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THE TRADE REQUIREMENT IS OBSOLETE FOR TAX PURPOSES

THABO LEGWAILA†
Professor of Law, University of the Witwatersrand

The Income Tax Act 59 of 1962 requires that a taxpayer should be carrying on a trade to be able to deduct expenses in terms of the general deductions formula, to deduct interest in terms of the specific provisions applicable to interest, or to set off assessed losses. The meaning of 'trade' has been the subject of many court cases. These cases have assigned varied and divergent meanings to the term 'trade'. The result has been that it has become a complex term that complicates the deductibility rules without adding much value to the rules. This article considers this trade requirement's continued relevance and importance and concludes that it is obsolete and ineffective, and adds no value to the deductibility provisions. The essence of the trade requirement is a duplication of the 'production of the income' requirement in the general deduction formula. It is also too broad for interest deductibility provisions, meaning that it lacks effect and is too restrictive in the assessed losses provisions. This disadvantages struggling businesses. The article recommends removing the trade requirement from the Income Tax Act.

Trade – the production of the income – interest – assessed losses

I INTRODUCTION

In determining a taxpayer's taxable income, the Income Tax Act ('the Act') generally allows for the reduction of taxable income by way of a deduction or a set off of expenses associated with a taxpayer's trade. For purposes of the general deduction formula, these expenses must be incurred by a taxpayer in carrying on a trade and are allowed only to the extent that they are expended or laid out for the purposes of trade. In relation to the specific provision dealing with incurring interest and the deductibility thereof, the provisions require that, for interest expenses to be deductible, the taxpayer must incur the interest expenditure while carrying on any trade. With regard to assessed losses, the provisions require that the taxpayer carry on trade in continuity for all tax years that the taxpayer seeks to carry over the losses for set off in later years.

The trade requirement and the definition of 'trade' have existed for almost 100 years. They first appeared in the 1925 Income Tax Act[1] and were reproduced in the 1940 Income Tax Act[2] as well as the 1941 Income Tax Act.[3] They have therefore been the subject of many court cases.

† BIuris (Venda) LLB LLM (Wits) PG Dip Tax LLM (Cape Town) LLD (Pretoria). *https://orcid.org/0000-0002-6915-7853.*

1 Act 40 of 1925.
2 Act 25 of 1940.
3 Act 31 of 1941.

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This should make the requirement clear and well-reasoned. However, in this article, I argue that the multiplicity and divergence of these decisions have caused so much confusion that it is no longer clear what 'trade' means. It is also unclear what the trade requirement adds to the general deduction formula, which contains a 'production of the income' requirement. It would be difficult to argue that a taxpayer who invests money to generate income is not carrying on a trade. It is also not logical to have a continuity principle associated with setting off assessed losses.

This article considers the relevance of the trade requirement to the three provisions that contain both the trade and the production-of-the-income requirements. These are the general deduction formulas contained in s 11*(a)*, read with the prohibited deductions in s 23*(g)*, the deductibility of interest in s 24J(2), and assessed losses in s 20.[4]

II THE CARRYING ON OF A TRADE

The three provisions under scrutiny require the taxpayer to be 'carrying on a trade'. The term 'trade' is defined in s 1 of the Act as follows:

> '"trade" includes every profession, trade, business, employment, calling, occupation or venture, including the letting of any property and the use or grant of permission to use any patent as defined in the Patents Act or any design as defined in the Designs Act or any trade mark as defined in the Trade Marks Act or any copyright as defined in the Copyright Act or any other property which is of a similar nature.'

As will be illustrated below, this definition has been the subject of much debate. Important conclusions can be drawn from its interpretation over the years. My analysis of these decisions will demonstrate how convoluted and even contradictory the courts' assertions have been, and how this has led to uncertainty about what 'trade' actually denotes.

(a) 'Trade' to be given wide interpretation

'Trade' is defined widely and also interpreted widely. In *Burgess v Commissioner for Inland Revenue* ('*Burgess*'),[5] the court considered whether the appellant was carrying on a trade within the meaning of the general deduction formula contained in s 11*(a)*, read with s 23*(g)* of the Act. Groskopf JA in *Burgess* considered it to be 'well-established' that the definition of trade should be given a wide interpretation.[6]

[4] This contribution does not cover the trade requirement on pre-trade expenses and losses in terms of s 11A of the Act because the requirements of deductibility in s 11A are dependent on the taxpayer satisfying the requirements of s 11.

[5] 1993 (4) SA 161 (A).

[6] Ibid at 181.

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As the definition indicates, 'trade' covers various aspects, including every profession, trade, business, employment, calling, occupation or venture.[7] Therefore, the definition of 'trade' circularly includes the word 'trade' in the ordinary sense. Concerning the concept of a 'venture', the court in *Burgess* found the taxpayer to have carried on a trade in the form of a venture. The court held that although an element of risk is included in the concept of a 'venture' in its ordinary meaning, it must not be taken to suggest that a scheme would constitute a trade only if it carried an element of risk.[8] Whether it would constitute a 'trade' or not would depend on the facts of the case. However, if no risk is involved, it might still be covered by giving an extended meaning to the word 'venture' or by applying the rest of the definition, which the court emphasised 'is in any event not necessarily exhaustive'.[9] 'Occupation' is defined as 'a person's usual or principal work or business, especially as a means of earning a living'.[10] A person's 'calling' is a strong urge towards a particular way of life, career or vocation,[11] or a profession or occupation.[12] It goes without saying that 'business',[13] 'employment' and 'occupation' are almost always carried out or undertaken to earn an income or make a financial gain or a profit, as the case may be. The letting of any property and the permission to use patents, designs, trademarks or copyrights are included specifically in the definition of 'trade' because of the passivity of the activities. This, in particular, draws activities that could be considered passive and therefore not active trade to fall under the definition of 'trade'.

Plainly, the various aspects of 'trade' are interrelated and are even used to define each other. Besides the definitions being circular, they have one thing in common: there needs to be a *financial benefit* in the form of a profit, income or means to earn a living. Fundamentally, then, it seems that 'trade' in its wide sense is any activity carried out to make a financial gain, or any profitable activity. The financial gain need not derive directly from that particular activity, but it could be from a related or associated one.

[7] Definition of 'trade' in s 1 of the Act.

[8] Supra note 6 at 182.

[9] Ibid.

[10] *Dictionary.com* sv 'occupation'. See *https://www.dictionary.com/browse/occupation*, accessed on 15 February 2024.

[11] 'Vocation' is defined as a person's employment or main occupation, especially regarded as worthy and requiring dedication. Ibid.

[12] *Merriam Webster Dictionary* sv 'calling'. See *https://www.merriam-webster.com/dictionary/calling*, accessed on 15 February 2024.

[13] The court in *Re Australian Industrial Relations Commission Ex parte Australian Transport Officers Federation* (1990) 171 CLR 216 at 226 said that 'of all words, the word "business" is notorious for taking its colour and its content from its surroundings'.

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(b) Is risk a requirement?

The taxpayer's activity does not need to carry an element of risk to qualify as a 'trade'. In some instances, the courts have required some form of risk; in others, the courts were firmly of the view that the presence of risk does not, on its own, signify that the taxpayer is carrying on a trade. In *Kirsch v CIR* ('*Kirsch*'),[14] the taxpayer entered into an agreement to lend money to his employer at an interest rate of eight per cent per year. In addition, the taxpayer was entitled to a further four per cent of the employer's net profits per year. The court had to decide whether the taxpayer was engaged in a venture as included in the definition of trade. The court found that the mere fact that an investment by way of a loan is attended with risk does not mean that the lender was engaged in a venture. The court held that 'so wide a meaning must not be assigned to the word "venture".[15] In a sense, very many investments by way of a loan are attended with risk, but it would be going much too far to suggest that whenever risk is run in a loan, the lender has engaged in a venture.'[16]

Brincker's view of the *Kirsch* case is that a loan provided by a person who does not carry on a moneylending business would not constitute a 'trade'. He goes on to say that, by contrast, if the loans are made as part of normal trading activities, the investment of monies in pursuit of one of the objects may well form part of the trade that the taxpayer conducts.[17]

In *Burgess*,[18] the taxpayer argued that a single transaction in which a taxpayer obtained a bank guarantee that exposed him to financial risk with the hope of making a profit was carrying on a trade in the form of a venture. The court went on to interpret the term 'venture' widely as a transaction in which a person risks something with the object of making a profit.[19] The court accepted the dictionary meaning of 'venture' as an enterprise of a business nature in which there is a risk of loss as well as a chance of gain, and that it included an element of commercial speculation.[20] The court stated that it did not matter whether the taxpayer himself realised the risks inherent in the scheme and that an undertaking does not cease to be a venture merely because the person pursuing it is of a sanguine temperament. However, the court cautioned that the mere existence of a risk element does not mean that trade is carried on.[21]

[14] 1946 WLD 261, 14 SATC 72.

