the steep hill of the Russell Road route. The new route was opened to the public on 20 July 1897.<sup>18</sup> The switch to electric tramcars had a positive influence on the economy of Port Elizabeth since it allowed the labour force from outlying suburban areas like Walmer, to travel quickly and cheaply to work. However, there was also a price to be paid. By 1932 there had already been two accidents of runaway trams on the Russell Road route. Fortunately, Piet Jacobs' accident in 1932 was the last major accident reported on this route until the tram routes were closed in 1948.

Two judges were involved in deciding the *Port Elizabeth Electric Tramway* case, namely, Watermeyer AJP and Davis J. Ernest Frederick Watermeyer,<sup>19</sup> who over a period of nearly 30 years, handed down many important tax judgments.<sup>20</sup> In several of these cases Davis J presided on the bench with him.<sup>21</sup> Watermeyer AJP's decision in the *Port Elizabeth Electric Tramway* case, together with his seemingly contradictory decision in the *Joffe*<sup>22</sup> case, decided some ten years later, provided what was to become recognised as legal precedent in respect of the meaning to be ascribed to the phrase

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16 Heritage. 2013. *Electricity in South Africa. Overhead trolley-wire electric trams*. [Online] Available at: [http://heritage.eskom.co.za/heritage/electricity\\_in\\_south\\_africa.htm](http://heritage.eskom.co.za/heritage/electricity_in_south_africa.htm). [Accessed: 24 January 2013].

17 Wikipedia. 2013. *Trams in Port Elizabeth*. [Online] Available at: [http://en.wikipedia.org/wiki/Trams\\_in\\_Port\\_Elizabeth](http://en.wikipedia.org/wiki/Trams_in_Port_Elizabeth) Wikipedia. [Accessed: 24 January 2013].

18 Harradine, M. 1997. *Port Elizabeth: A Social Chronicle to the End of 1945*. [Online] Available at: <http://bygonesandbyways.blogspot.com.au/search/label/Trams> [Accessed: 19 August 2013].

19 Refer to Stack, EM, Grenville, D, Poole, R, Horn, E & Harnett, H. 2014. "Commissioner for Inland Revenue v Lever Brothers and Unilever Ltd: a practical problem of source" (in this edition of the journal) for a more detailed discussion on Judge Ernest Frederick Watermeyer.

20 *Inter alia*, some of the well-known cases he decided: *Lategan v CIR*, 1926 CPD 203, 2 SATC 16; *Ochberg v CIR*, 1933 CPD 256, 6 SATC 1; *Pyott Ltd v CIR*, 1945 AD 128, 13 SATC 121; *Joffe & Co (Pty) Ltd v CIR*, 1946 AD 157, 13 SATC 354; *New State Areas Ltd v CIR*, 1946 AD 610, 14 SATC 155 and *CIR v Lever Bros & Unilever Ltd*, 1946 AD 441, 14 SATC 1.

21 Watermeyer became Chief Justice (CJ) of the Appellate Division in 1943 while Davis was later also to become a Judge of Appeal in the Appellate Division.

22 *Joffe & Co (Pty) Ltd v CIR*, 1946 AD 157, 13 SATC 354.

“in the production of the income”. Thus, it is considered appropriate to discuss in the next paragraph, the facts, the decision, the *ratio decidendi* (reasons for the decision) and the *obiter dicta* (explanations and discussion on a point of law not necessary for the decision – in effect an aside by the judge) of the *Port Elizabeth Electric Tramway* case before comparing the decision in that case to the decision in the *Joffe* case and other relevant cases that dealt with the interpretation and thus the meaning to be ascribed to the phrase “in the production of the income”.

### The facts, decision, *ratio decidendi* and *obiter dicta* of the *Port Elizabeth Electric Tramway* case

After the accident occurred on 20 July 1932, it was reported in the local newspaper the next day that only the tramcar driver and a passenger, Mr S Greyling, a post office official, were admitted to hospital reportedly with non-life threatening minor injuries. This was a lucky escape because the tramcar was so badly damaged that it had to be completely demolished to enable it to be removed.<sup>23</sup>

From a historical perspective, it is interesting to note that both Kruger, *et al*<sup>24</sup> and Williams<sup>25</sup> state that the driver lost control of the tram while descending the Russell Road hill and was killed in the ensuing accident. However, this statement clearly conflicts with the newspaper report. Perhaps the correct version is that, as stated in the court record, the tramcar driver suffered injuries from the accident from which he subsequently died.

In any event, as a result of the accident and the ensuing legal claim for compensation, the Port Elizabeth Electric Tramway Company Limited was ordered by the court, in terms of the Workmen’s Compensation Act, to pay compensation amounting to £664 to Piet Jacobs’ widow as well as the attendant legal fees of £748 in resisting the claim for compensation. Both these expenses were claimed by the taxpayer in terms of section 11(2)(a) read together with section 13(b) of the 1925 Income Tax Act,<sup>26</sup> which read as follows:

Section 11(2) – The deductions allowed shall be

- (a) 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...

