THE SUPREME COURT OF APPEAL OF SOUTH AFRICA

REPORTABLE

Case no: 277/02

In the matter between

WARNER LAMBERT SA (PTY) LTD **APPELLANT**

and

COMMISSIONER FOR THE SOUTH AFRICAN REVENUE SERVICE **RESPONDENT**

Coram: HOWIE P, SCHUTZ, CONRADIE, LEWIS JJA and MLAMBO AJA

Heard: 16 MAY 2003

Delivered: 30 MAY 2003

Summary: Whether social responsibility expenditure which the appellant was by United States legislation obliged to incur in South Africa was expenditure laid out for the purposes of trade and, if so, whether it was of a capital or a revenue nature

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JUDGMENT

CONRADIE JA

CONRADIE JA

[1] Reverend Sullivan was an anti-apartheid activist. He became known for his 'Sullivan Principles'. There were seven of them. They were assembled into a code intended to govern the conduct of their business by American companies trading in apartheid South Africa. One realizes with the bewilderment of hindsight that they were at the time considered by many South Africans to be revolutionary. They were actually sensible and most American companies operating in this country adopted them. The appellant was one of these companies. It joined an association of local signatories of the Sullivan Code in Cape Town in 1978 and became an enthusiastic participant. Its senior management devoted much time to what were called 'social responsibility projects' that eventually consumed amounts - dictated by the Sullivan Code - equivalent to 12% of the appellant's payroll. All in all the appellant was a model of compliance. Each year when its performance was assessed in the United States it attained a mark of one, the highest it could get.

[2] In 1986 the United States Congress passed the Comprehensive Anti-Apartheid Act, a measure which was, largely, intended to add statutory compulsion to compliance with the Sullivan Code. American parent companies had to see to it that their South African subsidiaries complied with the Act or the Code (the choice was that of the US company). If they did not they were liable to fines in the United States and their directors might even be imprisoned.

[3] The dispute between the parties is whether the amount of social responsibility expenditure claimed as a deduction by the appellant in respect of its

1990 to 1993 years of assessment is deductible under section 11(a) read with section 23(g) of the Income Tax Act 58 of 1962 ('the Act'). The Commissioner first allowed the deductions but then in revised assessments disallowed them on the basis that the expenditure had not been incurred in the production of the appellant's income. The appellant objected to the revised assessments. When its objection was overruled, it appealed to the Cape Special Income Tax Court where Davis J, assuming in favour of the appellant that the expenditure had been incurred in the production of income, found that it had been capital in nature and for that reason dismissed the appeal and confirmed the assessments.

[4] 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 programs, increasing the number of disadvantaged persons in management and supervisory positions and improving the quality of employees' lives outside the work environment. In large measure, therefore, the Sullivan Code expenses were clearly deductible in arriving at the appellant's taxable income. The social responsibility expenses now claimed by the appellant as deductions were the expenses incurred in 'Working to Eliminate Laws and Customs that Impede Social, Economic, and Political Justice.' This was the seventh and last and only fiscally troublesome principle of the Sullivan Code.

[5] The appellant's case is that it was instructed by its United States parent, a pharmaceutical company listed on Wall Street, to incur the expenses that went with the performance of its Sullivan Code obligations. Compliance was of such importance to the foreign directors that there was the possibility of disagreeable consequences for the appellant if it failed sufficiently to exert itself in this field. To save itself from political embarrassment and to protect its own business in the United States the American parent might either close down the appellant's business (as Kodak did with its South African business) or sell the appellant's concern to someone else (as Mobil Oil did). If this had happened and the appellant was no longer a subsidiary of the United States parent it might not have had access to its raw materials, trading stock, know-how and technology (which would impede its domestic growth) and it would be hamstrung in expanding into the rest of Africa (from which the parent company was withdrawing).

In short, the appellant would almost certainly have suffered a loss of income.

[6] In seeking to discharge the onus of proving that its social responsibility expenses were deductible in terms of s 11(a) and s 23(g) of the Act the appellant relied on the evidence of its financial director. He testified that the appellant's involvement in social upliftment included participation in national conventions, peace initiatives, providing information technology support, adopting schools and helping small businesses start up operations.

