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The tax treatment of compensation and damages

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THE TAX TREATMENT OF COMPENSATION AND DAMAGES

A dissertation submitted in part fulfilment of the requirements for the degree of Master of Laws.

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THE TAX TREATMENT OF COMPENSATION AND DAMAGES

Chapter 1 - Introduction

The purpose of this paper is to examine the tax consequences attaching to the payment of compensation or damages in South African Tax Law. Payments of compensation and damages are made in numerous divergent instances but more commonly in cases where assets are expropriated or destroyed or profits are lost and insurance proceeds become payable, where contracts are cancelled or simply as a result of faulty or deficient performance under a contract.

The payment of compensation or damages gives rise to two major queries, namely is the payment on the one hand a deductible expense in the hands of the payee and is the receipt of the payment a taxable receipt in the hands of the recipient? The answer to these two queries depends to a large extent on an analysis of the general principles applicable to the deduction of expenditure and the taxability of income. In other words, is a payment of compensation or damages an expenditure or loss incurred in the production of income and laid out wholly and exclusively for the purposes of trade; and, is the receipt of compensation income or capital? It is proposed to deal with these topics with reference to the provisions of the Income Tax Act No.

58 of 1962, as amended, ("the Act") and the decided South African cases on the topic, although extensive reference will also be made to English and Australian cases dealing with the topic. It is also proposed to attempt to analyse whether the nature of the particular payment in question, ie. a lump sum or on-going payment, in any way affects the issue.

A related issue to the two main questions stated above is whether or not when claiming damages, it is appropriate to take into account the possible incidence of tax in determining the amount of the damages payable. This question will also be discussed with reference to decided South African and English cases.

Chapter 2 - The taxability or otherwise of a payment in respect of compensation or damages

It is proposed to deal in this section with the question whether the receipt or accrual of a payment being in respect of compensation or damages, is taxable in the hands of the recipient.

"Gross Income" is defined in Section 1 of the Act as follows:

> "Gross Income, in relation to any year or period of assessment, means, in the case of any person, the total amount, in cash or otherwise, received by or accrued to or in favour of such person during such year or period of assessment from a source within or deemed to be within the Republic, excluding receipts or accruals of a capital nature, ..."

The definition then goes on to list certain specific types of payment which are expressly included in the definition. For purposes of the present enquiry, the crux of the problem relates to whether the receipt or accrual of a payment in respect of damages or compensation is income or capital. The Act does not define what is meant by receipts or accruals of "a capital nature" and accordingly it is

necessary to have recourse to the decided cases in this respect. As Lord Hanworth, M.R. said in the case of Van Den Berghs, Limited v Clark (H.M. Inspector of Taxes) (19TC 390) in the Court of Appeals at page 415 of the report:

> "This case raises once more the troublesome question - and it is really always a troublesome question - as to whether a payment or a receipt, according to the particular circumstances, is to be treated as paid or received on account of capital."

Maritz J. in C.I.R. v Visser (8 SATC 271) stated at 276:

> "If we take the economic meaning of "capital" and "income", the one excludes the other. "Income" is what "capital" produces, or is something in the nature of interest or fruit as opposed to principal or tree. This economic distinction is a useful guide in matters of Income Tax, but its application is very often a matter of great difficulty, for what is principal or tree in the hands of one man may be interest or fruit in the hands of another. Law books in the hands of a lawyer are a capital asset; in the hands of a book-seller they are a trade asset. A farm owned by a farmer is a capital asset; in the hands of a land jobber it becomes stock-in-trade."