[15] Ibid at 263.

[16] Ibid at 263–4.

[17] E Brincker 'The deduction of interest' *TaxTalk* (2015), available at *https://www.thesait.org.za/news/242362/The-Deduction-of-Interest-.htm*, accessed on 22 February 2024.

[18] Supra note 5.

[19] Ibid para 24.

[20] Ibid.

[21] Ibid para 25.

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(c) Investment activities as trade

The court in *ITC 770*[22] stated unequivocally that investment activities qualify as trade. In this case, the taxpayer was engaged in three different types of business activities: mining, share-jobbing, and investment. Concerning whether its investment activities amounted to a 'trade', the court stated that

> '[t]he business of investment in shares in companies is a well-established occupation in the business world and in my opinion it falls under all or some of the words "trade", "business", "occupation", or "venture" used in the definition of "trade", which is obviously intended to embrace every profitable activity and which I think should be given the widest possible interpretation'.[23]

The court went on to state that it could not find, on the authority of cases that the Commissioner for Inland Revenue had relied upon,[24] that investment activities do not constitute a trade.[25]

(d) Achieving other goals in addition to trade

The fact that a taxpayer is motivated by non-trade objectives does not negate the fact that they may be carrying on a trade according to the statutory definition. In *ITC 1404*,[26] the taxpayer was a director of companies, a former teacher, and a university lecturer. He had money available for investment and decided to invest in something which would provide a hedge against inflation and a reasonable source of income upon retirement. He purchased six flats in order to protect his parents and others from the risk of eviction in case a developer purchased the flats. He also regarded the flats as an excellent investment that would produce increasing rentals in the future.

The court found that the taxpayer's decision to purchase the flats had nothing to do with the position of his parents.[27] He was motivated by the desire to provide for his own pension and the fact that the flats would be an extremely good investment. Although the taxpayer appreciated the short-term loss of the purchase, he charged all his tenants rent, including his parents, with the hope of medium- and long-term profitability.[28] This fact led the court to find that he did not arrange his assistance for his parents in a way that would interfere with his trading activities.

[22] (1954) 19 SATC 216.
[23] Ibid at 217.
[24] The Commissioner had relied on *SA Bazaars v CIR* 1952 (4) SA 505 (A); *Platt v CIR* 1922 AD 42 and *Doves Industries v CIR* 1946 TPD 143.
[25] Supra note 22 at 217.
[26] 48 SATC 1.
[27] Ibid at 4.
[28] Ibid.

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Thus, his desire to achieve other purposes did not detract from his trading activities. Even if his primary motive for trading was to assist his parents, on the authority of *Burgess*, such a motive would not contradict the fact that he was carrying out trading activity.[29]

Returning to *Burgess*, the taxpayer in that case stood to obtain a tax benefit by entering into the venture in question. The court found that if a taxpayer pursues a course of conduct that, standing on its own, constitutes the carrying on of a trade, he will not cease to be carrying on a trade merely because one of his purposes, or even his main purpose in doing what he does, is to obtain some tax benefit. The motive is irrelevant if such a taxpayer carries on a trade. This position would be different if the transaction is so affected by tax considerations that its shape or character is no longer that of a trading transaction.[30]

In *CIR v Hickson*,[31] a physically disabled taxpayer undertook an extravagant business trip from South Africa to New York and the United Kingdom. He was accompanied by his wife because he could not travel alone due to his physical disability. He met business associates during the trip, and his income increased after the trip. The court found that the expenses were laid out for purposes of trade and were incurred in the production of the income since he could not travel alone and needed the support of his wife.[32] Thus, the fact that some of the expenses were designed to cover his wife's assistance did not change the fact that the full amount was expended for the purposes of trade.

(e) Is profit a requirement?

Making a profit, or having an objective to make a profit, is normally an indicator of someone carrying on a trade. However, a trade can still be carried on without any profit or even a profit motive. The court in *ITC 1404* expressed the view that the fact that losses were anticipated is insufficient to deprive the taxpayer of the right to claim a deduction: the facts of each case must be considered.[33] Nothing in the Act suggests that a person cannot incur losses in the hope of future profits and still, at the same time, claim those expenses as a deduction.[34] The taxpayer's motivation to assist his parents did not in any way affect and was in no way relevant to his decision to trade in the property.[35]

29 Ibid.
30 Supra note 5 at 182.
31 1960 (1) SA 746 (A), 23 SATC 243.
32 Ibid at 250.
33 Supra note 26 at 5.
34 Ibid.
35 Ibid at 6.

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In *ITC 1292*,[36] Myburgh J attributed trade to profit and stated that if the evidence excludes the possibility of profit, such expenses are not deductible.[37] The test, he said, is the real hope of making a profit, and such a hope must not be based on fanciful expectations but on reasonable possibility.[38] Referring to this rationale in *ITC 1292*, Friedman J in *ITC 1404* observed that nowhere in either s 11*(a)* or s 23*(g)* is there a reference to profits or the possibility of making profits.[39] Friedman J said that '[t]he relevance of the so-called test of profitability seems to lie in a completely different sphere'.[40] If there is no real possibility of the taxpayer making a profit, then, in the absence of other factors, the court may well be entitled to infer that the purpose of the expenditure was not for trade.[41] According to Friedman J, the possibility of making a profit is simply a factor (albeit a significant one) in determining whether the taxpayer is carrying on a trade, especially where no other factors are at play.[42] Olivier's view is that insisting on a reasonable prospect of generating a profit may be too stringent a test and that, at most, the possibility of generating a profit can be one of the factors to consider in determining whether a trade was conducted.[43]

In *De Beers Holdings (Pty) Ltd v CIR*,[44] the court emphasised that the absence of a profit does not necessarily exclude a transaction from being part of a taxpayer's trade. Therefore, a non-profitable transaction could satisfy the trade requirement. It should be shown on the facts that a taxpayer was trading, regardless of the lack of profit or lack of intention to make a profit from the particular transaction.[45] The court acknowledged that this money could well be expended on grounds of commercial expediency or in order to facilitate the taxpayer's trade indirectly.[46] For example, where a trader normally carries on the business of buying and selling goods at a profit, then, as a general rule, a transaction entered into with the purpose of not making a profit or a transaction that registers a loss must be shown to have been closely connected with the pursuit of the taxpayer's trade. It should be shown to have been so connected that, despite the absence of a

[36] 41 SATC 163.
[37] Ibid at 165.
[38] Ibid.
[39] Supra note 26 at 2.
[40] Ibid.
[41] Ibid.
[42] Ibid.
[43] L Olivier 'The "trade" requirement for income tax purposes: A reappraisal (CSARS v Smith 65 SATC 6)' 2009 (October) *Journal of Economic and Financial Sciences* 189 at 191.
[44] 1986 (1) SA 8 (A).
[45] L Olivier 'Assessed losses: A note on the trade and income requirements' (2009) 20 *Stellenbosch LR* 387 at 388.
[46] Supra note 44 at 36.

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profit motive, the transaction was still undertaken for the taxpayer's trade. And this, the court said, would need an explanation from the taxpayer unless the facts speak for themselves.[47]

(f) Continuity is not a requirement

While continuity is a credible indicator of the carrying on of a trade, it is not peremptory. The degree of activities that are required varies from case to case. In *Burgess*, the taxpayer sought to deduct interest incurred on a single loan that was obtained to be used to invest in a single policy. The court held that this constituted trade, even though it was a single transaction, because the investment entailed an intention to make a profit.[48] The courts do not seem to place any importance on the word 'carrying' in the term 'carrying on a trade'. The word 'carrying' on its own requires some level of continuity, as it is in the present continuous tense.

(g) Does trade require something active?