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23 *Eastern Province Herald*. 1932. Runaway Tram Dashes into Main Street Shop. 21 July. Port Elizabeth: Cape of Good Hope at 5.

24 Kruger, D, Stein, M, Dachs, P & Davey, T. 2012. *Broomberg on Tax Strategy*, 5th edition. Durban: LexisNexis at 251.

25 Williams, RC. 2009. *Income Tax in South Africa*, 3rd edition, Durban: LexisNexis at 444.

26 No. 40 of 1925.

Section 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 purposes of trade.

These sections are easily recognised because they later became embodied in sections 11(a) and 23(g) of the present Income Tax Act. The section 23(g) phrase “wholly and exclusively laid out or expended for the purposes of trade” has, however, now been amended to read “to the extent laid out or expended for the purposes of trade”. The amendment has opened the door to the apportionment of expenses between those lump-sum expenses that are incurred for a dual purpose, namely, expenses that are incurred “in the production of the income” and “laid out for the purposes of trade”, and those expenses that are not so incurred, for example, private or domestic expenditure. However, any further discussion on section 23(g) of the Income Tax Act is considered to be beyond the scope of this article.

As already indicated, the Commissioner disallowed both the compensation paid and attendant legal expenses claimed by the taxpayer as not being incurred “in the production of the income”. As a result, the taxpayer immediately appealed the decision to the Special Court. The appeal was dismissed in that court and the next step in the appeal process was to approach the Cape Provincial Division of the Supreme Court, which the taxpayer did.

During the course of his judgment in the Cape Provincial Division, Watermeyer AJP specifically remarked on the obscure and ambiguous nature of the language used in the phrase “in the production of the income”. In his opinion, expenditure or losses could not directly produce income. Rather, income is produced by a series of operations and transactions entered into for the purpose of manufacturing or acquiring a saleable product and thereafter selling it or rendering services for which payment is received.<sup>27</sup>

Watermeyer AJP then dealt with the three qualifications necessary before expenditure can become deductible, namely:<sup>28</sup>

- the expenditure must be actually incurred,
- it must not be of a capital nature, and
- it must be incurred in the production of the income.

It is important to note that the Income Tax Act (both past and present legislation) uses the words “actually incurred” and not “necessarily incurred” when prescribing

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27 8 SATC 13 at 14.

28 *Supra* at 15.

the prerequisite for the deduction of the expenditure. Using the qualification “necessarily incurred” would certainly have narrowed the type of expenditure that can be claimed. Thus, Watermeyer AJP held that even if a taxpayer conducts his business inefficiently or extravagantly, that is no ground in itself for disallowing such expenditure. Thus, for example, a taxpayer may fly overseas on business. The cost of the air ticket, irrespective of whether the taxpayer flies economy class or first class, is deductible. The deductible amount is not restricted to the cost of an economy class air ticket, which would have been the position had the deduction of expenditure been restricted only to expenditure necessarily incurred.

Furthermore, Watermeyer AJP stated that expenses “actually incurred” cannot mean “actually paid” because, for as long as there is a liability to pay, the expense is actually incurred and may therefore be deductible.<sup>29</sup> He, therefore, found that the payment of compensation to the driver was expenditure “actually incurred”.<sup>30</sup>

The expenditure, to be deductible, must also not be of a capital nature. This requirement was, however, neither argued nor even discussed in any detail in the *Port Elizabeth Electric Tramway* case. Watermeyer AJP accepted, relying on the judgement of Innes CJ in *George Forest and Timber Company Limited v CIR*,<sup>31</sup> that the expenditure was not capital expenditure incurred “for the purpose of acquiring some income producing concern”.

The third requirement for expenditure to qualify as a deduction is that the expenditure must be actually incurred “in the production of the income”. To determine the nature of the expenditure that may be deductible, Watermeyer AJP used two tests, namely:<sup>32</sup>

- to determine whether the act to which the expenditure was related, was to produce income, and
- was the expenditure linked closely enough to the act?

These tests are referred to by Williams<sup>33</sup> as the “subjective *purpose* test” and the “objective *nexus* test”. The objective test is also referred to as the “closely connected” test or, as later described in *Joffe & Co (Pty) Ltd v CIR*,<sup>34</sup> as the “inevitable concomitant” test.<sup>35</sup>

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29 *Supra* at 15. Also refer to ITC 1553, (1989) 55 SATC 105 at 111.

30 *Supra* at 16.

31 1924 AD 527, 1 SATC 20.

32 *Port Elizabeth Electric Tramway Company Ltd v CIR*, 1936 CPD 241, 8 SATC 13.

33 Williams, RC. 2009. *Income Tax in South Africa*, 3rd edition, Durban: LexisNexis at 446.

34 Also decided by Watermeyer CJ (as he later became).

35 13 SATC 354 at 359.



