IN THE TAX COURT OF SOUTH AFRICA
(GAUTENG SOUTH DIVISION)

CASE NUMBER: 12 401

Date of hearing 11-13 May 2009
Date of judgment 15 March 2010

In the matter between

XYZ HOLDINGS (PTY) LTD Appellant

and

THE COMMISSIONER FOR THE SOUTH AFRICAN REVENUE SERVICE Respondent

---

JUDGMENT

Gildenhuys J

[1] This is an appeal against additional income tax assessments in respect of the appellant's 2001, 2002, 2003 and 2004 years of assessment, in which the respondent has disallowed the deduction of certain expenditure.

[2] All the shares in the appellant are held by a listed public company. The appellant, in turn, is the holding company of five fully owned subsidiary companies. It also has a number of indirectly held subsidiaries. The collective business of the companies ("the Group") is the operation of mobile communications networks, the provision of related services and the performance of related functions. The appellant is an

investor in shares and a lender of funds, primarily in the context of a debenture scheme arrangement which exists in relation to companies within the Group and their staff members[1], but also in wider contexts.

[3] The appellant submitted income tax returns supported by detailed statements for the 2001 to 2004 tax years. The revenue[2] for those years, as summarised in Exhibit C, are as follows:

Source of Revenue	**2001**	**2002**	**2003**	**2004**
Dividends	R 170,000,000	R 350,000,000	R 1,125,273,121	R 717,000,000
Interest	R 21,765,415	R 22,223,856	R 21,636,279	R 6,000,000
TOTAL INCOME	R 191,765,415	R 372,223,856	R 1,146,909,400	R 723,000,000

[4] The percentage of total revenue derived from dividends and from interest for the relevant tax years are as follows:

[1] In par 12 of the appellant's Statement of Grounds of Appeal it is stated that the appellant's involvement in the scheme includes the generation of capital through the issue of debentures. The debentures attracted a low rate of interest. The capital so generated was on-lent by the appellant to other companies in the Group at a higher rate of interest. This resulted in a net interest gain for the appellant.

[2] By "revenue" I mean income in the wide sense, not restricted to the narrow meaning given to the term "income" in sec 1 of the Income Tax Act, 1962.

Tax Year	Revenue from dividends	Revenue from interest
2001	89% of total revenue	11% of total revenue
2002	94% of total revenue	6% of total revenue
2003	98% of total revenue	2% of total revenue
2004	99% of total revenue	1% of total revenue

[5] The appellant claimed deductions of certain expenses for the relevant tax years.[3] The expenses at issue in these proceedings, which were disallowed in full or in part, are as follows:

Expenses	2001	2002	2003	2004
Audit Fees	R 365,505	R 647,770	R 427,871	R 233,786
Audit fees disallowed	R 323,884 (89%)	R 609,094 (94%)	R 419,799 (98%)	R 231,826 (99%)
Professional fees (for consulting)				R 878,142
Professional fees disallowed				R 878,142 (100%)

[3] There are discrepancies between the amounts of some adjustments listed in the respondent's letter setting forth the calculation of the appellant's taxable income (page 459 of the court bundle) and the amounts for the same items contained in Annexure A to the respondent's *Statements of Grounds of Assessment*. I have relied on the amounts set forth in the first-mentioned document.

The audit fees incurred by the appellant relate to revenue from dividends, as well as revenue from interest. The respondent apportioned the audit fees in accordance with the ratio between dividends received and interest earned, and disallowed the portion allocated to dividends received. In the result, the bulk of the expenditure for audit fees was disallowed.

[6] Although dividends constituted the bulk of the appellant's revenue for each of the four tax years, the auditors estimated that only about 6% of the audit was devoted to auditing the revenue from dividends.[4] The appellant also demonstrated that, on an analysis of the number of postings to the various accounts on a journal level for each of the relevant tax years, only 9%, 6%, 5% and 4.5% respectively of its transactions relate to dividends; the balance of the entries relate to the acquisition of interest income and to other items.[5]

[7] The following provisions of the Income Tax Act No 58 of 1962 are relevant for purposes of this judgment:

- The definition of "income" in sec 1 of the Income Tax Act, according to which "income" means:

> "The amount remaining of the gross income of any person for any year or period of assessment after deducting therefrom any amounts exempt from normal tax under Part I of Chapter II."