Is the trade requirement intended to curb the deductibility of expenses incurred to generate passive income? The view that 'trade' does not include activities that might produce passive income is not cast in stone. In *CSARS v Megs Investments (Pty) Ltd* ('*Megs Investments*'),[49] Jones AJA said that '[i]t is settled that in ordinary circumstances income in the form of interest on an investment is not income derived from carrying on a trade within the meaning of the Act'.[50] Titus's view, however, is that it is not settled that interest earned from investment is not incurred in the carrying out of trade.[51] In her view, Jones AJA's statement in *Megs Investments* is merely obiter and does not settle the issue of whether the activities of an individual taxpayer in investing in interest-bearing securities, despite not being a moneylender, may constitute a trade.[52]

Stiglingh et al argue that expenses to generate passive income are disqualified from the trade requirement in terms of SARS's Interpretation Note 33,[53] and conclude that the active-step requirement means that

[47] Ibid at 36–7. See Thabo Legwaila 'The trade and production of income requirements for the deductibility of interest — Unitrans Holdings Ltd v Commissioner for the South African Revenue Services (A3094/2022) 2024 ZAGPJHC 3 (9 January 2024)' 2024 *TSAR* 365 at 369.

[48] Supra note 5 para 24.

[49] 2005 (4) SA 328 (SCA).

[50] Ibid para 11.

[51] Afton Titus 'May an investment in interest-bearing securities constitute a trade for the purposes of the Income Tax Act?' (2016) 133 *SALJ* 504 at 505.

[52] Ibid at 506.

[53] SARS 'Assessed losses: Companies: The "trade" and "income from trade" requirements' Interpretation Note 33 (Issue 5) (2017) at 7, available at *https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-IN-2012-33-Assessed-Losses-Companies-Trade-Income-Requirements.pdf*, accessed on 5 April 2024.

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something more is required than watching over existing investments that are not income-producing and are not intended to be so.[54] This view, which emanates from the decision of Kirk-Cohen AJ in *ITC 1476*,[55] is expressly limited to instances where passive income is not generated and was not intended to be generated.[56] In *ITC 11329*,[57] Satchwell J stated that '[w]e know of no authority which requires no more than existence as a holding company to constitute the "carrying on of a trade"'.[58]

In relation to the active-step requirement, SARS states that the act must comprise more than the mere laying of plans. In this regard, SARS refers to the judgment of Eksteen AJ in *C:SARS v Contour Engineering (Pty) Ltd*,[59] where he held that there is a vast difference between the mere laying out of plans for the future, on the one hand, and the commencement of preparatory activities for a future venture, on the other hand. SARS agrees with Eksteen AJ that laying out plans does not amount to the carrying on of a trade.[60] In addition to making plans, much more is required to constitute a trade.

In modern times, 'business' — and therefore 'trade' — is carried on in many more ways than in the past. 'Business' may take the form of self-driving activities, such as recording a blog, a video, or a song and posting it online, and income may be generated from that activity. This is the same as investing in a product that generates income without the investor's further involvement. A person may carry on an active trade over the years to enable themselves to invest in capital to generate revenue. The revenue generated may be in the form of interest, rental, dividends and royalties. These are items generally referred to as passive income. The requirement that, for an amount of expenditure to be deductible, the taxpayer should be carrying on a trade has no effect on the expenditure incurred to generate these forms of income. This is because, looking at these passive income items individually:

(i) the deductibility of interest is specifically provided for in s 24J(2) (additionally, it is inapposite to argue that a person that borrows money and lends that money on to produce income is not carrying on a trade);

[54] M Stiglingh, A D Koekemoer, L van Heerden, J S Wilcocks & P van der Zwan *Silke: South African Income Tax* (2023) para 6.2.

[55] (1989) 52 SATC 141 (T).

[56] Ibid at 148.

[57] Unreported case available at *https://www.sars.gov.za/wp-content/uploads/Legal/Judgments/TC/LAPD-DRJ-TC-2005-11-TCIT11329-10-August-2005.pdf*, accessed on 19 March 2024.

[58] Ibid para 46.

[59] (1999) 61 SATC 447 at 451.

[60] Op cit note 53 at 7.

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(ii) rental income is specifically included in the definition of trade;

(iii) royalties arise from the use of a patent, design, trade mark, copyright or property of a similar nature, as provided for in the definition of trade; and

(iv) expenses incurred to generate dividends are not deductible, not because dividends are passive income, but because dividends are exempt,[61] and do not form part of income as defined.[62]

Therefore, I conclude that the theory that trade is required to curb the deduction of expenses incurred to generate passive income can be neither substantiated nor maintained. The definition of trade itself already recognises passive income, at least in the form of rent or royalties.

(h) Conclusions on the carrying on of a trade

As I have indicated above, there are no clear, decisive rules to determine what trade means. A trade may include the earning of passive income. A trade may be conducted in the absence of activity, risk, continuity in actions, and even the intention to make a profit. Investment activities may constitute trade, and the fact that the taxpayer has non-trade motives does not deprive the activity of its status as a trade. A 'trade' can include a wide spectrum of possibilities: it seems that anything and everything could be 'trade', and even doing nothing can amount to carrying on a 'trade' in certain circumstances.

III 'FOR PURPOSES OF TRADE' AND 'IN THE PRODUCTION OF THE INCOME'

Section 11*(a)*, read with s 23*(g)*, requires, among other things, that expenditure be incurred in the production of the income and be deductible to the extent that it is laid out for the purposes of trade. In this part of the article, I consider whether an item of expenditure can satisfy the

[61] Section 23*(f)* of the Act specifically prohibits the deduction of expenses incurred in the production of exempt income. Local dividends are exempt from normal tax in terms of s 10(1)*(k)*(i) and taxed under a special withholding tax on dividends in terms of s 64D. See further on the non-deductibility of interest incurred to produce dividends the cases of *Ticktin Timbers CC v CIR* 1999 (4) SA 939 (SCA); *Commissioner for SARS v Van der Westhuizen* [2001] 2 All SA 297 (C); *Natal Laeveld Boerdery BK v Kommissaris van Binnelandse Inkomste* [1998] 1 All SA 5 (A); *Commissioner, South African Revenue Service v Scribante Construction (Pty) Ltd* 2001 (2) SA 601 (E). See also Thabo Legwaila 'In the production of income: *Natal Laeveld Boerdery (Edms) Bpk v KBI* [1998] 1 All SA 5 (A) in the light of decision in Commissioner for the *South African Revenue Services v Van der Westhuizen* [2001] 2 All SA 297 (C)' (2002) 119 *SALJ* 43.

[62] Section 1 defines 'income' as 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.

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'in the production of the income' requirement but not the trade requirement. The question is hardly ever asked because the trade requirement is tested first, and if it is not satisfied, then cadit quaestio. In such instances, the courts hardly ever go on to determine whether the production-of-the-income test is also satisfied. They only probe the production-of-the-income requirement if the trade requirement and other requirements are met, and often find that it is not met. This is because all the requirements of the general deduction formula must be satisfied for the deduction to be allowed. I assert that if courts were to venture further, they would find, at least in most cases, that where the trade requirement in s 23*(g)* is not met, the production-of-the-income requirement would also not be met. The 'in the production of the income' requirement requires more than the trade requirement. It therefore serves no purpose to have the trade requirement if, once it is satisfied, a transaction will still be subjected to another test that requires the same (or very similar) requirements. To substantiate my argument, I shall juxtapose the production-of-the-income requirement with the 'purposes of trade' requirement.

An additional controversial aspect is that the tests for purposes of trade and production of income can be conflated and confused as they tend to require the same (or similar) attributes. For example, in *Warner Lambert SA (Pty) Ltd v Commissioner for the South African Revenue Service* ('*Warner Lambert*'),[63] Conradie JA quoted Hefer JA as having said, in *Ticktin Timbers CC v Commissioner for Inland Revenue*,[64] that when dealing with the issue of trade, the purpose for which expenditure was incurred was 'the decisive consideration in the application of s 23*(g)*'.[65] Conradie JA then noted that Hefer JA had quoted Corbett JA in *Commissioner for Inland Revenue v Standard Bank of South Africa Ltd* ('*Standard Bank*')[66] on the close relationship between expenditure and what the expenditure actually affects.[67] Conradie JA was incorrect in what he said because Hefer JA specifically referred to s 11*(a)* and not s 23*(g)*. It does not appear to have been a slip of the pen or a typo by Conradie JA, as he was addressing the issue of trade. Conradie JA also quoted the cases of *Port Elizabeth Electric Tramway Co Ltd v CIR* ('*PE Electric Tramway*'),[68] *Solaglass Finance Company*

[63] 2003 (5) SA 344 (SCA).

[64] Supra note 61.

[65] Ibid at 942F–G.

[66] 1985 (4) SA 485 (A) at 500H–J.