In the *Port Elizabeth Electric Tramway* case, Watermeyer AJP, using the two tests, attempted to set the limits or ambit for the interpretation and thus the meaning to be ascribed to the phrase “in the production of the income”. It is submitted, however, that the words used in the judgment to describe its meaning, especially taking into account the facts in the case and the *obiter dicta*<sup>36</sup> made by him during the course of his judgment – to be discussed in detail below – were somewhat vague, confusing and even impractical, and inevitably set the scene for contradictory and even absurd judgments that followed, as was suggested by Kruger, *et al.*<sup>37</sup>

Watermeyer AJP logically pointed out that the employment of drivers was necessary for the carrying on of the transport business of the taxpayer, for without passengers, no income could be earned. The employment of drivers carried with it, as a necessary consequence,<sup>38</sup> a potential liability to pay compensation in terms of the Workmen’s Compensation Act if there were to be an accident and a driver injured. Thus, in his opinion, the payment made by the taxpayer as compensation had to be regarded as part of the cost of its operations and thus incurred “in the production of the income”. After all, there was irrefutable evidence that there had previously been two such similar tram accidents on the Russell Road route.

The question that may be posed at this point is why, if the taxpayer correctly won the argument on the compensation claim, Watermeyer AJP has been criticised by Kruger, *et al.*<sup>39</sup> for being too “mechanical and contrived” in his interpretation of the phrase “in the production of the income”.<sup>40</sup> It is submitted that this criticism can be attributed to two reasons, namely, certain *obiter dicta* made by Watermeyer AJP during the course of his judgement, which may incorrectly have been interpreted as being part of the *ratio decidendi*, as well as the decision of Watermeyer AJP to disallow the claim for legal expenses. His reasoning was that the legal expenses were incurred in resisting a demand for compensation and thus were not incurred “in the production of the income” in that the incurral of a legal expense was “not an operation entered upon for the purpose of earning income”.<sup>41</sup>

It is submitted that Watermeyer AJP erred in disallowing the legal expenses incurred by the taxpayer. After all, the legal expenses were only incurred because of

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36 Pronouncements not necessary for the judgement.

37 Kruger, D, Stein, M, Dachs, P & Davey, T. 2012. *Broomberg on Tax Strategy*, 5th edition. Durban: LexisNexis at 252.

38 *Supra* at 18

39 Kruger, D, Stein, M, Dachs, P & Davey, T. 2012. *Broomberg on Tax Strategy*, 5th edition. Durban: LexisNexis.

40 *Supra* at 152.

41 Further discussion on the disallowance of the legal expenses is considered to be beyond the scope of this article as the legislature recognised the unfairness of disallowing legal expenses in the circumstances that prevailed in the *Port Elizabeth Electric Tramway’s* case and later in *Joffe’s* case (the events for judgement relating to the *Joffe* case took place in 1938 and 1939) by promulgating legislation in 1941 to permit the deduction of legal expenses incurred in the ordinary course of, or by reason of the ordinary operations of the taxpayer.

the claim against the taxpayer for compensation, the claim of which the taxpayer was entitled to and properly did resist. There was no other purpose for the expenditure. The legal expenses incurred were an essential and integral part of the compensation claim. Thus, logic dictates that it should follow 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 that are incurred solely in connection with resisting the compensation claim should also meet the “closely connected” test.

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*<sup>42</sup> 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”.<sup>43</sup> 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*<sup>44</sup> contend.

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42 1922 TPD 42, 32 SATC 150.

43 32 SATC 150 at 152.

44 *Supra*.

During the course of his judgment in the *Port Elizabeth Electric Tramway* case, it appears as if Watermeyer AJP went beyond what was required to decide the matter at hand. He indicated, as *obiter dicta*, that for an expense to be deductible, the act must be *bona fide* done for the purpose of carrying on an income-producing trade. Thus, in his opinion, unlawful or negligent acts are not *bona fide* and the related expenditure that arises from such acts would probably not qualify as a legitimate deductible expense.<sup>45</sup> His opinion in this regard is indicative of how strict and narrow an interpretation he attempted to place on the phrase “in the production of the income”. Negligence was not even an issue in the *Port Elizabeth Electric Tramway* case as the compensation was paid under a claim brought in terms of the Workmen’s Compensation Act. The claim was not a delictual action for compensation caused by negligence, but a statutory liability in terms of the claim arising from an employer-employee relationship. Thus, whether or not negligence played a part in the accident was irrelevant to the decision and it was not necessary for Watermeyer AJP to discuss the deductibility or otherwise of expenditure incurred as a result of negligence.

Unfortunately, his *obiter dicta* put him in an unenviable position ten years later when he was required to give judgment in the *Joffe*<sup>46</sup> case where negligence was actually found to be present. Thus, it is considered relevant to discuss, in the following paragraph, Watermeyer CJ’s judgment in the *Joffe* case as well as the decisions given by judges in other cases where there were issues of negligence.