[4] Court bundle, p 391.
[5] Court bundle, p 478.

- Sec 11(a) of the Act, under which the following deductions from "income" are allowed:

> "For the purpose of determining the taxable income derived by any person from carrying on any trade, there shall be allowed as deductions from the income of such person so derived-
>
> (a) expenditure and losses actually incurred in the production of the income, provided such expenditure and losses are not of a capital nature…"
>
> *(emphasis added)*

- Sec 23 (f) and (g) of the Act, whereunder the following items of expenditure may not be deducted from "income":

> "(f) any expenses incurred in respect of any amounts received or accrued which do not constitute income as defined in section one;
>
> (g) any moneys claimed as a deduction from income derived from trade, to the extent to which such moneys were not laid out or expended for the purposes of trade;"
>
> *(emphasis added)*

[8] The essential issues before the Court are –

- Whether and to what extent the disallowed audit and professional fees were incurred by the appellant "*in the production of income*" as required under sec 11(a) read with sec 23(f) of the Income Tax Act; and
- whether or not the disallowed professional fees were "*of a capital nature*", as contemplated in sec 11(a) of the Income Tax Act.

[9] It is common cause between the parties that –

- the interest received by the appellant was in respect of loans made by it, and that such interest are "*income*" as defined in sec 1 of the Act;
- the dividends received by the appellant are not "*income*" as defined;
- the professional fees included in the disallowed expendure was incurred by the appellant in obtaining assistance from a firm of auditors (KMPG) in relation to a new computer system known as the "*hyperion system*"; and
- the appellant has traded during each of the tax years concerned[6].

[10] I will commence by considering the disallowance of expenditure relating to the audit fees. I turn to the first issue, *viz* whether the audit fees were incurred in the production of "income" (as defined), or in respect of dividends, or for both purposes.

[11] It was held in *Port Elizabeth Tramway Co Ltd v* CIR, 1936 CPD 241[7] at 246 that, generally speaking,

[6] Minutes of the pre-trial conference, page 6.
[7] Also cited as 8 SATC 13.

> "…all expenses attached to the performance of a business operation *bona fide* performed for the purpose of earning income are deductible, irrespective of whether such expenses are necessary for its performance or attached to it by chance or are *bona fide* incurred for the efficient conduct of such business operation, provided they are so closely linked to it that they can be regarded as part of the cost of performing it."

It is not necessary for the expenditure to have been causally connected to the income to render it deductible under sec 11 (a). Schreiner J said in *CIR v Drakensberg Garden Hotel (Pty) Ltd,* 1960 (2) SA 475 (A) at 479H–480A that –

> "To be deductible the expenditure must have been actually incurred in the production of income, it must not be of a capital nature and it must have been wholly or exclusively laid out for the purpose of trade. It need not, however, have been causally related to the income which is the subject of the assessment in question."

The expenditure must, however, have some connection to the income-earning operations of the taxpayer to render it deductible. In *Commissioner for Inland Revenue v Genn & Co (Pty) Ltd*, 1955 (3) SA 293 (A), Schreiner J stated (at 229) that –

> "In deciding how the expenditure should properly be regarded the court has to assess the closeness of the connection between the expenditure and the income-earning operations, having regard both to the purpose of the expenditure and to what it actually effects."

(emphasis added)

[12] The respondent submitted that, in order to determine whether a specific expenditure is incurred in the production of income, it has to pass the following test dual test:

- The expenditure must have been incurred for the purpose of producing income. This is the subjective leg of the test. It should be assessed by considering the stated intention of the taxpayer at the time when the expenditum was incurred.
- The effect of the expenditure must have been to produce income. This is the objective leg of the test. It requires a direct *nexus* between the expenditure and the income.

[13] Mr Koekemoer, who appeared on behalf of the respondent, pointed out that under company law the appellant is obliged to appoint an auditor and to have its financial records audited.[8] The respondent is must comply with this statutory obligation, irrespective of whether or not it intends to earn income. The mere fact that a taxpayer is by law required to perform certain acts does not necessarily mean that the costs of performing those acts are expenditure incurred in the production of income.[9] The duty to incur expenditure for auditing, so Mr Koekemoer argued, follows the type of corporate entity adopted. I cannot accept this submission. The appellant as a legal *persona* is not responsible for the corporate identity which it bears.