[67] Ibid, where Corbett JA stated that '[g]enerally, 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'.

[68] 1936 CPD 241.

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(Pty) Ltd v Commissioner for Inland Revenue ('*Solaglass*')[69] and *CIR v Pick 'n Pay Wholesalers (Pty) Ltd* ('*Pick 'n Pay*'),[70] the last two dealing specifically with the trade requirement.

(a) For purposes of trade

Section 11*(a)* allows for the deduction of expenditure or losses incurred by a taxpayer in the production of the income from the carrying on of any trade during a year of assessment, provided that such expenditure or losses are not of a capital nature. Section 23*(g)* prohibits allowable deductions exclusively to those funds expended for trade purposes. It provides that no deduction shall be made with respect to any money claimed as a deduction from income derived from trade to the extent to which the money was not laid out or expended for the purposes of trade. Up to and including the 1992 year of assessment, the money must have been wholly or exclusively laid out or expended for the purposes of trade. Any non-trade purpose was generally fatal to the deductibility of expenditure. From the 1993 year of assessment onwards, a legislative amendment after the decision in *Solaglass* permits a deduction of expenditure to the extent to which such expenditure is laid out or expended for the purposes of trade.[71] The Explanatory Memorandum states that it had been a long-standing practice of Inland Revenue (as it then was) to allow an apportionment of expenditure that was incurred partly for trade and partly for non-trade purposes. The amendment was made to restore the previous practice of allowing the apportionment of such expenditure.[72] For contextual purposes it is important to note that some of the cases discussed in this part were decided on the basis of the law as it was before 1993.

There are no hard-and-fast rules for deciding whether a taxpayer's expenditure was incurred for the purposes of trade. Botha JA in *Solaglass* acknowledged that it is impossible to devise any precise universal test to determine whether expenditure comprises money laid out or expended for the purposes of trade. This issue can only be determined by examining the particular facts of each case.[73]

The purpose of the transaction is determined by considering the circumstances at the time that the transaction was concluded. Even so, practically, the courts only have a chance to determine that purpose after the fact, either when the transaction has achieved or has failed to achieve

[69] 1991 (2) SA 257 (A).

[70] 1987 (3) SA 453 (A), 49 SATC 132.

[71] The amendment was effected by s 20*(b)* of the Income Tax Act 141 of 1992.

[72] Republic of South Africa 'Explanatory memorandum on the Income Tax Bill' (1992) 17, available at *https://osall.org.za/docs/2011/02/1992-IT-Bill.pdf*, accessed on 4 September 2024.

[73] Supra note 69 at 281D–E.

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its purpose. This makes it quite easy to mistake the purpose of an act for its consequences.[74] Conversely, the consequences of an act often broadcast its purpose. One cannot be faulted for presuming that a person intended the natural consequences of the person's 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.'[75]

In *Pick 'n Pay*,[76] the taxpayer made a donation to a charity organisation on whose board the taxpayer's founder served. It was accepted that this donation was made with two objects in mind: the first was the philanthropic objective of assisting a deserving charity, and the second was to gain advertising and marketing exposure from its donation, thereby attracting customers to its stores (that is, indirect advertising). In a divided decision, the court found that the donation, which was presented at a press conference as an act of disinterested benevolence, was made for both business and philanthropic purposes and was therefore not wholly and exclusively for the purposes of trade.[77] The minority held that the donation was actuated purely by commercial motives and was purely a mechanism for acquiring indirect advertising from favourable publicity.[78]

In *Warner Lambert*, the taxpayer was a subsidiary of a US holding company. The holding company was compelled by US law to comply with legislation that required it to impose certain obligations on the taxpayer. This included wage increases and social responsibility expenditure. It was readily accepted that the wage-increase costs were for the purposes of trade, but the same did not apply to the social-responsibility expenditure that had been incurred outside the workplace. The court held that the social-responsibility expenses were deductible mainly because the taxpayer had no choice about paying them.[79] The court linked the production-of-the-income and the trade requirements by saying that the social-responsibility '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.'[80]

[74] Supra note 63 para 13.
[75] Ibid para 14.
[76] 1987 (3) SA 453 (A), 49 SATC 132.
[77] Ibid at 471.
[78] Ibid at 474. See also Trevor Emslie 'Is generosity a bar to tax deductibility?' (1988) 105 *SALJ* 214.
[79] Supra note 63 para 16.
[80] Ibid para 17.

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(b) In the production of the income

Expenditure is deductible in terms of the general deductions formula if it is incurred in the production of the taxpayer's income. Whether expenditure has been incurred in the production of the income is determined by examining the act that produces the income and then judging whether the attendant expenditure can be said to be sufficiently close to that act to be regarded as having been incurred in the production of the income.[81] Expenditure is regarded as being incurred in the production of the income if it is an inevitable concomitant of the taxpayer's income-producing operations.[82]

As to how closely the expenses must be linked to the business operation, the court in *PE Electric Tramway*[83] held that all expenses that are attached to the performance of a business operation and are bona fide performed to earn income are incurred in the production of the income. This is so regardless of whether such expenses are necessary for the business operation's performance, are attached to it by chance, or are bona fide incurred for the more efficient performance of such an operation, provided that they are so closely connected with it that they may be regarded as part of the cost of performing it.[84]

In *PE Electric Tramway*, the court allowed deductions involving the payment of compensation by the taxpayer employer for a claim of damages arising from the death of an employee.[85] The death occurred while the employee was discharging his employment obligations. In *Joffe*, though, the court disallowed the deduction of expenditure incurred in compensating for the death of an independent contractor because the employees were found to have been negligent in carrying out their duties and that this negligence had caused or contributed to the contractor's death.[86] In both cases, however, legal expenses incurred by the employer in defending the claim for damages were not allowed as a deduction because these expenses were not sufficiently closely connected to the act of producing income to be regarded as having been incurred in the production of the income.

Case law indicates that in determining whether an expense was incurred in the production of the income by a moneylender, one can ignore the actual expense and focus on the taxpayer's general purpose. In *Standard Bank*, for example, the taxpayer — a bank — sought to deduct interest on money deposited by its customers. The taxpayer had used the money to earn tax-free dividends on preference shares. The court held that since all

[81] Supra note 68 at 245.
[82] *Joffe & Co (Pty) Ltd v CIR* 1946 AD 157 at 163.
[83] Supra note 68 at 246.
[84] Ibid.
[85] Ibid at 248.
[86] Supra note 82 at 165–6.

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the money from depositors went into a general pool, it could not be said for which specific purpose the money was borrowed, so one had to look at the bank's general purpose, which was to borrow money at one interest rate and to lend it on at a higher interest rate to produce income.[87]

The compensation expenditure was incurred in *PE Electric Tramway* for the purposes of trade and in the production of the income. Therefore, it was deductible.[88] In *Standard Bank*, the court specifically looked at the purpose of borrowing the money and found that it was to produce income. Considering the wide meaning of 'trade', when a person incurs expenditure to produce income, it is unlikely that the person would fail to satisfy the trade requirement. That is, it would be hard to argue that the person did not incur that expenditure for the purposes of trade. But perhaps *Joffe* proves the point more graphically. If the expenditure incurred in *Joffe* was for the purposes of trade but not in the production of the income, why would one need to consider if there was trade if the production-of-the-income requirement would be fatal to the claim in any event?

(c) The direct link between the act and the production of income

There should ideally be a direct link between the expenditure and the production of income. This link was tested in *The Commissioner for the South African Revenue Service v Spur Group (Pty) Ltd* ('*Spur*').[89] In this case, the taxpayer, Spur Group (Pty) Ltd ('Spur'), was the chief operating arm of a group of companies and a wholly owned subsidiary of the group's holding company ('HoldCo').[90] The group sought to incentivise its managerial staff by giving them an indirect interest in the listed shares of HoldCo. To achieve this, HoldCo established a discretionary trust ('the trust'), of which HoldCo was the sole beneficiary. The trust acquired a shelf company ('NewCo') in which employees of the taxpayer were offered ordinary shares.[91] The taxpayer contributed R48 million to the trust, which the trust utilised to subscribe to NewCo preference shares.[92] NewCo thereafter applied this funding to purchase HoldCo shares. As shareholders of NewCo, the employees became entitled to the incremental value of the HoldCo shares by virtue of NewCo's investment in HoldCo.[93]

Later, when the HoldCo shares had appreciated to the extent that the investment (and hence the value of NewCo) significantly exceeded the preference-share liability, NewCo redeemed some of the preference

[87] Supra note 66 para 51.
[88] Supra note 68 at 247–8.
[89] [2021] ZASCA 145, 84 SATC 1.
[90] Ibid para 3.
[91] Ibid paras 4–5.
[92] Ibid para 6.
[93] Ibid para 7.