## Other related negligence cases

In 1946, Watermeyer, who had by then been appointed Chief Justice of South Africa, had a chance to further articulate his views on the meaning to be ascribed to the phrase “in the production of the income” and the potential effect that negligence on the part of the taxpayer has on the deductibility of compensation paid. He presided in the *Joffe*<sup>47</sup> case where the taxpayer carried on business as engineers in reinforced concrete. A concrete cantilever hood<sup>48</sup> 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

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45 *Port Elizabeth Electric Tramway Company Ltd v CIR*, 8 SATC 13 at 17.

46 *Joffe & Co (Pty) Ltd v CIR*, 1946 AD 157, 13 SATC 354.

47 *Supra*

48 Cantilevers are important structures in the design of bridges, cranes and even power stations. A cantilever is defined as a “beam, girder or structural framework that is fixed at one end and is free at the other”. *The free dictionary*. 2013. Cantilever. [Online] Available at: <http://www.thefreedictionary.com/> [Accessed: 4 September 2013].

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<sup>49</sup> that the negligent construction was a “necessary concomitant” of, and was “closely linked” to the trading operations of a reinforced concrete engineer.

If one reads this judgement closely, it is clear that, far from excluding all acts of negligence as automatically prohibiting the expenditure incurred from being deducted, the judgment in the *Joffe* case was, in effect, contrary to Watermeyer AJP's own *obiter dicta* in the *Port Elizabeth Electric Tramway* case in regard to negligence. It therefore follows that the deduction of expenditure resulting from negligence may be claimed, provided that the taxpayer can discharge the onus of proof placed upon him, as is now required under section 102 of the Tax Administration Act.<sup>50</sup> Placing as evidence before a court, for example, valid statistics of the number of workmen who have been killed on building sites over a period of 20 years due to negligence, could go a long way towards discharging the onus of proof provisions by showing that negligent acts by employees is an occurrence that is expected and that even if strict precautionary measures are undertaken to prevent such accidents happening, it is still an inherent risk of doing business in the construction industry.

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49 The onus of proof provisions that were included in section 57 of the Income Tax Act (No. 40 of 1925) and later in section 82 of the Income Tax Act (No. 58 of 1962) are now embodied in section 102 of the Tax Administration Act (No. 28 of 2011).

50 No. 28 of 2011. The onus provisions were previously contained in section 82 of the Income Tax Act.

Support for the view that where negligence is involved there should be no automatic disallowance of the compensation paid as a result thereof, had already been given in 1922 in the *Lockie Bros*,<sup>51</sup> case when Mason J, in dealing with negligence, said the following:<sup>52</sup>

“The handling of the goods is a necessary incident of the business and negligence in that respect does not alter the nature of the transaction.”

Further support for the deduction of expenditure resulting from negligence was given in *ITC 233*<sup>53</sup> where a taxpayer carried on the business of a stevedore. A passer-by was killed when an article fell out of a net while the taxpayer was unloading cargo from a vessel during the course of carrying on its business. The taxpayer had been negligent in securing the cargo in the net. The court held that the resultant payment for damages had to be regarded as incidental to a stevedoring business and was therefore deductible.

*ITC 815*<sup>54</sup>— decided some ten years after the *Joffe* judgment — also lends support for the submission that the *Joffe* judgment is not precedent for the principle that all expenditure, including claims for damages arising as a result of negligence by a taxpayer, is not deductible as not being “in the production of the income”. In that case, the taxpayer — a partner in a firm of attorneys — sought to deduct his proportionate share of a loss incurred by the partnership for trust moneys held for investment that had been embezzled by employees of the partnership. The Commissioner refused to allow the deduction. On appeal, Roper J, in regard to negligence, had the following to say:<sup>55</sup>

“An examination of *Joffe*’s case will show that it does not decide that losses incurred through the negligence of the taxpayer are not deductible from the taxpayer’s income. It turned on the point that there was *no evidence* (author’s emphasis) that losses arising from the negligence of the particular taxpayer were necessary concomitants of the business which he carried on.”

In spite of all these judgements favouring and supporting the deductibility of compensation paid as a result of negligence, the judge in *ITC 1058*,<sup>56</sup> 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

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51 1922 TPD 42, 32 SATC 150.

52 *Supra* at 152.

53 (1932) 6 SATC 259.

54 (1955) 20 SATC 487 (T).

55 *Supra* at 488 and 489.

56 (1963) 26 SATC 305.

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.<sup>57</sup> 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.

From an analysis of the above cases, it may be concluded that even expenditure that has some form of negligence attached to it, may be deductible as being incurred "in the production of the income" provided the taxpayer can discharge the onus of proof placed upon him. Neither the *Port Elizabeth Electric Tramway* nor the *Joffe* cases created a precedent that automatically disallows expenditure claimed as a deduction arising as a result of negligence.