[8] Section 269 read with sections 282, 300, 300A and 301 of the Companies Act No 61 of 1973 and section 20 of the Public Accountants' and Auditors' Act No 80 of 1991.

[9] CSARS v Akharwary 68 SATC 41.

[14] The *criterium* for determining whether expenditure was incurred in the production of income is, in my view, whether the expenditure was connected to the taxpayer's income earning operations, rather than whether the expenditure actually produced income or was directly linked to income. In *Joffe & Co Ltd v Commissioner for Inland Revenue,* 1946 AD 157, Watermeyer J held (at 163) that –

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

[15] The auditing of financial records is clearly a function which is "necessarily attached" to the performance of the appellant's income-earning operations. The absence of any revenue directly attributable to the audit does not entail that moneys laid out for the audit have not been expended for purposes of earning income.[10]Apart from the statutory obligation to audit, audited financial statements are also necessary to comply with the requirements of the Johannesburg Stock Exchange, to give comfort to creditors and to access further funding as and when it may be required for the appellant's business.

[10] *Cf* the judgment of Corbett JA in *de Beers Holdings v Commissioner for Inland Revenue,* 1986 (1) SA 8 at 36H-J.

[16] Expenditure may be incurred for a dual purpose, namely for producing "income" (as defined) and for producing revenue which are not "income" (*eg* exempt dividends). In such circumstances the Courts may apportion the expenditure between the two purposes.[11] This approach finds support in the judgment of Corbett J A in the case of *Commissioner for Inland Revenue v Nemojim,* 1983 (4) SA 935 (A). The learned Judge held as follows (at 951B-E):

> "As pointed out in the *Rand Selections* case *supra*[12] at 131E-G, the Income Tax Act makes no provision for apportionment. Nevertheless, apart from the *Rand Selections* case, it is a device which has previously been resorted to where expenditure in a globular sum has been incurred by a taxpayer for two purposes, one of which qualifies for deduction and one of which does not (see eg *Schonegevel v Commissioner for Inland Revenue* 1937 CPD 258; *Income Tax Case No 832 21* SATC 320; *Secretary for Inland Revenue v Guardian Assurance Holdings (SA) Ltd* 1976 (4) SA 522 (A); *Borstlap v Sekretaris van Binnelandse Inkomste* 1981 (4) SA 836 (A)). It is a practical solution to what otherwise could be an intractable problem and in a situation where the only other answers, *viz* disallowance of the whole amount of expenditure or allowance of the whole thereof, would produce inequity or anomaly one way or the other. In making such an apportionment the Court considers what would be fair and reasonable in all the circumstances of the case."
>
> (my underlining)

Over time, the courts applied various *formulae* to achieve a fair apportionment.

[11] See *Secretary for Inland Revenue v Guardian Assurance Holdings Ltd,* 1976 (4) SA 522 (AD) at 533F-H and *Borstlap v Sekretaris van Binnelandse Inkomste*, 1981 (4) SA 836 (AD) at 849 E-G.
[12] *Commissioner for Inland Revenue v Rand Selections Corporation Ltd,* 1956 (3) SA 124 (A).

> "For example, in one case an apportionment based on the proportion which the different types of income bear to the total income might be proper. In another case, such an apportionment might be grossly unfair. For example, the bulk of the expenditure may be devoted exclusively to operations intended to earn income that in fact earn very little income, whereas from operations that incurred little expense, relatively large non-taxable amounts are earned. In such a case, to apportion the bulk of expenses to the non-taxable amounts would be unfair.
>
> In another case a fair method of apportionment might be to take the proportion that the capital invested in the operations earning the non-taxable amount bears to the total capital invested."[13]

[17] In *Commissioner for Inland Revenue v Rand Selections Corporation Ltd,* 1956 (3) SA 124 (A), the taxpayer received "income" (as defined) and dividends. It sought to deduct certain expenditure which were incurred in respect of both the "income" and the dividends. Centlivres CJ (who delivered the majority judgment) held that only a portion of the expenditure, *viz* that which is related to "income", may be deducted,

> "…but in my opinion, it was not legally competent for him to allow as a deduction from the "income" an amount which is arbitrary. In my opinion the obvious method of apportioning the expenditure is to adopt the following formula (X being the expenditure incurred, Y the amount of "income" and Z the amount of the "dividend"):
>
> $$X \text{ multiplied by } \frac{Y}{Y \text{ plus } Z}$$ "

[13] *Apportionment of Expenditure: Investment Companies*, 1973 (12) Income Tax Reporter 273.