[7] Deductible expenditure has certain characteristics: it must be incurred in the production of income (s 11(a)) and will not be allowed as a deduction against gross income if it is not laid out or expended for the purposes of trade. Up to and including the 1992 year of assessment such moneys must have been 'wholly or exclusively laid out or expended for the purposes of trade' (s 23(g). From the 1993 year of assessment onwards expenditure was not permitted as a deduction save 'to the extent to which such moneys were…laid out or expended for the purposes of trade.'

[8] In *Ticktin Timbers CC v Commissioner for Inland Revenue* 1999 (4) SA 939 (SCA) at 942F-G Hefer JA called the purpose for which expenditure was incurred, 'the decisive consideration in the application of 23 (g)'. He quoted the following passage from the judgment of Corbett JA in *Commissioner for Inland Revenue v Standard Bank of South Africa Ltd* 1985 (4) SA 485(A) at 500H-J:

> 'Generally, in deciding whether money outlayed by a taxpayer constitute expenditure incurred in the production of income (in terms of the general deduction formula) important and sometimes overriding factors are the purpose of the expenditure and what the expenditure actually effects; and in this regard the closeness of the connection between the expenditure and the income-earning operations must be assessed.'

[9] As to how close this connection must be, the court in *Port Elizabeth Electric Tramway Co v Commissioner for Inland Revenue* 1936 CPD 241 explained that '…income is produced by the performance of a series of acts and attendant upon them are expenses. Such expenses are deductible expenses provided that they are so closely linked to such acts as to be regarded as part of the cost of performing them... The purpose of the act entailing expenditure must be looked to. If it is performed for the purpose of earning income, then the expenditure attendant upon it is deductible' (at 245).

[10] The respondent argues that the kind of Sullivan Code expenditure that the appellant seeks to deduct served three purposes. One of these was the saving of the parent company from embarrassment and possible economic reprisals in the United States and elsewhere. There was also an altruistic purpose. This is shown by the fact that after the repeal of the Comprehensive Anti-Apartheid Act the appellant continued to incur the same expenditure, although on a smaller scale. The third purpose of the expenditure was to protect the appellant's income - earning structure; only the last, according to the respondent's counsel, qualified as expenditure laid out for the purposes of trade.

[11] Money spent by a taxpayer in order to advance the interests of the group of companies to which it belongs is not regarded as expenditure in the production of income. The link between the expenditure and the production of income is too tenuous. This has been firmly established in *Solaglass Finance Company (Pty) Ltd v Commissioner for Inland Revenue* 1991 (2) SA 257(A). Moneys expended by a taxpayer from motives of pure liberality also fail to qualify as expenditure in the production of income. This was reconfirmed in *Commissioner for Inland Revenue v Pick 'n Pay Wholesalers (Pty) Ltd* 1987 (3) SA 453 (A). If the Sullivan expenditure was incurred for either of these purposes, the appeal would fail. If it was partly incurred for either of these purposes the appeal in respect of the 1990 to 1992 assessments would fail for lack of proof that the Sullivan Code moneys had been wholly and exclusively expended for the purposes of trade. In relation to the 1993 year of assessment it would fail for want of proof of the extent to which the expenditure had been incurred for the purposes of trade. What is more, if the respondent is correct that the expenditure, although incurred for the purposes of trade, was of a capital nature, the appeal would fail for that reason as well.

[12] As I have said earlier, it is uncontested that some of the Sullivan Code expenditure - wage improvements and expenses of that kind - was incurred in the production of income. This expenditure was incurred with the same motives and produced exactly the same results as the social responsibility expenditure: it reduced the risk that the appellant might lose its privileged subsidiary status, it benefited the underprivileged and it pleased the American parent. If the respondent's argument is to be accepted it would mean that this admittedly deductible expenditure was also incurred for mixed purposes and should therefore not have been allowed. For although the doctrine of dominant purpose may swing the verdict one way or the other in the capital versus revenue contest, it is inapplicable in any contest between expenditure for trade or for other purposes (*Mallalieu v Drummond (Inspector of Taxes)* [1983] 2 All E R 1095 (HL) at 1099j).

[13] It is quite easy to mistake the purpose of an act for its consequences. This may have been what happened in *ITC 1706* 63 SATC 334 but it is difficult to tell since the evidence was, of course, different. Botha JA emphasized the point when he said in the *Solaglass* case *supra* at 281D-E:

'The truth is, in my judgment, that there are no hard and fast rules for deciding whether a taxpayer's expenditure falls within or outside the ambit of the section [s 23(g)]; it is not possible to devise any precise universal test for determining whether expenditure comprises moneys 'exclusively laid or expended for the purposes of trade'. In general, one can say no more than that the issue is to be resolved by examining the particular facts of each individual case.'