Despite the difficulty which the courts often have in attaching an income or capital label to a particular amount, it is clear that every amount must be either income or capital. It cannot be a mixture of the two. See Crowe v C.I.R. (1930 AD 122). In Sub-Nigel Limited v C.I.R. (1948 (4) SA 580 AD) the Appellate Division, although dealing in that case with a question of expenditure rather than income, stated (at page 595 of the judgment) that it was "impossible to give a definition of what is expenditure of a non-capital nature which will act as a touchstone in deciding all cases and it would be impracticable to attempt such a definition." Numerous tests and guidelines have been laid down by the courts however in attempting to resolve the issue of whether an amount constitutes income or capital (see, for example, C.I.R. v George Forest Timber Co Limited (1924 AD 516), New State Areas Limited v C.I.R. (1946 AD 610) and Natal Estates Limited v C.I.R. (1975 (4) SA 177 A)). It is however beyond the scope of this paper to deal with the question in its widest context, but to restrict the analysis to the principles applicable to the receipt or accrual of an amount by way of compensation or damages.

The factual situations in which a payment of compensation or damages has occurred are numerous, but it is possible to distinguish several broad categories of factual situations (eg. the cancellation of an agency agreement) and, insofar

as this may be possible, it is proposed to analyse the decided cases within the various broad categories.

The initial category with which it is proposed to deal is that relating to compensation paid as a result of the loss or expropriation of an asset or right. This category furthermore contains several of the leading cases dealing with the nature of a receipt by way of compensation or damages. The leading South African case in this particular category is undoubtedly that of C.I.R. v Illovo Sugar Estates Limited (17 SATC 387; 1951(1) SA 306N). In this case Illovo Sugar Estates Limited carried on the business of sugar cane farming and the manufacturing of sugar. In the course of its business it both owned and leased land on which canefields were planted. Certain canefields were requisitioned by military and naval authorities during the war years of 1943 and 1944 for military purposes. In respect of land owned by the company, certain areas were taken over by way of lease and in respect of certain land which was leased by the company, the military authorities either took over the leases or cancelled the leases. The company was permitted to reap its standing crops of cane on the ground requisitioned by the military, but the cane ratoons which would in the normal course give rise to future crops were, in the process, destroyed. Evidence was produced to the satisfaction of the court that canefields were usually productive for a period of 14 to 16 years, and that

during that period some 6 crops of cane could be expected. Furthermore, damage to standing crops of cane was caused.

Compensation was paid to the company in respect of the loss of cane destroyed and also in respect of damage done to standing crops. The Commissioner for Inland Revenue regarded the various payments as income and assessed them to tax. The case was heard by the Special Court and thereafter appeals were lodged to the Natal Provincial Division which held that the amounts paid for damage to standing crops constituted income and were properly assessable to tax. However, the amounts paid in respect of the destruction of the sugar cane was in fact compensation for the loss of portion of the company's income-producing machine and were receipts of a capital nature irrespective of whether the land was owned or leased by the company. In reaching this conclusion the court had regard to what it termed "the true nature of a canefield in the economy of a cane grower", and was of the view that a canefield constituted a portion of the capital of a cane grower, being the "income-producing machine" (see page 393).

The principle to be extracted from this case is that where compensation is paid for the loss or destruction of an asset which forms part of the capital of a business, then that compensation itself assumes a capital nature.

In reaching its decision the court applied the case which is probably the leading case in this field, namely Glenboig Union Fireclay Company Limited v The Commissioner of Inland Revenue (1921 SC 400; 12 TC 427). In this case the company had a business consisting in the mining, sale and manufacture of fire-clay, and included in its assets were rights to certain seams of fire-clay. A certain area over which it held rights to fire-clay was reserved by a railway company for the support of its line and an amount was paid to the company by way of compensation. It was held, by 6 Judges out of 7, in the Court of Session that the compensation was not profits but was paid as consideration for a capital asset which had been rendered unavailable for the purposes of the company's business. It was said by the Lord President (Clyde) that:

> "It is obvious that it (ie the compensation) did not arise or accrue by or through any of the processes whereby the company's trade or business is carried on. On the contrary, it was paid because the company was prevented from applying any of those processes to the fire-clay in the areas affected directly or indirectly by the embargo. It was not a profit derived from the carrying on of the company's trade or business, it was paid because the company was wholly deprived of the opportunity to carry on its trade or business so far as the fire-clay in the affected areas was concerned ....