[18] In *Commissioner for Inland Revenue v Nemojim (Pty) Ltd* (*supra*), the facts were as follows (I quote from the headnote):

> "One R, acting through the medium of the respondent company, sought out and purchased dormant companies with substantial cash reserves available for distribution. The *modus operandi* was to cause the company to declare a dividend distributing the total cash reserve as soon as the shares in the company had been transferred into the name of the respondent company, and then to resell the shares in the "stripped" company – the so-called "shell". The dividend and the resale price of the shares constituted in each case the proceeds of the transaction as a whole. In each case the dividend constituted by far the major component of such proceeds and was a *sine qua non* to the profitability of the transaction. …..The issue which arose in this appeal from the Natal Income Tax Special Court was, in essence, whether the respondent company …… was entitled, in calculating its taxable income, to deduct from the income derived by it from the sale of shares the full cost of the acquisition of those shares. If it were allowed to do so, it would in effect be entitled to claim a substantial assessed loss on the overall transaction: the cost of acquisition was generally far greater than the price realised on resale of the shares and the dividends "stripped" from the purchased company were exempt from tax".

Corbett JA, who delivered the Court's judgment, applied the following formula for determining the extent of deductible expenses (at 958D-F of the judgment):

"$A = (B + C) \times \frac{D}{D + E}$

where A = deductible expenses

B = general expenses relating to share-dealing

C = total cost of acquisition of shares in companies subjected to dividend stripping in tax year

D = total proceeds of the sale of such shares

E = total dividends received in respect of such shares."

[19] In *Kommisaris van Binnelandse Inkomste v van Blommestein,* 1999 (2) SA 367 (SCA), the taxpayer inherited certain assets from his father. Some of the assets were income-producing, others not. The inheritance was subject to the condition that he pays a bequest price to his two sisters over a period of ten years, the outstanding amount to bear the interest. It was held that, because the income producing assets came to 60% of the taxpayer's inheritance, the taxpayer was entitled to a 60% deduction of the interest paid by him.[14]

[20] In *Income Tax Case No* 1589,[15] the Zimbabwe Special Court considered an objection against the disallowance of certain expenditure which related partially to revenue from dividends. The Commissioner calculated the disallowance by using the following formula:[16]

$$\frac{A}{B} \times B$$

Where

A = value of dividend producing assets

[14] See also *Income Tax Case No 1144*, 32 SATC 272, *Income Tax Case 1017*, 25 SATC 337 and *Income Tax Case 832*, 21 SATC 320, where corresponding methods of apportionment were applied.

[15] 57 SATC 153.

[16] Page 156 of the judgment.

B = value of total assets
C = relevant expenses

The taxpayer objected to the formula on the basis that the maximum amount of expenditure incurred by it for the purpose of receiving tax-exempt dividends would have been $1000. In the course of this judgment, Smith J observed (at p 158):

> "It does not seem possible to me to lay down any general rules as to how the apportionment should be made, other than saying that the apportionment must be *fair* and *reasonable, having regard to all the circumstances of the case.* For example, in one case an apportionment based on the proportion which the different types of income bear to the total income might be proper, as was done in the *Rand Selections Corporation case, supra.* In another case, however, such an apportionment might be grossly unfair; for example, in the case where the bulk of the expenditure was clearly devoted exclusively to operations intended to earn income, but which unfortunately in fact earned very little income, with the result that in the particular year of assessment the company earned very little "income", but from operations which incurred little expense earned relatively large non-taxable amounts. In such a case to apportion the bulk of the expenses to the non-taxable amounts would be unfair. In another case a fair method of apportionment might be to take the proportion which the capital invested in the operations earning the non-taxable amount bears to the total capital invested, as was done in ITC No 382 of 1956 *supra*"

The court then came to the following conclusion (at p 160):

> "With regard to the 'dividend receiving' operations of the appellant, as Mr *de Bourbon* pointed out, the appellant takes no active steps to produce the income. The dividends are declared and paid by the company concerned and the only function

> performed by the appellant in relation thereto is to bank the cheques and make the relevant entries in the journal and the cash book. The work involved in relation to each dividend is the same, whether the dividend is $10, $1 000 or $1 000 000. ………I agree with the concession made by Mr *de Bourbon* that there must be some apportionment. I consider that the figure of $1 000 suggested by the appellant is fair and reasonable in the circumstances."