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shares and paid out the trust R22.5 million, leaving the employees as the only shareholders of NewCo. NewCo then sold some of the HoldCo shares and paid dividends to the employees. The trust did not repay the taxpayer's contribution of R48 million.[94] The preference share dividends of R22.5 million received by the trust in December 2009 vested in HoldCo as the sole beneficiary. After the termination of the scheme, NewCo was deregistered on 10 December 2012. The taxpayer sought to deduct the R48 million that had been contributed to the trust as expenditure incurred in producing the taxpayer's income.[95]

The SCA disallowed the deduction of the expenditure because it was not directly or closely connected to the production of the income. The court held that the deductibility of an expense is dependent upon two criteria that must be considered on the particular facts of each case.[96] The court stated that the taxpayer must show an adequate closeness between the expenditure and the production of the income by determining (i) the taxpayer's purpose in incurring the expenditure in question and whether the purpose was to produce income; and (ii) whether a close nexus or link exists between the expenditure and the ultimate production of income.[97] According to the SCA, the participants — the managerial staff — did not benefit directly (or even indirectly, for that matter) from the taxpayer's contribution of R48 million. [98] According to a taxpayer's witness, this was because, at the end of the scheme, the R48 million, now in the form of HoldCo shares, was still sitting in the trust. Therefore, the participants did not directly benefit from the R48 million.[99]

I disagree with this decision. Section 11*(a)* does not require that there be a direct connection between the act and the production of income. It merely requires that there be a link between the two. A close connection could be proven through an indirect link. Evidence was led to the effect that dividends were paid to the participants in terms of the scheme. The court also seemed to favour SARS's argument because there was some benefit to the group company arising from the contribution. However, the fact that someone else benefits from the contribution does not mean that the expenditure was not incurred in the production of the income. Witnesses testified that, following the scheme's establishment, they felt incentivised and, therefore, more productive, which enhanced the taxpayer's income-producing activities.[100]

[94] Ibid paras 9–10.
[95] Ibid paras 11–15.
[96] Ibid para 27.
[97] Ibid.
[98] Ibid para 30.
[99] Ibid.
[100] Further on this discussion see Thabo Legwaila 'The Supreme Court of Appeal limits the deduction of expenditure incurred in the production of the

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Nonetheless, if we must accept for the purposes of precedent that the SCA's reasoning in *Spur* is correct, it is inconceivable that a taxpayer could incur an expense that is directly linked to the production of income but that such expenditure is not for the purposes of the taxpayer's trade. The link between the expenditure and the production of the income would not exist if the expenditure were not laid out for purposes of trade. The activity of producing the income is trade. Expenditure that is deductible in the production of the income will be the expenditure that is laid out for purposes of trade. Indeed, Watermeyer CJ alluded to this in *Joffe*: the trade requirement would defeat the taxpayer's claim for a deduction because, for the same reasons that the expenditure was not incurred in the production of the income, it cannot be successfully argued that the damages were laid out or expended for the purposes of trade.[101]

It is my conclusion, therefore, after taking the *Spur* decision into consideration, that there is no value added to the deductibility provisions by requiring that the expenditure be laid out for purposes of trade because of the 'in the production of the income' requirement.

(d) The importance of the first 'the' in 'in the production of the income'

Section 11*(a)* specifically requires that expenditure will be deductible from the income of the person if it is incurred in *the* production of the income. A literal reading of the provision determines that the expenditure is meant to be deducted from the income that it produces. Such a reading would support the conclusion that the expenditure must be linked to the particular item of income. It is this income from which the expenditure should be deducted.

However, Centlivres JA in *Sub-Nigel Ltd v CIR* ('*Sub-Nigel*')[102] dismissed the argument that stress should be laid on the definite article 'the' and that, as the expenditure (in that case, premiums) produced no income, the expenditure was not incurred in the production of the income.[103] In that case, the Commissioner argued that since the insurance policies with respect to which the premiums were paid did not ever pay out, the premiums were not incurred in the production of the income. Centlivres JA gave a time-based example to illustrate his argument. If an expense is incurred on the last day of the tax year, if the Commissioner's argument were to be accepted, that expense would never be deducted because

income: The Commissioner for the South African Revenue Service v Spur Group (Pty) Ltd [2021] ZASCA 145' (2023) 37 *Speculum Juris* 397.

[101] Supra note 82 at 167.

[102] 1948 (4) SA 580 (A).

[103] Note that *Sub-Nigel* dealt with s 12*(g)* of the Income Tax Act 31 of 1941, a similar provision that was the predecessor to the current s 11*(a)*.

the expense would not generate income in that year.[104] Conversely, if a taxpayer were to open his business on the first day of the year, the taxpayer would never be able to deduct the price paid for the goods. I do not think this argument was valid in the *Sub-Nigel* case, as pre-trade expenses were not allowed in terms of the Income Tax Act of 1941.

Having dismissed the Commissioner's argument, Centlivres JA found that there was no reason to think that the legislature, by using the word 'the' before 'income', intended for the particular expenditure to produce the particular income.[105] It seemed clear to him, based on the authorities, that the court should not be concerned whether a particular item of expenditure produced any part of the income. What the court should be concerned with, according to Centlivres JA, is whether that item of expenditure was incurred for the purpose of earning income.[106] He hazarded a guess in his judgment that the reason why the legislature had used the article 'the' was probably because it had used it in the immediately preceding subsection of the legislation as it existed at the time.[107] The preceding subsection provided that, for the purpose of determining the taxable income derived by any person from carrying on any trade, 'there shall be deducted from or set off against the income of such person so derived as defined by section seven *the* amounts set out in this section'.[108] This subsection determined the item from which the expenses would be deducted. The subsection further determined the identity of the expenses that would be deductible — that is, those that are incurred in the production of the (or that) income. The contexts of the two subsections were too different to suggest that the same meaning should apply in the subsequent subsection.

The legislature could retain a word because it is not certain what meaning the words impart and, therefore, what a change to the words would mean. The risk with this, as is the case in this matter, is that interpreters, for sound economic reasons, ignore the plain, direct and unambiguous words in legislation and attribute to them a different interpretation based on their views about the legislature's intention.

The Commissioner's argument in *Sub-Nigel* should have been different and should have focused on the nature of the premium as opposed to whether any income had been produced. The Commissioner had a better chance of arguing that the premium was not closely connected to the

[104] Supra note 102 at 589.

[105] Ibid at 591.

[106] Ibid. See also *ITC 224* 6 SATC 156; *ITC 247* 6 SATC 379; *COT v Rendle* 1965 (1) SA 59 (SRA); *ITC 815* 20 SATC 487; *CIR v Genn & Co (Pty) Ltd* 1955 (3) SA 293 (A); *CIR v Rand Selections Corporation Ltd* 1956 (3) SA 124 (A); *ITC 1274* 40 SATC 185; *CIR v Nemojim (Pty) Ltd* 1983 (4) SA 935 (A); *CIR v De Beers Holdings (Pty) Ltd* 1984 (3) SA 286 (T).

[107] Supra note 78 at 592.

[108] Section 11(1) of the Income Tax Act of 1941 (emphasis supplied).

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production of the income but to the preservation of the income-earning structure to the detriment of the taxpayer, which is more akin to capital than it is to revenue (especially in respect of fire-damage cover).

In *Lockie Bros Ltd v CIR*,[109] the court avoided the issue and did not engage with the intricacies of the word 'the' by simply eliminating the word 'the' from its consideration. The court opted to consider the meaning of the words 'in production of the income'. The court stated that the usual meaning that an ordinary person would attach to these words in connection with a business is that deductions are to be allowed for any losses or expenses actually incurred in the course of the ordinary operations undertaken for the purpose of conducting the business.[110] The court probably felt that if it were to read and attach importance to the word 'the' in 'in the production of the income', the result would be absurd and out of touch with commercial reality. However, ignoring the word and its role in meaning is wrong simply because one desires a particular outcome. The correct approach would be for the legislature to intervene and remove the word. Perhaps the legislature sought to limit the deductibility to the income that was produced, and the rest would be dealt with as assessed losses.