> we know nothing of how the company dealt with the value of its leasehold property in its books, or in framing its balance sheets. But prima facie the sterilisation of parts of them seems to me to imply a capital loss, and the payment of compensation to repair the injury to the company's undertaking which flowed from that sterilisation seems to me to be a restoration of capital."

The case then went on appeal to the House of Lords, where it was confirmed that the payment was in fact a capital receipt. At page 463 of the Judgment of the House of Lords Lord Buckmaster said:

> "In truth the sum of money is the sum paid to prevent the fire-clay company obtaining the full benefit of the capital value of that part of the mines which they are prevented from working by the railway company. It appears to me to make no difference whether it be regarded as a sale of the asset out and out, or whether it be treated merely as a means of preventing the acquisition of profit that would otherwise be gained. In either case the capital asset of the company to that extent has been sterilised or destroyed, and it is in respect of that action that the sum of £15 360 was paid. It is unsound to consider the fact that the measure, adopted for the purpose of seeing what the

total amount should be, was based on considering what are the profits that would have been earned. That, no doubt, is a perfectly exact and accurate way of determining the compensation, for it is now well settled that the compensation payable in such circumstances is the full value of the minerals that are to be left unworked, less the cost of working, and that is, of course, the profit that would be obtained were they in fact worked. But there is no relation between the measure that is used for the purpose of calculating a particular result and the quality of the figure that is arrived at by means of the application of that test. I am unable to regard this sum of money as anything but capital money ..."

The question touched on in the above quotation relating to the manner in which compensation is calculated, will be dealt with more fully at a later stage, but it may be stated here that the fact that compensation is calculated by reference to loss of future profits, does not necessarily taint that payment as a revenue receipt. Of importance however, is the thread running through both the judgments of the Court of Sessions and the House of Lords that the loss of the rights to the fire-clay seam constituted "a sterilisation" of part of the capital structure of the fire-clay company. It was accordingly for this sterilisation that the company was receiving the compensation which in turn was to

be regarded as capital. The Glenboig case has been cited as authority in numerous subsequent South African and English cases and may be regarded as laying down a basic principle, namely, that where compensation is paid in respect of the loss of a capital asset, then that compensation is itself capital. The converse of the principle is accordingly that where an amount is paid for loss of profits or for loss of a revenue item, then the compensation itself will be regarded as revenue and accordingly subject to tax.

Other cases dealing with the appropriation of an asset are ITC 740 (18 SATC 219) and ITC 835 (21 SATC 328). In the former case the taxpayer was a farmer whose farm was subject to a servitude in favour of the SA Railways and Harbours who, in terms of the servitude, were entitled to take water from the farm. The servitude, which was expropriated under statutory authority, entitled the Railways to enter upon the farm, sink boreholes and take water therefrom. In return the farmer received a payment of compensation. This payment was held subject to tax by the Commissioner for Inland Revenue and on appeal to the Tax Special Court, it was held that the transaction by virtue of which the compensation was received was akin to a sale, despite the element of expropriation, of the water which was a product of the taxpayer's farm. The payments were accordingly not in respect of a capital asset but were periodical payments for a product of the farm and accordingly constituted income. The Court

distinguished the Glenboig case and held that the corpus of the land was left intact and unimpaired.

In ITC 835 the taxpayer was a property dealer and also obtained income by way of rents. The Government erected a radar station near to certain land owned by the taxpayer company and a servitude was granted to the Government restricting the height to which buildings could be erected on the land in question so as not to interfere with the radar station. An amount of compensation was paid in respect of the grant of the servitude. The Glenboig case was distinguished by the Court on the basis that in the present case the land constituted part of the taxpayer's stock-in-trade and was a trading asset in the hands of the taxpayer. The receipt was accordingly held to form part of the taxpayer's revenue and was not a capital receipt.

Although the above cases have dealt with compensation paid as a result of the expropriation of assets, the same principles are applicable to the receipt of insurance payments for losses suffered.