[21] In all the above cases, the apportionment had an arithmetic basis, either through the use of a formula, or by allocating specific components of expenditure to deductible and non-deductible categories. Circumstance may occur, however, where it is not possible to devise a fair and reasonable formula, and also not possible to break down the expenditure into deductible and non-deductible components. In a case where the apportionment of expenditure between revenue and capital was at issue, *Tuck v Commissioner for Inland Revenue*, 1988 (3) SA 819 (A), Corbett CJ said at 834J-835B:

> "The problem in this case is to establish an acceptable basis of apportionment. The appellant has all along suggested apportionment on a 50/50 basis; and this was Mr *Welsh's* suggestion to us. Having regard to the inherent nature of the receipt and its origin in the plan, it is not possible to find an arithmetical basis for appointment (*cf Commissioner for Inland Revenue v Rand Selections Corporation Ltd* 1956 (3) SA 124 (A) at 131; the *Nemojin* case *supra at 958)* but I do not think this should constitute an insuperable obstacle."

The learned judge then weighed the comparative importance of each element of expenditure against the other, and held (at 835G):

"It is not possible to infer that the one element is more important than the other and, in all the circumstances, I consider that a 50/50 apportionment would be fair and reasonable."

[22] In order to weigh up the relative importance of a company's annual audit for its interest income as against its dividend income, regard should be had to the duties of a company's auditor, as set forth in sec 300 of the Companies Act, 1973. Sec 300 reads as follows:

"It shall be the duty of the auditor of a company –

(a) to examine the annual financial statements and group annual financial statements to be laid before its annual general meeting;

(b) to satisfy himself that proper accounting records as required by this Act have been kept by the company and that proper returns adequate for the purpose of his audit have been received from branches not visited by him;

(c) to satisfy himself that the minute books and attendance registers in respect of meetings of the company and of directors and managers have been kept in proper form as required by this Act;

(d) to satisfy himself that a register of interests in contracts as required by section 240 has been kept and that the entries therein are in accord with the minutes of directors' meetings;

(e) to examine or satisfy himself as to the existence of any securities of the company;

(f) to obtain all the information and explanations which to the best of his knowledge and belief are necessary for the purposes of carrying out his duties;

(g) to satisfy himself that the company's annual financial statements are in agreement with its accounting records and returns;

(h) to examine group annual financial statements and satisfy himself that they comply with the requirements of this Act;

(i) to examine such accounting records of the company and carry out such tests in respect of such records and such other auditing procedures as he considers necessary in order to satisfy himself that the annual financial statements or group annual financial statements fairly present the financial position of the company or of the company and its subsidiaries and the results of its operations and those of its subsidiaries, in conformity with generally accepted accounting practice applied on a basis consistent with that of the preceding year;

(j) to satisfy himself that statements made by the directors in their reports do not conflict with a fair interpretation or distort the meaning of the annual financial statements and accompanying notes;

(jA) when he gets to know, or has reason to believe, that the company is not carrying on business or is not in operation and has no intention of resuming operations in the foreseeable future, to report forthwith accordingly by registered post to the Registrar;

(k) to comply with any other duty imposed on him by this Act; and

(l) to comply with any applicable requirements of the Public Accountings' and Auditors Act, 1991 (Act 80 of 1991)."

[23] The appellant submitted evidence that only about 6% of the time spent by the auditors on their audit was in respect of revenue from dividends[17]. In contrast, much work was done in respect of the appellant's interest income. The appellant furthermore says that on average only about 6% of the entries in the appellant's cash book and ledgers relate to dividends. The appellant therefore submits that only

[17] See par 6.15 of the appellant's *Statement of Grounds of Appeal* and, in general, the testimony of Mr Steyn, an auditor who was involved in the appellant's 2006 audit.