Both the *Port Elizabeth Electric Tramway* and *Joffe* cases dealt with compensation and damages paid and the related legal fees. However, the apparent narrow interpretation of the phrase "in the production of the income" by 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. The question that arises in this respect is whether the judiciary slavishly followed the narrow interpretation of Watermeyer AJP in subsequent cases that did not deal with compensation and damages claims, or whether it merely paid lip service to the interpretation and surreptitiously widened its ambit by taking into account the moral, common law and other statutory legislation costs as well as the economic realities that the modern business has to face in the 21<sup>st</sup> century. In the next paragraph, the deductibility of expenditure incurred by a taxpayer as a result of statutory and other stakeholder requirements will be discussed.

### **Interpretation of the phrase "in the production of the income" where the expenditure incurred is not related to damages and compensation paid**

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

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57 Kruger, D, Stein, M, Dachs, P & Davey, T. 2012. *Broomberg on Tax Strategy*, 5th edition. Durban: LexisNexis at 252.

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. Furthermore, by 2003 the judiciary, unlike SARS, 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.

### Interest incurred as a result of the conversion of a dividend declared to a shareholder's loan account

*C:SARS v Scribante Construction (Pty) Ltd*<sup>58</sup> 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 circumstances in the *Scribante* case must be distinguished from the situation when a taxpayer borrows money to pay a dividend to its shareholders. The interest incurred on such a loan is not an expense "in the production of the income",<sup>59</sup> as dividends do not constitute "income" as defined in section 1 of the Income Tax Act. In addition, the circumstances must also be distinguished from the situation where the taxpayer borrows money to buy shares in a company as was the case in *CIR v Shapiro*.<sup>60</sup> In the *Shapiro* case, the court did not allow the interest incurred on the loan used to purchase the shares as a deduction as the dividends received do not produce income as defined.

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58 2001(2) SA 601 (E), 62 SATC 443.

59 Also refer to *Tickin Timbers CC v CIR*, [1999] 4 All SA 192 (A), 61 SATC 399.

60 1928 NLR 436, 4 SATC 29.

Although the circumstances in the *Scribante* case were completely different to those in the *Port Elizabeth Electric Tramway* case, Watermeyer AJP's interpretation of the phrase "in the production of the income" may possibly have been wide enough to cover the deduction of interest paid to shareholders on dividends that could have been paid in cash but are converted to shareholders' loan accounts. In any event, the *Scribante* judgement has, it is submitted, been part of the clarification process as to how the judiciary interpret the phrase "in the production of the income" for general business expenditure other than for damages and compensation.

### Insurance premiums

In *Sub-Nigel Ltd v CIR*<sup>61</sup> the taxpayer company carried on the business of mining for gold. It made a practice of taking out policies of insurance against losses incurred by fire in respect of net profits and standing charges. The insurance against the loss of net profits was undertaken in order to enable the company to maintain a steady rate of dividends to be paid to its shareholders, notwithstanding a cessation of its operations in part or in whole by reason of fire. The insurance in respect of the standing charges was designed to enable the company to carry on its essential services without loss. These insurance premiums were claimed as a deduction by the taxpayer although no insurance claims were made during that year. It was held that section 11(a) does not require that claimable expenditure must have produced income in the same year it was incurred. Therefore in the view of Centlivres JA, it was irrelevant that no income was received and he allowed the expenditure as its purpose was to produce income in the case of a fire. This decision, it is submitted, also clarified and widened the meaning of the phrase "in the production of the income" as originally postulated by Watermeyer AJP.

### Expenditure incurred at the behest of its holding company

In *Warner Lambert SA (Pty) Ltd v C:SARS*,<sup>62</sup> the taxpayer, an American-owned company operating in South Africa during the apartheid regime, was a voluntary signatory to the Sullivan Code.<sup>63</sup> During the height of apartheid, an Act was

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61 1948 (4) SA 580 (A), 15 SATC 381.

62 2003 (5) SA 344 (SCA), 65 SATC 346.

63 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).



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.<sup>64</sup> 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 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.<sup>65</sup> See also *Solarglass Finance Limited v CIR*<sup>66</sup> 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.

Perhaps in interpreting the phrase "in the production of the income" a type of "remoteness" test to expand the meaning of the "close connection" test as used by Watermeyer AJP in the *Port Elizabeth Electric Tramway* case, was used by Conradie JA. In explaining the remoteness connection, he distinguished between the Sullivan Code expenditure that was admittedly deductible, such as salaries, and other Sullivan Code social responsibility expenditure where the deductibility of the expenditure was questionable, such as "working to eliminate laws and customs that impede social, economic and political justice".<sup>67</sup> He made the following comments in this regard:<sup>68</sup>

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64 *Warner Lambert SA (Pty) Ltd v C:SARS*, 2003 (5) SA 344 (SCA), 65 SATC 346 at 349.

65 *Supra* at 352.

66 1991 (2) SA 257, 53 SATC 1

67 65 SATC 346 at 349.

68 *Supra* at 352.

“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* (author’s emphasis). To qualify as moneys expended in the course of trade, an outlay does not itself have to produce a profit.”