In ITC 3 (1 SATC 50) an insurance payment received in respect of goods destroyed in transit was held to be a taxable receipt. ITC 594 (14 SATC 249) dealt with the proceeds of a claim under an insurance policy covering loss of profits. In this case the appellant taxpayer carried on

an engineering business. The taxpayer suffered a fire resulting in a loss of profits, which loss it recovered under a loss of profits insurance policy. The taxpayer contended that the receipt was of a capital nature and in the course of delivering its judgment, the Court referred, inter alia, to various English decisions. The Court relied on the case of Gliksten and Son Limited v Green (8 ATC 46) where it was held that an amount received on an insurance for the replacement value of a stock of timber destroyed by a fire, which was stock-in-trade, was held to be a revenue receipt as being in replacement of the stock-in-trade. It also referred to the Privy Council decision of Rex v British Columbia Fir and Cedar Lumber Company Limited (15 ATC 624; 48 TLR 284). This case was directly in point with the case under discussion in that in that case the taxpayer's premises and plant were insured against loss or damage by fire and in addition loss of profits was insured against. In holding that an insurance payment in respect of the loss of profits policy was a revenue receipt, the Privy Council stated:

> "This insurance receipt, therefore, was the product of a revenue payment prudently made by the respondents to secure that the gains which might have been expected to accrue to them had there been no fire should not be lost, but should be replaced by a sum equivalent to their estimated amount."

The appeal was therefore dismissed.

In ITC 597 (14 SATC 264) an amount received from an insurer under a loss of profits policy, as a result of damage to stock by a fire, was also held to be a taxable receipt.

An Appellate Division decision places the seal of approval upon the approach adopted in the above cases, namely that the receipt of an insurance payment for the loss of profits or for the loss of trading items constitutes revenue in the hands of the recipient and is subject to tax. The case referred to is, of course, that of Sub Nigel Limited (supra) where the Court was in fact concerned whether premiums of insurance payable on a particular insurance policy were deductible or not. In reaching its conclusion the Court dealt with the question of whether the proceeds of the policy would be capital or income. In this case the appellant company was a gold mining company which as a matter of course held policies of insurance against loss of net profits and standing charges. The rationale for the policy in regard to loss of profits was that the company wished to maintain its earnings should a fire occur interrupting production. Furthermore, in the event of a cessation of operations certain essential services and maintenance would have to continue which would involve the company in on-going costs, referred to as standing charges. Certain costs in regard to the retention of the labour force would also be

on-going. The evidence before the Court was that a failure to insure against standing charges could seriously affect the financial standing of the company in the event of the cessation of operations due to fire. The company sought to deduct the insurance premiums paid on the policies and the matter eventually came before the Appellate Division. In the course of deciding the question, the Court stated that the purpose of the insurance was to ensure that the company received an income in the event of a fire which would prevent the normal income-producing operations. At page 592 Centlivers, J.A. said:

> "There can, to my mind, be no doubt that, if a fire had occurred, the proceeds paid by the company's insurer in respect of the policies insuring net profits would have been of a non-capital nature and would therefore have had to be included in the company's "gross income" as defined ... see Rex v B.C. Fir and Cedar Lumber Company Limited ...
>
> Even apart from the above authority, it is difficult to understand how such proceeds could be regarded as receipts of a capital nature within the meaning of "gross income" as defined in Section 7. Similarly it seems to me that the proceeds of the policies in respect of the standing charges would also be of a non-capital nature ..."

He then went on to say:

> "To adapt the language used by the Privy Council in Rex v B.C. Fir and Cedar Lumber Company Limited ... the effect of complying with Section 12(c) (the account being otherwise in credit) would necessarily be to increase by the amount of the monies received from the insurer the taxable income of the company."

In the course of its judgment the Court analysed certain English decisions relating to situations similar to that before the Court. There appeared to be a conflict among the English cases insofar as the cases of Rhymney Iron Company Limited v Fowler (1896 (2) QBD 79) and Thomas Merthyr Colliery Co Limited v Davis (1933 (1) KB 349) seem to indicate that money received by taxpayers for purposes of indemnifying them against loss of profits would not be a trading receipt and would not be subject to income tax; whereas the Court of Appeal in C.I.R. v Williams Executors (1943 (1) AER 318) and the Privy Council in Rex v B.C. Fir and Cedar Lumber Company Limited (supra) appeared to indicate to the contrary.