6% of the expenditure on audit fees should be disallowed. It is significant, however, that the appellant's dividend receipts over the four tax years constituted on average about 95% of its total revenue.[18] It must also be remembered that the duties of the auditors extend far beyond the verification of interest "income" and dividend receipts. An apportionment of the audit fees based on the ratios which the different categories of revenue bear to the total revenue, which the respondent applied, is in my view unfair in the circumstances of this case, given that the bulk of the appellant's income is derived from dividends. The auditors, on the other hand, spent much more time on auditing the rental "income" than in auditing dividend receipts. Neither the ratio suggested by the appellant nor the ratio applied by the respondent can, in my view, constitute a fair basis of an apportionment of the audit fees.

[24] Prof J L Pretorius, in an article "*Die rol en funksie van die maatskappy-ouditeur by finansiële verslagdoening*"[19], said the following:

> Indien die rol van die Suid-Afrikaanse maatskappy-ouditeur van naderby beskou word, blyk dit dat die oogmerk van die ouditfunksie is om die belange van aandeelhouers, potensiele aandeelhouers, skuldeisers, en trouens alle beleggers te beskerm.

The audit function is, in the light of the much larger amounts of money involved in the appellant's dividend producing operations than in its interest producing operations, and bearing in mind the purpose of auditing as described by Prof

[18] See the table in par [4] above.
[19] 1986 *Modern Business Law* 82 at 90.

Pretorius, of greater importance for its dividend producing operations than for its interest producing operations.

[25] Mr DA Steyn, an auditor and erstwhile partner of Siswe and Seluba who was involved in the 2006 audit, testified that an audit is not made up of distinct measurable units. The biggest work in the 2006 audit related to the consolidation of accounts. An audit fee is not based only on time. It is not determined solely in accordance with the charge-out rates of the various persons performing the audit. The risk involved and the complexity of the audit are also taken into account.

[26] Since neither the appellant nor the respondent suggested an acceptable basis of appointment, I am free to devise a basis which would in my view be fair.[20] All in all, I am of the view that a 50/50 apportionment of the audit fees would be just and equitable. It will recognise not only the greater importance of the audit for the dividend earning operations, but also the longer time spent by the auditors on the interest earning operations. In the result, the appellant would be entitled to claim 50% of the audit fees as a deduction from "income" in respect of each of the four years of assessment.

[27] I turn to the disallowed professional fees. The expense was incurred to obtain assistance from outside consultants (KMPG auditors) with the operation of the

---

[20] Sec 83(13) of the Income Tax Act.

Hyperion computer system. The respondent contends that the expenditure is not deductible because it does not meet the following prerequisites:[21]

- it was not incurred in carrying on any trade ;
- it was not incurred in the production of 'income" (as defined), because there is no link between the 'income' (consisting of interest) and the expense; and
- the expense is of a capital nature.

[28] The appellant says, in its *Statement of Grounds of Appeal,* that the Hyperion management system was introduced in the 2004 tax year to effectively capture, record and index certain aspects related to its financial affairs. The system also aids in the consolidation of its financial results and the reporting thereof to the Group.[22] According to the *Statement of Grounds of Appeal,* the professional fees payable by the appellant to the consulting auditors (KPMG) –

> "……..was in relation to services rendered by the auditors in respect of the implementation, adjustment, fine tuning and user operation of the system."[23]

[21] Required under sec 11(a), 23(f) and 23(g) of the Income Tax Act.
[22] Par 6.20 of the *Statement of Grounds of Appeal.*
[23] Par 6.21 of the *Statement of Grounds of Appeal.*

[29] Mr G, a general manager in the Group, testified at the hearing that the Hyperion system facilitates and expedites the consolidation of accounts, thereby reducing audit costs. It is also used for budgets and forecasts, and to produce the management accounts required by the Group's auditors, Siswe Seluba. According to Mr G, the consulting auditors (KPMG) were employed to assist with the operation of the system and to teach staff how to run it. Mr DA Steyn, an auditor previously with Siswe Seluba, described the Hyperion system as an "consolidation tool". Ms S, financial manager of the group, testified that the Hyperion system is used for budgeting, forecasting and reporting, and also for reports to the Group's financiers. Its use in respect of "income" (interest) is minimal and coincidental. Its function, in the main, is reporting and consolidation. The consulting auditors were brought in to assist the staff operating the system to understand the system, and to teach them how to use it. The consulting auditors could not and did not adapt the system.