It is submitted that the use of the remoteness test is simply another way of establishing, analysing and confirming the closeness of the connection between the trade being carried on and the expenditure incurred. The remoteness test theoretically adheres to Watermeyer AJP’s interpretation of the phrase, but if one looks at the facts of the *Warner Lambert* case, it is submitted that the interpretation of the phrase in that case goes far beyond that which Watermeyer AJP ever intended. It is further submitted that such expenditure may not even have qualified under Mason J’s interpretation of the phrase in the *Lockie Bros*<sup>69</sup> case as being “actually incurred in the course of and by reason of the ordinary operations undertaken for the purpose of conducting the business” if one reads these words together with the facts of that case. The *Lockie Bros* decision will be discussed in greater detail in this context later on in this article.

The decision in the *Warner Lambert* case, it is submitted, was the first judgement of major importance to break down the barriers and restrictions that Watermeyer AJP in the *Port Elizabeth Electric Tramway* decision had placed before taxpayers in claiming general business expenditure incurred as a deduction. The decision, it is submitted, now potentially leaves the door open for taxpayers to claim a greater range of business expenses that may be deductible than was previously available or possible in terms of the *Port Elizabeth Tramway* and *Joffe* interpretation of the phrase “in the production of the income”.

## Audit fees

In the light of the rather narrow interpretation placed on the phrase “in the production of the income” in the *Port Elizabeth Electric Tramway* and *Joffe* cases, it is surprising that the Commissioner, in practice, permitted taxpayers to deduct audit fees without question. Where is the “close connection” between audit fees and the production of income? How can audit fees ever produce income, even indirectly? According to Watermeyer – the presiding judge in both the *Port Electric Tramway* and the *Joffe* cases – even legal fees that are directly related and attributable to the payment of deductible compensation may not qualify as being expenses incurred “in the production of the income”. Mason J’s possibly wider interpretation of the phrase in the *Lockie Bros*<sup>70</sup> case may have permitted the deduction of audit fees.

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69 (1922) 32 SATC 150 at 152.

70 (1922) 32 SATC 150 at 152.

An audit fee is statutorily imposed upon a company and thus, it is submitted, may be considered, like legal expenses incurred, as an expense incurred in the ordinary course of carrying on a trade.

Amazingly, after close to a century of permitting the deduction of audit fees, the Commissioner appeared to have questioned its own practice of permitting such expenditure and the matter had to proceed to court to be resolved. The Supreme Court of Appeal in *C:SARS v Mobile Telephone Networks Holdings (Pty) Ltd*,<sup>71</sup> held that the auditing of financial records was part of the taxpayer's general overhead expenditure enabling it to carry out all of its activities and endorsed the court *a quo*'s conclusion that the audit fees were deductible as it is clearly a function that is "necessarily attached" to the performance of the income-earning operations of a company.<sup>72</sup>

This decision, it is submitted, was the second judgement of major importance to break down the barriers and restrictions that Watermeyer AJP in the *Port Elizabeth Electric Tramway* decision had placed before taxpayers in claiming general business expenditure incurred as a deduction.

Before finally concluding on the present day interpretation of the phrase "in the production of the income", it seems appropriate to first examine the deductibility of losses arising as a result of theft by employees. After all, the *Lockie Bros*<sup>73</sup> case dealt with this matter and the facts of this case provides insight into the interpretation that Mason J intended to place on the phrase "in the production of the income".

## Losses from theft or misappropriation by employees

For the purposes of the general deduction formula, it has been held that there is no difference between expenditure and loss, one being a voluntary payment and the other an involuntary deprivation.<sup>74</sup> Thus, losses suffered by a taxpayer as a result of theft and misappropriation of funds, and whether these losses have been incurred "in the production of the income" and therefore qualify as a deduction, have been examined in various cases over the years. Although Mason J in the *Lockie Bros*<sup>75</sup> case is credited by Kruger, *et al*<sup>76</sup> as giving a fairly wide interpretation to the meaning of the phrase "in the production of the income", this interpretation was

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71 [2014] ZASCA 4.

72 *C:SARS v Mobile Telephone Networks Holdings (Pty) Ltd*, [2014] ZASCA 4 at par 11.

73 (1922) 32 SATC 150 at 152.

74 *Joffe & Co (Pty) Ltd v CIR*, 1946 AD 157, 13 SATC 354.

75 1922 TPD 42, 32 SATC 150.

76 Kruger, D, Stein, M, Dachs, P & Davey, T. 2012. *Broomberg on Tax Strategy*, 5th edition. Durban: LexisNexis at 252.

not, surprisingly, in his opinion, wide enough to cover losses arising as a result of the embezzlement of funds by a senior manager (employee) of the taxpayer. He held that embezzlement by a senior manager was not an operation that was ordinarily undertaken for the purposes of the business and consequently, the loss was not deductible. It is submitted that based upon his judgement of the facts in this case, his interpretation, although couched in words that appear to convey a wider meaning to the phrase “in the production of the income” than that of Watermeyer AJP in the *Port Elizabeth Electric Tramway* case, his intended interpretation is in actual fact not much wider.