Centlivers, J.A. at page 597 and following decided that the former two cases were not to be followed and that English law may differ from our law in this respect and that "such monies do not constitute receipts of a capital nature". The

Court therefore concluded that as any receipts of the insurance policy would be of a revenue nature, the premiums were deductible as they were expended in order to produce income. The decision is, with respect, a satisfying and correct one.

Despite the reservations expressed by Centlivers, J.A. in regard to the applicability of English decisions in this area of the law, there are certain decisions which are informative and instructive and, with respect, in accordance with the principles enunciated by our own Courts. In the case of Gray & Co Limited v Murphy (H.M. Inspector of Taxes) (23 TC 225) the Court was asked to decide whether certain monies payable to the taxpayer company pursuant to an accident insurance policy over members of its staff were liable to tax. The facts were that the taxpayer company had for several years taken out accident insurance policies in terms of which the company would receive compensation in the event of accident to members of its staff. The monies were payable irrespective of whether or not the company had any liability to its employee as a result of the accident. In 1935 the company's works manager suffered a fatal accident and the company received a payment in terms of the policy. An ex gratia payment had been made to the employee's widow. Both the receipt and the payment had been entered in the company's profit and loss account. MacNaghten J. argued that if an employee was injured so that he was temporarily

unable to fulfil his duties, the company would nevertheless remain liable to pay his wages which would be treated as a trading expense. Any amounts which the company received under its insurance policy would similarly be treated as income. He then enquired whether the fact that an employee was killed or totally disabled would make any difference to the question. He concluded that it should not and that the payments received by the company should be regarded as income. The amount received by the company was accordingly liable to tax but the ex gratia payment to the widow was not deductible.

A similar case came before the House of Lords, namely William's Executors v C.I.R. (26 TC 23). In this case the company was a beneficiary under policies against the death or disablement by accident of its directors. In 1938 one of the directors died as a result of an accident and the company received the proceeds of the policy from the insurance company. The question then arose whether the receipt was income or capital in the hands of the company. It was proved that the deceased director had particular experience and expertise which was of great value to the company. It was held by the House of Lords that the payment was a revenue payment and was taxable. In the course of delivering judgment, Lord Greene, M.R. stated the following general principles at page 35:

"If a company insures its stock goods against fire and that stock is destroyed by fire, however great and valuable it may be, the receipts must be treated in exactly the same manner as receipts from a sale of the goods would have been treated. The trader, it is true, as has been said, does not trade in fires but in goods, but if he disposes of the whole of his stock by sale or if the whole of his stock is destroyed by fire and the insurance money is received, there can be no ground for differentiating for tax purposes between the purchase money and the insurance money.

It seems to me that the benefits derived from a service contract fall into the same broad class. Suppose a company has a particularly valuable servant engaged under a contract of service. So long as that contract remains in force the salary which the company pays is expenditure on revenue account. The benefits which the company receives are reflected in its output and the profits that it makes. They are equally matters for revenue account. If during the course of that employment the servant is temporarily incapacitated the company's revenue account is affected by reason of the fact that during the incapacity it produces less goods or earns less profits. ... If the company takes out a policy for a sum which the director is to make or fairly represents the loss or part of the loss - it

> matters not - which they will suffer if they are deprived of those services, can it be said that the 50 pounds a week, or whatever the figure may be, that the company receives under such a policy is anything but a revenue receipt? ... The important matter is the object of the insurance, which may or may not be entirely achieved according to the accuracy of the estimate made."