[30] The witnesses who testified on behalf of the appellant were vague and unclear on exactly what services the consulting auditors rendered. The services were described in the *Statement of Grounds of Appeal* to be the "*implementation, adjustment, fine tuning and user operation"* of the system. [24] In my view, the appellant is bound by this description. There was no application to amend the *Grounds of Appeal.*

[31] I will first consider whether the professional fees were expenditure of a capital nature. It was held by *Ogilvie Thompson JA in Secretary for Inland Revenue v Cadac Engineering Works (Pty) Ltd,* 1965 (2) SA 511 (AD) at 521H, that expenditure

[24] Par 6.21 of the *Statement of Grounds of Appeal.*

"of a capital nature" eludes precise and comprehensive definition.[25] The learned judge quoted the following *dictum* of Watermeyer CJ in *New State Areas Ltd v Commissioner for Inland Revenue,* 1945 AD 610 at 627 as a general guide:

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

[32] In *Atlantic Refining Company of Africa (Pty) Ltd v Commissioner for Inland Revenue,* 1957 (2) SA 330 (A), Malan JA (at 334G) referred to this *dictum* as settling the law, with the remark that the difficulty lies in its application to the facts of particular cases. Clayden CJ, in *Nchanga Consolidated Copper Mines Ltd v Commissioner of Taxes,* 1962 (1) SA 381 (FC) also referred to this *dictum* (at 387C-D) but, as did Ogilvie Thompson JA in the *Cadac Engineering* case (*supra)*, preferred the term "income earning structure" to "income producing machine".

In the latest reported decision on this issue, *WJ Fourie Beleggings Bk v Commissioner, South African Revenue Services*, 2009 (5) SA 238 (SCA), Leach AJA underlined (at 241I-242B) that –

---

[25] See also *Sub-Nigel Ltd v Commissioner of Inland Revenue* 1948 (4) SA 580 (A) at 595.

> "…it has not been possible to devise a definitive or all-embracing test to determine whether a receipt or accrual is of a capital nature, despite the regularity with which the issue has arisen. At the same time, and although common sense has been described as 'that most blunt of intellectual instruments' it remains the most useful tool to use in deciding the issue."
>
> (footnotes omitted)

[33] Clayden CJ, in his judgment in the *Nchanga Copper Mines* case (*supra),* discussed the tests which were applied in a number of South African and English cases to determine whether expenses were attributable to revenue or to capital. The learned judge concluded that, as an initial approach and before reverting to other tests, it would be

> "…… proper first to try to determine whether, according to the true nature of the expenditure, it was made as part of the cost of performing the income earning operations or as part of the cost of the income earning machine or structure."

The case went on appeal to the Privy Council. The above *dictum* of Clayden CJ is consistent with what Viscount Radcliff said in his judgment in the appeal, reported *sv Commissioner of Taxes v Nchanga Consolidated Copper Mines Ltd,* 1964 (2) SA 472 (PC) at 477 A-B:

> Again Courts have stressed the importance of observing a demarcation between the cost of creating, acquiring or enlarging the permanent (which does not mean

> perpetual) structure of which the income is to be the produce or fruit and the cost of earning that income itself or performing the income earning operations. Probably this is as illuminating a line of distinction as the law by itself is likely to achieve.

The same *indiciae* have been used in several other judgments, for instance in *Commissioner, South African Revenue Service v BP South Africa (Pty) Ltd*, 2006 (5) SA 559 (SCA) at 568F-569A, and the cases referred to therein. See, however, *Rand Mines (Mining and Services) Ltd v Commissioner for Inland Revenue,* 1997 (1) SA 427 (A), in which case Marais JA pointed out (at 433H-J) that the *indiciae* identified by the Courts to distinguish between the two classes of expenditure are no more than that. Each case must be decided on its own particular facts.