It is clear that after the *Lockie Bros*<sup>77</sup> case, the judiciary was confused as to the interpretation to be placed on the phrase “in the production of income” when it comes to the deductibility of losses arising from theft or embezzlement. In *COT v Rendle*,<sup>78</sup> a clerk in a firm of accountants misappropriated trust funds belonging to two clients as well as funds belonging to the firm. The court held that the misappropriation of the trust funds of the clients by the clerk, who was a subordinate,<sup>79</sup> “was sufficiently closely connected to the firm’s business operations as to be regarded as part of the cost of performing those operations”. However, the misappropriation of the taxpayer’s own funds by the same clerk was not deductible as the taxpayer had not discharged the onus of proof that there was a sufficiently close connection to the firm’s business operations and the misappropriation. It is submitted that this is a further example of an absurd conclusion. No account was taken of the similar economic consequences suffered by the taxpayer and the taxpayer’s clients. They both suffered losses from the same act of misappropriation by the same employee, yet in the case of the misappropriation of the funds of the client, the losses were permitted as deductions while when the taxpayer’s own funds were misappropriated, the losses could not be claimed as a deduction.

The later decision in *ITC 1221*<sup>80</sup> also dealt with the misappropriation of funds by a subordinate employee. The court confirmed that the *Lockie Bros*<sup>81</sup> case was authority that theft by a managing director, a director or a manager in the position of a proprietor will not be deductible as theft is not a loss that can be regarded as connected with or arising out of trade. However, losses suffered as a result of “thefts

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77 (1922) 32 SATC 150.

78 1965(1) SA 59 (SRAD), 26 SATC 326.

79 (1963) 26 SATC 326 at 333–334.

80 (1974) 36 SATC 233.

81 (1922) 32 SATC 150.

by subordinate employees may be regarded as losses, which are an incident of the taxpayer's trading activities".<sup>82</sup> The same principle was also applied in *ITC 1242*.<sup>83</sup>

It is submitted that a more reasoned approach that assists with the somewhat confusing issue of permitting a loss as a result of a misappropriation, theft or embezzlement by junior staff to be deductible, but prohibiting the same deduction when the misappropriation is by a senior staff member, is the judgment in *ITC 1383*.<sup>84</sup> The court held that there is no logical basis for restricting the deductibility to the petty thefts of junior employees, and further, that in the ordinary course of its business a commercial bank must necessarily allow its employees to handle large sums of money. The risk of theft is then inherent in and an inseparable element of this business and that the loss in issue is therefore deductible as being "incurred in the production of income".

The cases discussed above dealt mainly with misappropriations by employees. The position is different in relation to proprietors, including sole traders, partnerships, members of close corporations and shareholders. A man cannot steal from himself, so there is no question of deducting the loss as a result of the theft by a sole proprietor from his own business. A partnership is not a legal entity. Under section 24H of the Income Tax Act, each partner is taxed on his portion of the income of the partnership business and is entitled to deduct his portion of the deductions or allowances related to that income. The partner misappropriating the assets would therefore not be able to deduct his share of the loss. He would instead be taxed on the amounts he had misappropriated as such amount, in effect, would be part of the partner's profit share.<sup>85</sup> The same principle would apply to members of a close corporation or a shareholder, for example, in a private company.

The deduction of misappropriated funds by senior employees appears to be related more to the taxpayer being able to discharge the onus of proof that the risk of the loss is inseparable from, or a necessary incident of, the incomeproducing operations of the business rather than the seniority of the employee. The more senior the employee, for example, a manager or a director, implies that the taxpayer has a heavier onus to establish the link between the risk of loss and the ordinary operations of the business. It is submitted that the risk of loss from theft from an employee, even a senior employee, is not too "remote" (see *Warner Lambert*<sup>86</sup>) for such losses to be deductible as being incurred "in the production of the income".

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82 *Supra* at 235.

83 (1975) 37 SATC 306.

84 (1978) 46 SATC 90.

85 *ITC 952*, (1961) 24 SATC 547 and *ITC 1661*, (1998) 61 SATC 353.

86 2003 (5) SA 344 (SCA), 65 SATC 346 at 349.

## The Constitution and the “purposive” approach to interpreting fiscal statutes

Neither the *Warner Lambert*<sup>87</sup> nor the *Mobile Telephone Network*<sup>88</sup> judgements referred to section 39(2) of the Constitution<sup>89</sup> with regard to how statutes, including fiscal statutes, must be interpreted. It is submitted that there was no necessity to do so since generally, if the interpretation of a statute follows an approach that will promote the democratic values enshrined in the Constitution, such as fairness and equity, such interpretation will survive a constitutional challenge (Davis<sup>90</sup> and Du Plessis & De Ville.<sup>91</sup> See also *Du Plessis and Others v De Klerk and Another*<sup>92</sup>). The approach followed by the judges in those two cases was both fair and equitable to taxpayers and therefore there are no constitutional issues at stake.