I acknowledge that Meyerowitz argues that the Act has anomalies that entitle a court to depart from the literal meaning of the words.[111] However, my view is that the effect of the word 'the' in the term 'in the production of the income' is that the expenditure that is to be deducted should have a causal link to the income *from which* it is to be deducted. Based on this argument, it is hard to imagine that this sort of expenditure could be for purposes other than for trade, and yet exhibit such a causal link. Thus, an expense cannot produce a particular item of income and yet not be for that purpose. Even if I am wrong, the residual position remains that an item of expenditure that is incurred to produce income is incurred for the purpose of trade, considering that the purpose of trade is to produce income.

(e) Income presupposes the presence of trade

The opening words of s 11 — 'there shall be allowed as deductions from the income of such person' — presuppose that there will be some form of trade. 'Income', as used in these opening words, refers to income as defined in s 1 of the Act, which is gross income less exempt income. Generally, gross income only includes amounts that are not of a capital nature. Normally, the taxpayer intends those amounts to be in the nature

[109] 1922 TPD 42.
[110] Ibid at 44.
[111] D Meyerowitz *The Taxpayer* (2008) 93–5.

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of revenue. A taxpayer who intentionally engages in an activity to generate revenue income is conducting a trade. The intention of the taxpayer is what determines whether a receipt or expense is capital or revenue.[112] A revenue intention is also invariably a trade intention. The capital is the tree, and the revenue is the fruit.[113] In a literal example, a person who plants a fruit-bearing tree in order to sell the fruits is carrying on a trade. The same applies to a person who disposes of trading stock or engages in a profit-making scheme. A person who derives income from floating capital inevitably does so in the carrying on of a trade of some sort.

The ordinary dictionary meaning of income is money received, especially on a regular basis, for work or through investments.[114] It is defined by the *Merriam-Webster Dictionary* as 'a gain or recurrent benefit usually measured in money that derives from capital or labor'.[115] These definitions encapsulate the involvement in an activity of trade without requiring further elaboration.

(f) Conclusions on 'for the purposes of trade' and 'in the production of the income'

Corbett J stated in *De Beers* that '[o]ften expenditure incurred in the production of the income (not being of a capital nature) is wholly and exclusively laid out or expended for the purposes of trade; but not necessarily so. To be deductible, expenditure must pass both tests.'[116] He made this statement in the context of the general principle that the absence of profit does not necessarily also mean the absence of trade. The statement could also mean that expenditure incurred in the production of the income is normally also laid out for purposes of trade, although this may not always be the case. Unfortunately, he did not provide any examples of instances where it would not also be for the purposes of trade.

As I have demonstrated above, a person who engages in an activity to produce income is inevitably carrying on a trade. There is no need for both tests. By way of example, the donation in *Pick 'n Pay* would not pass

[112] See *CIR v Stott* 1928 AD 252; *Matla Coal Ltd v CIR* 1987 (1) SA 108 (A); *CIR v Pick 'n Pay Employee Share Purchase Trust* 1992 (4) SA 39 (A).

[113] In this regard see *BP Southern Africa (Pty) Ltd v CSARS* 69 SATC 79; *CIR v George Forest Timber Co Ltd* 1 SATC 2; *SARS v Knuth and Industrial Mouldings (Pty) Ltd* (1999) 62 SATC 65; *CIR v Richmond Estates (Pty) Ltd* 1956 (1) SA 602 (A), 20 SATC 355; *African Life Investment Corporation (Pty) Ltd v SIR* 1969 (4) SA 259 (A), 31 SATC 163; *Barnato Holdings Ltd v SIR* 1978 (2) SA 440 (A), 40 SATC 75; *Bloch v CIR* 1980 (2) SA 401 (C), 42 SATC 7; *CIR v Tod* 1983 (2) SA 364 (N), 45 SATC 1.

[114] See eg *The Pocket Oxford Dictionary* (1969) 408 sv 'income'.

[115] Se the *Merriam-Webster Dictionary* sv 'income' at *https://www.merriam-webster.com/dictionary/income*, accessed on 8 October 2024.

[116] *De Beers Holdings (Pty) Ltd v CIR* 47 SATC 229 (A) at 258.

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the production-of-the-income test, as disinterested benevolence generates no income.[117] The duplication has not been highlighted as the courts tend to start by looking at the trade requirement. Ultimately, however, the determination of whether a person is carrying on a trade is to be found in the answer to whether the person is engaged in an activity to produce income.

IV TRADE IN THE INCURRING OF INTEREST

Section 24J is a timing provision in relation to the accrual and incurring of interest. It determines when a borrower incurs interest and can then deduct such interest to determine its taxable income. It also regulates the timing of the accrual of interest in respect of the lender, and when the lender should include the interest in its gross income.[118] It spreads the interest over a period or term of the instrument by compounding the interest over fixed periods using a predetermined rate, referred to as the 'yield to maturity'.[119] The amount of interest that is derived from carrying on any trade is deducted from the income of a person if that amount is incurred in the production of the income. Section 24J does not require that a taxpayer be carrying on any particular trade for the section to apply. It specifically states that an amount must be deducted 'from the income of that person derived from carrying on *any* trade if that amount is incurred in the production of the income'.[120]

In *Commissioner, South African Revenue Service v Tiger Oats Ltd* ('*Tiger Oats*'),[121] the taxpayer sought to deduct interest on loans that it had made to lend on to its subsidiaries. The taxpayer had no employees or fixed assets but paid for management services that it provided to its operating subsidiaries and associated companies. It made loans to subsidiaries and associated companies and not to anyone else. The loans were funded mainly by share capital and reserves and some with surplus cash. The loans were shareholder loans and typically did not bear interest. Where interest was charged, the interest rate was invariably lower than the rate at which the subsidiary could borrow from outside sources.

The court found that the taxpayer was involved in the subsidiaries' business. In addition to paying management fees, it shared directors with the subsidiaries and paid those directors' fees. The court found that this involvement showed that the taxpayer was actively involved in the operations of the subsidiaries and associated companies and was

[117] Supra note 68 at 471.
[118] Thabo Legwaila 'Tax planning using interest — An organised chaos for those interested' (2022) 25 *PER/PELJ* 1 at 6.
[119] Ibid at 369; Stiglingh op cit note 54 at 515.
[120] Section 24J(2) of the Act (emphasis supplied).
[121] [2003] 2 All SA 604 (SCA), 65 SATC 281.

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not simply a passive investor. The taxpayer was not to be equated with a member of the public who invests in listed shares on the stock exchange.[122] This case is authority for the proposition that a company carrying on business as an investment holding company, and which makes interest-free or low-interest loans to its subsidiaries in whose management it is intimately involved, is a company carrying on a business and therefore carrying on a 'trade' for income-tax purposes.[123]

In *Unitrans Holdings v C:SARS* ('*Unitrans*'),[124] the taxpayer traded as an investment and holding company performing a treasury function for the Unitrans group of companies. The treasury function included the provision of loan funding and cash management. The taxpayer's wholly owned subsidiaries had a cash management arrangement with a bank — Standard Bank — whereby the group's bank accounts were balanced to zero on a daily basis. If the group's net position ended up in overdraft, the taxpayer would borrow funds from Standard Bank on a call loan, and if the group was in a positive cash position, the taxpayer would pay back the call loan. At some point, the taxpayer had cash resources of over R300 million available, which, according to the taxpayer, demonstrated that its dealings with its wholly owned subsidiaries and with the bank were not only interrelated but actively managed on a daily basis. The taxpayer borrowed money from its shareholder and lent that money on to its subsidiaries at a rate less than the borrowing cost.

The High Court held that the taxpayer's investment activities constituted a trade. The court affirmed that if interest is incurred in the production of the income (which is not limited to interest income), it can be deducted from the income derived from carrying on any trade, which is not limited to the trade of moneylending. The court considered this position to be 'a trite enough principle'.[125] However, the court found that the production-of-the-income requirement was not met because its activities were intended to assist its subsidiaries to produce income, rather than itself. The court therefore disallowed the deduction.

The requirement in s 24J(2) is of minimal effect compared to that in s 11*(a)*, read with s 23*(g)*. In this regard, a taxpayer merely needs to prove that it is carrying on a trade — any trade. In *Tiger Oats* and *Unitrans*, the taxpayer did not have to show that it carried on any particular trade. With the broad definition of trade, a taxpayer who borrows money

[122] Ibid para 36.

[123] See for a discussion on *Tiger Oats* see Jackie Arendse 'General rules regarding interest deductibility' *The Tax Faculty* (August 2020), available at *https://taxfaculty.ac.za/news/read/general-rules-regarding-interest-deductibility*, accessed on 15 March 2024.