[34] I turn to the facts of this case. According to the appellant –

> "……[the Hyperion] system was introduced by the Appellant in 2004 tax year in order to effectively capture, record and index certain aspects related to its financial affairs, and which system assists it in the conduct of its business, and which system aids also in the consolidation of its financial results and the reporting of its results to other companies within the XYZ Group."[26]

The costs of acquiring the Hyperion system is undoubtedly of a capital nature. It is part of the appellant's income earning structure.

[26] Appellant's *Statement of Grounds of Appeal,* par 6.20.

[35] The fees paid to the consulting auditors were, according to the *Statement of Grounds of Appeal,* for services relating to the "implementation, adjustments, fine tuning and user operation" of the system.[27] There is very little evidence to establish that such were the services which the consulting auditors did actually perform. The evidence centered on the alleged obligation of the consulting auditors to teach the staff to understand and operate the system. But be that as it may, it seems to me that the services were intended to add value to the appellant's income earning structure in the form of the Hyperion system. Such value remains intact from year to year.[28] Without it, the appellant would have been unable to utilise the system to its full extent, if at all.

[36] I was conceded by Ms S that the use of the Hyperion system in respect of "income" (as defined, *in casu* interest income) is minimal and coincidental. In my view, the services obtained from the consulting auditors enhanced the usefulness of the income earning structure for the appellant's rather than form part of the income earning operations.[29] In the words of Watermeyer CJ in the *New State Areas* case (*1945 AD 610* at 621*),* it is part of the costs of establishing or improving or adding to the income earning structure. Even if the services did not bring about any adaptation to the income earning structure (the Hyperion system), it undoubtedly added to its value by making the system accessible and user-friendly to the staff responsible for its operation.

---

[27] Par 21 of the *Statement.*

[28] Compare *Commissioner for Inland Revenue v George Forest Timber Company Ltd, 1924 AD 516.*

[29] Fees for services rendered by consultants which are connected to the establishment of an income earning structure was held to be of a capital nature and consequently disallowable. See *Income Tax Case No 703*, 17 SATC 208.

[37] In my view, the expenditure of R 878 142 in respect of fees paid to the consulting auditors constitutes an expense of a capital nature. In the light of this finding, it is not necessary for me to decide whether the expense was incurred in the production of “income” or in carrying on any trade.

[38] In summary, our finding is:

- 50% of the audit fees incurred for the 2001, 2002, 2003 and 2004 tax years is deductible from “income” (as defined) for those tax years.
- The expenditure of R 878 142 in respect of professional fees is of a capital nature and is therefore not deductible.

[39] I come to the issue of costs. Section 83 (17) of the Income Tax Act provides as follows:

> “(17) Where-
>
> (a) the claim of the Commissioner is held to be unreasonable;
>
> (b) the grounds of appeal of the appellant are held to be frivolous;
>
> the tax court may, on application by the aggrieved party, grant an order for costs in favour of that aggrieved party, which costs shall be determined in accordance with the fees prescribed by the rules of the High Court.”

The appellant applied for a cost order against the respondent on the basis that, up to the date of the pre-trail conference on 29 April 2009, the respondent persisted in its position that the appellant did not trade. It was only during the conference the respondent conceded the "trade argument", thereby accepting that the respondent did in fact trade.[30] The appellant submitted that, given this belated concession, the position adopted by the respondent in the *Statement of Grounds of Assessment* on this aspect was "grossly unreasonable, without foundation and vexatious."

[40] I agree that the respondent's original denial that the appellant has traded was without foundation. That does not necessarily make it vexatious. The concession that the appellant did trade was made almost two weeks before the hearing. In my view, the lateness of the concession did not add to any significant extent to the costs of the hearing. I will therefore make no cost order.

[41] For the reasons set forth above, the following order is made:

(a) The matter is remitted to the Commissioner to enable him to make new assessments for the 2001, 2002, 2003 and 2004 tax years, in accordance with this judgment.

(b) There is no order as to costs.

____

[30] Page 6 of Exhibit A, being the minutes of the pre-trial conference.

A GILDENHUYS
Judge of the Tax Court

I agree

____

for N Matlala

Assessor

I agree

____

for A C Geake

Assessor

APPEARANCES

For the appellant

Mr R Bhana SC

instructed by

Spencer & Associates

Kensington B, Randburg

For the respondent

Mr P Koekemoer