## Conclusion

It is submitted that this article makes a contribution to the field of taxation in two ways:

- A pedagogical contribution to the teaching and learning of tax principles by telling the story behind the *Port Elizabeth Electric Tramway* case by placing the case and even subsequent cases in their historical and social context, which results in a more accessible and interesting journey of discovery for the tax scholar.
- Reanalysing the tax principles as enunciated by Watermeyer AJP in the *Port Elizabeth Electric Tramway* case in regard to his interpretation of the phrase “in the production of the income”. The reanalysis of the principles was done with reference to other relevant and subsequently decided cases in order to establish whether the rather narrow and restrictive interpretation and meaning attributed to that phrase by Watermeyer AJP is still religiously adhered to today or whether the meaning of the phrase has been subtly changed and expanded by the judiciary over time to meet the dictates of how trade and business is presently conducted.

It is submitted that from the re-analysis of the interpretation of the phrase that the claim by Kruger, *et al*<sup>93</sup> that the “close connection” test as laid down by Watermeyer

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87 *Supra*.

88 [2014] ZASCA 4.

89 Constitution of the Republic of South Africa, 1996.

90 Davis, D. *Democracy—Its Influence upon the Process of Constitutional Interpretation*, (1994) 10 SAJHR 103

91 Du Plessis & De Ville, *Bill of Rights Interpretation in the South African Context*, (1993) 4 Stell LR 63.

92 1996(5) BCLR 658(CC) at page 722.

93 Kruger, D, Stein, M, Dachs, P & Davey, T. 2012. *Broomberg on Tax Strategy*, 5th edition. Durban: LexisNexis at 252.

AJP for the interpretation of the phrase is too ‘mechanical and contrived’, is supported. In fact, when the test has been applied in practice, it has led to some absurd results with even more absurd reasons being given by the judiciary to justify why an expense is not incurred “in the production of the income”. The cases of *COT v Rendle*<sup>94</sup> (theft case) and *ITC 1058*<sup>95</sup> (trailer case) are two cases that immediately spring to mind. But this absurdity began with the *Port Elizabeth Electric Tramway* case itself when Watermeyer AJP allowed the deduction for the compensation paid but disallowed a deduction for the legal expenses directly related to resisting the claim as not being incurred “in the production of the income”.

Kruger, *et al*<sup>96</sup> suggest that instead of using Watermeyer AJP’s interpretation of the phrase, Mason J’s interpretation of that phrase in the *Lockie Bros*<sup>97</sup> case, namely, 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”, should be used. However, it is submitted that even the use of that interpretation is fraught with difficulties if one takes into account the facts of the case. That case itself, it is suggested, also led to an absurd result in that Mason J held that losses incurred as a result of theft or embezzlement of money by an employee may be deductible if the employee is a junior employee, but may not be deductible if the employee was a senior manager. It is thus submitted that even the adoption of Mason J’s interpretation when considered in the light of the facts of the case would not have widened the interpretation of the phrase much further.

The contention by Kruger, *et al*<sup>98</sup> that the interpretation by Watermeyer AJP never really recovered from its rocky start has, it is submitted, been superseded by two comparatively recent decisions of the Supreme Court of Appeal. In the *Warner Lambert*<sup>99</sup> case, the judge used a type of “remoteness” test to establish the “close connection” between expenditure incurred and the production of income. He found that the social responsibility expenditure incurred by the taxpayer at the behest of its holding company was incurred “in the production of the income”. In the second instance, the judge in the *Mobile Telephone Networks*<sup>100</sup> case appears to have gone even further in finding that the incurral of audit fees by a taxpayer are incurred “in the production of the income” and are thus deductible.

It is submitted that both these decisions of the Supreme Court of Appeal have considerably widened the meaning to be attributed to the phrase “in the production

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94 1965(1) SA 59 (SRAD), 26 SATC 326.

95 (1963) 26 SATC 305.

96 Kruger, D, Stein, M, Dachs, P & Davey, T. 2012. *Broomberg on Tax Strategy*, 5th edition. Durban: LexisNexis at 252.

97 (1922) 32 SATC 150 at 152.

98 Kruger, D, Stein, M, Dachs, P & Davey, T. 2012. *Broomberg on Tax Strategy*, 5th edition. Durban: LexisNexis at 252.

99 2003 (5) SA 344 (SCA), 65 SATC 346 at 349.

100 [2014] ZASCA 4.

of the income” and they have opened the door for a taxpayer to claim expenditure incurred as a deduction that was previously unthinkable before these decisions. These decisions can be regarded as victories for taxpayers and are in line with our constitutional principles of fairness and equity.

The judiciary has, it is submitted, at last broken the shackles of Watermeyer AJP’s narrow and restrictive interpretation of the phrase “in the production of the income” and has come to terms with and aligned the interpretation of the phrase to take into account the realities, *inter alia*, economic, social, statutory and other requirements, of doing business in the 21<sup>st</sup> century. Perhaps the old Latin adage *tempora mutantur et nos mutamur in illis*<sup>101</sup> is appropriate to describe this subtle change in interpretation over time.

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