[124] [2023] ZAGPJHC 3.

[125] Ibid para 14.

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and incurs interest in the production of the income should pass the trade test. In my view, this again renders the trade requirement in s 24J superfluous and redundant. The cases of *Tiger Oats* and *Unitrans* illustrate that the production-of-the-income requirement is more pertinent than the open-trade requirement referred to in s 24(J)(2). The taxpayers passed the trade requirement in both cases, but only in *Tiger Oats* was the production-of-the-income test passed.

(a) SARS's practice on interest derived from non-trading activities

SARS's view is that a person (not being a moneylender) earning interest on capital or surplus funds that the person has invested does not carry on a trade and that any expenditure incurred in producing such interest cannot be allowed as a deduction. In light of this understanding, and the anomaly it creates, SARS issued Practice Note No 31 ('Practice Note').[126] This Practice Note allowed the deduction of expenditure incurred in the production of the income even though the receipt or accrual of the income does not constitute the carrying on of a trade. The Practice Note acknowledges that it has been SARS's practice to allow expenditure that is incurred in the production of the interest to the extent that it does not exceed such income. This practice is also applied in cases where funds are borrowed at a certain interest rate and invested at a lower rate. The Practice Note concedes that, strictly speaking, there is no justification for the deduction in terms of the letter of the law. However, this practice has developed over the years, and SARS has chosen to follow it.

In November 2022, SARS announced its intention to withdraw the Practice Note for years of assessment commencing on or after 1 March 2023.[127] According to SARS, this was because there had been increasing abuse of the concession — taxpayers have relied on the Practice Note to structure transactions or undertake transactions to obtain a deduction of interest or expenditure incurred.[128] It is important to note that SARS

[126] SARS Practice Note: No 31 of 3 October 1994 'Income Tax: interest paid on moneys borrowed' available at *https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-PrN-2012-21-Income-Tax-Practice-Note-31-of-1994.pdf*, accessed on 4 March 2024. Although Practice Note 31 provides that the practice set out therein will be followed by SARS, the Practice Note is not binding in terms of South African law.

[127] SARS 'Withdrawal of Practice Notes 31 of 1994 and 37 of 1995', available at *https://www.sars.gov.za/wp-content/uploads/Legal/Drafts/Legal-LPrep-Draft-2022-67-Withdrawal-of-Practice-Notes-31-of-1994-and-37-of-1995-effective-1-March-2023-15-November-2022.pdf*, accessed on 23 January 2024; SARS 'Postponement of withdrawal of Practice Notes 31 and 37', available at *https://www.sars.gov.za/wp-content/uploads/Legal/Drafts/Legal-LPrep-Draft-2023-04-Postponement-of-Withdrawal-of-Practice-Notes-31-and-37-22-February-2023.pdf*, accessed on 25 January 2024.

[128] SARS 'Withdrawal of Practice Notes 31 of 1994 and 37 of 1995' ibid. According to SARS, these are deductions which would not otherwise have been

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did not withdraw the Practice Note because it believes that the expenses should not be deductible. It is purely because of the abuses that have been attributed to it.

In my view, the treatment of interest under the Practice Note is SARS's acknowledgement of the fact that the trade requirement is futile and should be ignored. It adds a layer of enquiry that does not add any value to the deductibility of interest. It is unfortunate that instances of abuse should have resulted in a change in SARS practice. The change will result in bona fide expenses, which should be deductible, no longer being allowed as deductions.

(b) Conclusions on trade in the context of the incurring of interest

A taxpayer does not have to show that it was carrying on any trade that is relevant to the interest that the taxpayer seeks to be deducted. The interest expenditure is deductible if the taxpayer can demonstrate that it was carrying on a trade — any trade. It is difficult to understand the purpose of the trade requirement in this regard.

V TRADE IN ASSESSED LOSSES

Another important provision in which trade is an imperative requirement is s 20: a provision that allows a set-off of losses that have been incurred in previous years. The provision allows a taxpayer to set off against income derived in the current year any balance of assessed loss incurred by that taxpayer in any previous year that has been carried forward from the preceding year of assessment.[129] The amount of the set-off is limited to the higher of R1 million or 80 per cent of the taxpayer's taxable income, determined before taking into account the application of the set-off.[130]

The set-off is allowed to determine the taxable income derived by any person from carrying on any trade. Thus, if a taxpayer does not carry on a trade in the current year, they cannot set off the balance of assessed losses from the preceding year. It therefore follows that, in the following year, the losses will be lost because there would not be any balance carried over

allowed as a deduction under the Act. According to SARS the development of tax legislation has resulted in the reclassification of certain income streams to interest. This reclassification has further allowed taxpayers the deduction under the Practice Note against the reclassified income. SARS is of the view that certain transactions are structured to maximise the deduction of interest or other expenditure incurred, whilst there is no corresponding inclusion in gross income for the recipient. This is achieved where the transactions are concluded with either exempt or non-resident taxpayers.

[129] Section 20(1).

[130] Section 20(1)*(a)*.

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from the current year. Thus, the taxpayer must trade in each year to carry forward the losses from all preceding years. This continuity requirement applies only to companies.[131]

The court in *ITC 664*[132] emphasised that, to allow the set-off to operate, the balance must be carried forward from the preceding year of assessment because the Act does not contemplate the set-off of a balance of assessed loss not so carried forward.[133] The court highlighted that in any given year, there must be some income against which the set-off can operate and that the income must be derived from trade. Therefore, if the taxpayer had not traded and has received no income from trade, it cannot invoke the set-off provision. Ingram KC gave an example of a taxpayer who relinquished his trade for more than a year and then resumed at a later stage. This taxpayer is precluded from setting off the balance of its assessed loss because the loss has not been carried forward from the preceding year of assessment.[134] The court concluded that because assessments are made every year, if there is no income in any particular year, all that is revealed in such a case is a minus quantity, not a balance. 'Hence, one is thrown back to the original loss or balance of assessed loss, the set-off of which is negatived by the requirements that it must have been carried forward from *the* preceding year of assessment.'[135] This position was reiterated in *ITC 1679*,[136] where the court stated that income from trade was an additional requirement before an assessed loss could be brought forward from the preceding year to be set off in the current year of assessment.[137] I disagree with a view that demands that there should be actual income. As stated earlier, income is not a prerequisite for trade to exist, and, as is the practice, a taxpayer could generate assessed losses each year, thus increasing its balance of assessed losses. Unfortunately, the issue of the taxpayer trading but not making any income was also left unaddressed in *SA Bazaars (Pty) Ltd v CIR* ('*SA Bazaars*').[138]

In *New Urban Properties Ltd v SIR*,[139] the taxpayer had an assessed loss and was hopelessly insolvent. A change in ownership resulted in the taxpayer not trading for a period. The court stated that the Act envisaged a continuity in setting off an assessed loss in every year following the year

[131] Section 20(2A) exempts natural persons from the application of the perpetual trade requirement.
[132] 16 SATC 125.
[133] Ibid at 126.
[134] Ibid at 127.
[135] Ibid.
[136] 62 SATC 294.
[137] Ibid at 300F.
[138] Supra note 24.
[139] 1966 (1) SA 217 (A).