[14] The consequences of an act often proclaim its purpose. After all, a person is presumed to have intended the natural consequences of his acts. Nevertheless, a court must look carefully at the evidence. If there is credible evidence about a taxpayer's purpose it is not open to the court to turn what is in reality a consequence into a purpose and ascribe that to the taxpayer. 'In a tax case,' says Smalberger JA in *CIR v Pick 'n Pay Employee Share Purchase Trust* 1992 (4) SA 39 (A) at 58F-H, 'one is not concerned with what possibilities, apart from his actual purpose, the taxpayer foresaw and with which he reconciled himself. One is solely concerned with his object, his aim, his actual purpose.' As Lord Brightman explains in a passage from *Mallalieu's* case *supra*, (at 1100a) 'An expenditure may be made exclusively to serve the purposes of the business, but it may have a private advantage.'

[15] The evidence for the appellant is to the effect that the purpose of the Sullivan Code expenditure - all the Sullivan Code expenditure, not merely the social responsibility expenditure - was to insure against the risk of losing its treasured subsidiary status. If, therefore, the purpose of the admittedly deductible expenditure and that of the contested expenditure was the same, their tax treatment should also be the same. Both were expended in the production of income or neither was.

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

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

A loss of the appellant's subsidiary status might have directly brought about the loss of all kinds of trade advantages. It was unthinkable that the appellant should not comply with the Sullivan Code at all. It was not certain what would become of it if it complied but failed to do so adequately; but the appellant was not obliged, and if the truth be told would not have been permitted, to take the risk of finding out. The Sullivan Code expenses were *bona fide* incurred for the performance of the appellant's income producing operation and formed part of the cost of performing it. The social responsibility expenditure was therefore incurred for the purposes of trade and for no other.

[17] The social responsibility expenses incurred by the appellant were seen by the court *a quo* as a capital expenditure. Its counsel submitted, correctly, that there was no question here of the creation or improvement of a capital asset in the hands of the appellant. That is not conclusive, for as Ogilvie Thompson JA pointed out in *Secretary for Inland Revenue v Cadac Engineering Works (Pty) Ltd* 1965 (2) SA 511 (A) at 522H-523 I '…the mere circumstance that a payment has neither created a new asset nor made any addition to an existing asset is not necessarily conclusive in favour of such payment being a revenue expense.' I agree that it may not be conclusive, but it is a consideration of considerable importance in assessing on the one hand the 'closeness of the connection between the expenditure and the income-earning operations' (per Schreiner JA in *Commissioner for Inland Revenue v Genn & Co (Pty) Ltd* 1955 (3) SA 293 (A) at 299G, and on the other hand whether there is '…a relation between expenditure and capital close enough to draw the expenditure into the ambit of capital' (per Steyn CJ in *Smith v Secretary for Inland Revenue* 1968 (2) SA 480 (A) at 488C-D). Where no new asset (for the enduring benefit of the trading operation) has been created any questioned expenditure naturally tends to assume more of a revenue character.

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

[19] I should say in conclusion that the issue of whether or not the Commissioner ought in the Special Court to have been permitted to rely on the contention that the Sullivan Code expenses were of a capital nature when he had as part of his 'decision' in issuing his revised assessments, determined that they had not been incurred for the purposes of the appellant's trade, was not raised before us. That is just as well. The point has no merit. Unless it had been conceded that the expenses were of a revenue nature, the appellant could not have succeeded in its appeal before the Special Court without demonstrating that the expenses incurred by it had all the attributes necessary for deduction under s 11(a). That would be so whether the point had previously been determined by the Commissioner or not.

[20] The appeal succeeds with costs which include the costs of two counsel where two counsel were employed. The order of the Special Court is altered to read: 'The appeal is allowed. The Commissioner is to issue revised assessments in respect of the appellant's 1990 to 1993 assessments allowing the expenditure in question as a deduction.'

J H CONRADIE
JUDGE OF APPEAL

HOWIE P	**)CONCUR**
SCHUTZ JA	**)**
LEWIS JA	**)**
MLAMBO AJA	**)**