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in which it was originally incurred. In each succeeding year, a balance can be struck and carried forward from year to year until it is exhausted. However, if the assessed loss cannot be so set off and balanced in any particular year, there is no balance of assessed loss for that year (viewed from that year of assessment) that can be carried forward to the succeeding year. Alternatively (viewed from the following year of assessment), no balance of assessed loss would been carried forward from the preceding year of assessment. In this case, the essential continuity was fatally interrupted.[140]

In *SA Bazaars*, the taxpayer was a company that carried on a general retail business. The business suffered trading losses, leading the taxpayer to close in 1942. As expected, the taxpayer had assessed losses at the time of its closure. During the succeeding years, the taxpayer maintained a banking account, obtained transfer of its trading licences to different premises, renewed the licences annually, paid income tax and licence duties, held annual general meetings, and prepared annual accounts recording that its assessed losses had been carried down from year to year in its books. In 1948, the taxpayer earned income by way of commission, and in 1949, it was earned from commission and the sale of merchandise. The court found that the taxpayer did not carry on a trade between 1942 and 1947 and stated that the mere fact that the taxpayer kept itself alive during that period did not mean that it was carrying on trade.[141]

The interesting case of *ITC 777*[142] highlights the trade controversy even more clearly. In this case, the taxpayer carried on a manufacturing business and made losses. The manufacturing business closed down. The company changed its name and acquired fixed property and shares as income-producing investments. The taxpayer earned dividends from the shares and sold certain shares. It derived no rental income despite its endeavours to let its properties, even though it had little hope of success in this regard. The court found that because the taxpayer was not a share dealer, it did not carry on a trade by selling its shares.[143] The court also found that since dividends received could not be a portion of income, it could never have been intended that the mere investment of money in shares could be regarded as carrying on a trade.[144] However, the court found that the taxpayer's argument that it was carrying on a trade in that it had endeavoured to let its property during the years in question was well founded. Had the company succeeded in renting the properties, there would be no question whether it was trading, or that the income it earned was from the carrying on of a trade. The court held that a mere intention

140 Ibid at 224.
141 Supra note 24 at 510.
142 19 SATC 320.
143 Ibid at 321.
144 Ibid.

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to rent would not amount to carrying on a trade but that actual letting was also not required. Neser J stated that '[i]t was the intention of the company if possible to let the property and though its efforts were not sustained or strenuous it did endeavour to let it to and through associated companies'.[145] The court referred to but sought to distinguish the judgment in *Kirk & Randal Ltd v Dunn*,[146] a case in which the taxpayer persisted much more strenuously in seeking business than the taxpayer in *ITC 777* and expended considerable sums of money in its efforts. Neser J concluded that the extent of the efforts or the amounts of money expended cannot be the test of whether a taxpayer is trying to get business. It is sufficient if there was some attempt, even if no money was expended.[147]

In *ITC 777*, the activities that generated income were held not to be trade, but the activities that generated no income were held to be carrying on a trade. A person who is not a share dealer may buy shares to sell, or a person who is not a moneylender may borrow money to lend on at a profit. Such a person may not be designated as a share dealer or moneylender. However, the fact that the person is not so designated does not mean that their activities do not qualify as a trade. I believe that holding otherwise is in defiance of the simple logic that it is the activity itself that is either a trade or not, and not the title, name or description of the taxpayer or the activity. In its dismissal of the ratio decidendi in *Kirk & Randal Ltd v Dunn*, the court also insinuated that a feeble attempt could qualify as trade. In terms of that rule, a single trade, carried out with a profit-making intent, can qualify as trade. There is no justification in the cases that require the formalities for share dealing or moneylending for deviating from this sensible principle.

I believe that if a taxpayer ceases to trade and resumes trading years later, there is no reason why they should not be allowed to set off such losses.[148] The fall and rise of businesses and business ventures are commonplace in business, especially in the case of small businesses. For example, a farmer who, on professional advice from a climatologist, makes a business decision not to plant or sow through a tax year because there will be poor rainfall, and holds off for the better rains that are projected for a subsequent or later year, is still carrying on a trade in the year that he holds off. He need not do anything. His purpose for not planting or acting is a business decision that does not eliminate his venture, even in that tax year. This is the same as an employee who takes sabbatical leave for a year but retains his employment status. The court in *Tiger Oats*[149] quoted with

[145] Ibid at 322.
[146] 8 TC 663.
[147] Supra note 142 at 322.
[148] See Meyerowitz op cit note 111 at 93–5.
[149] Supra note 121.

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approval the words of Lord Diplock in *American Leaf Blending Co v Director General of Inland Revenue*[150] that '[t]he carrying on of "business", no doubt, usually calls for some activity on the part of whoever carries it on, though, depending on the nature of the business, the activity may be intermittent with long intervals of quiescence in between'.[151]

I advocate that, from a policy perspective, there is no rationale for having the continuity requirement. As can be seen from the cases dealing with continuity, most taxpayers cease to operate or take breaks not because they want to, but because of factors outside of their control. Most commonly, business challenges, particularly of a financial nature, temporarily or permanently halt business activities. In the case of a taxpayer who ceases to operate because of these financial challenges, in a typical double-jeopardy case, the law refuses to allow them to realize the losses they made in the earlier attempt, choosing to tax them from the first dime they make, if they have made any money at all. Logically, companies make tax losses akin to business losses. And they fail to continue with business because of that very fact. They are not helped in clawing those losses back if they are in a more dire situation, while those who are not in dire straits and can continue trading are allowed to set off their losses. This is an untenable state of affairs, flying in the face of equity in tax.

Regarding the requirement in s 20(1) that a person should be carrying on a trade in the current year to be able to set off the balance of assessed loss from the previous year, the fact that the set-off is against the income derived by such person once again nullifies the need for the trade requirement, as I have discussed above.[152]

VI CONCLUSION

It is common cause that the test as to whether a taxpayer carries on a 'trade' is a factual enquiry, and no single set of rules can be laid down in this regard. However, the few convoluted and somewhat contradictory principles regarding the trade requirements in the Act as distilled from case law and the above analysis can be summarised as follows:

(i) Trade is defined and interpreted widely, and its definition is not exhaustive (*Burgess*).

(ii) The word 'venture' in the definition of trade should be given a wide meaning (*Burgess* and *ITC 770*), but at the same time, a 'wide meaning must not be assigned to the word "venture…"' (*Kirsch*).

(iii) While merely watching over investments does not constitute a trade — it requires something more (*ITC 1476*) — '[t]he 'business

[150] [1978] 3 All ER 1185.
[151] Ibid at 1185. See *Tiger Oats* supra note 121 at 37.
[152] See part III(d).

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of investment in shares in companies is a well-established occupation in the business world' (*ITC 770*).

(iv) Passive investment is not trade. However, the definition of trade encapsulates items of passive income, such as rent and royalties. Other items, such as investment in shares, are not included because they generate exempt income.

(v) Trade requires a taxpayer to intend to generate profits, but profit is not required to be generated. The hope of making a profit must not be based on fanciful expectations but on reasonable possibility (*ITC 1292*). The possibility of making a profit may be a decisive factor in determining whether the taxpayer is carrying on a trade. However, a taxpayer may incur expenses for business reasons other than making a profit.

(vi) Feeble attempts are not enough. Persisting strenuously in seeking business amounts to trade (*Kirk & Randal Ltd v Dunn*), yet attempts to seek trade need not be strenuous to meet the definition (*ITC* 777). At the same time, some inactivity may result in a trade not being carried on.

(vii) Continuity is a credible indicator of trade, but a single transaction is sufficient.

(viii) Money could well be expended on grounds of commercial expedience or in order to facilitate the taxpayer's trade indirectly (*De Beers*).

I conclude that the trade requirement is outdated for purposes of the general deduction formula. The court cases that have been decided in this regard offer no clarity about what trade means. If anything, they have muddied the water so much that trade can be anything and everything, and even, in some cases, nothing (for example, a taxpayer who watches over investments without taking any active steps cannot be ruled out as not carrying on a trade).

The trade requirement for the interest deductibility in s 24J is worthless and ineffective, especially because it does not even require the taxpayer to carry on any particular trade, let alone a trade connected to the interest for which the taxpayer seeks a deduction. The production-of-the-income requirement brings this about if the latter is to be interpreted in its literal form. The production-of-the-income requirement remains essential, as expenditure will be deducted from the income.

There is no valid policy rationale for the continuity requirement for setting off the balance of assessed losses in s 20, and it is punitive to businesses that are struggling financially. As it stands, it applies as a penalty for the taxpayer's previous business misfortunes.

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A person could trade at lower than cost in order to out-compete competitors, capture the market, or advertise goods or services. In that case, a taxpayer would incur an expense with a business intention to compete, enter the market or advertise, which would carry with it an indirect intention to generate a loss or not make a profit. While it is trite that the deductions provisions are not the exact converse of the gross-income elements, the fact that there is no corresponding requirement that a person should be carrying on a trade for an accrual or receipt to be included in gross income is not insignificant in this discussion. The trade requirement would not have added value to that aspect and does not add any value to the deductibility of expenses. It should be remembered that once the trade requirement is met, one still needs to satisfy the production-of-the-income requirement, which is a more demanding test than the trade requirement. It also considers the same traits that the trade requirement requires. All that makes the trade requirement superfluous when it is tested as a prelude to the production-of-the-income requirement. I therefore conclude that the trade requirement for tax deductibility is obsolete and unhelpful, and unduly complicates the rules for deductibility. The fact that courts invariably find that, if an amount is in the production of the income, it therefore must be for purposes of trade speaks volumes about the futility of the trade requirement.

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