Although the Court stated that this case was different to Gray's case, the result was the same, and in essence, it is difficult to see on what basis the Court regarded the two cases as distinguishable. The above two cases are, it is believed, in accordance with the principles of South African law in that the compensation paid for the loss of services of employees or directors is, to use the terminology used in the Burmah Steamship Company case (1931 SC 156), to fill a hole in the company's income rather than in its income-producing machine. In other words, the employees or directors of a company do not constitute its capital and the loss of an employee is not a capital loss. It is perhaps conceivable that in certain situations this may not be the case, for instance, where the business is the provision of particular personal services which can be rendered only by a particular person or persons. In that case it may well be that the services of the person in question constitute the capital or the income-producing machinery of the business in

question and that the loss of such a person would be a capital loss.

The receipt or accrual of any amount under any policy of insurance upon the life of any person who, at any time while the policy was in force, was an employee of the taxpayer or, where the taxpayer is a company, was a director or employee of that company, is now dealt with in terms of paragraph (m) of the definition of gross income in Section 1 of the Act. Paragraph (m) provides that to be included in gross income is "any amount received or accrued under or upon the surrender or disposal of, or by way of any loan or advance granted on or after 1 July 1982, by the insurer concerned under or upon the security of, any policy of insurance upon the life of any person who, at any time while the policy was in force, was an employee of the taxpayer or, where the taxpayer is a company, was a director or employee of that company, if any premium paid in respect of such policy is or was deductible from the taxpayer's income, whether in the current or any previous year of assessment, under the provisions of Section 11: Provided that where any amount received or accrued under or upon the surrender or disposal of any such policy falls to be included in the taxpayer's gross income, the amount so to be included in his gross income shall be reduced by the amount of any loan or advance under or upon the security of that policy which has been included in his gross income, whether in the current or any

previous year of assessment; provided further that where any such policy has been terminated by the insurer and a paid-up policy has been issued the terminated policy and the paid-up policy shall for the purposes of this paragraph be deemed to be one and the same policy".

It is not proposed to deal any further with this provision but for a further discussion of this paragraph see Silke on South African Income Tax, 10th Edition, paragraph 4.57.

The above discussion has dealt with the case where the proceeds of a policy following on the death or disablement of an employee are payable to the employer. The question, of course, also arises in regard to a person who takes out a policy in terms of which he himself will be paid an amount should he either temporarily or permanently become disabled and be unable to work for a living. In an article appearing in the Income Tax Reporter, Volume 10, at page 153, it is stated that normally an insurance premium is only deductible in terms of Section 11(w) of the Act. Furthermore it is stated that it can hardly be argued that the premium is laid out "wholly and exclusively for the purposes of trade" as required by Section 23 of the Act and that accordingly a premium would not be deductible. Furthermore compensation for personal injury is to be regarded as being of the nature of capital. Reference is made to the English case of Forsyth v Thompson (23 TC 374) where it was held that

payments by way of sickness benefits to a permanently disabled dentist were held liable to tax as being payments in the nature of an annuity. However, the loss of an ability to earn an income must surely be regarded as the loss of a capital asset in the same way that payments in restraint of trade are regarded as capital payments. The above analysis that premiums on a disability policy are not deductible and that the proceeds thereof are capital would appear to be correct. It is, however, apparently the practice of the Department to allow the deduction of the premiums and to subject the proceeds of the policy to tax (in this regard see Volume 11, Income Tax Reporter, page 17 and Silke, op. cit., paragraph 7.33).

The above discussion of employees leads conveniently to the next broad category to be discussed, namely compensation payable as a result of loss of employment. The position is now governed by the Act and paragraph (d) of the definition of gross income in Section 1 includes in gross income "any amount, including any voluntary award, received or accrued in respect of the relinquishment, termination, loss, repudiation, cancellation or variation of any office or employment or of any appointment (or right or claim to be appointed) to any office or employment; provided that the provisions of this paragraph shall not apply to any lump sum award from any pension fund, provident fund, retirement annuity fund or benefit fund."

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The above amounts referred to may qualify for the exemption provided in Section 10(1)(x) of the Act (presently R30 000) if the various provisos laid down in that Section are complied with, namely that the person has attained the age of 55 years in the case of a male or 50 years in the case of a female; or the Commissioner is satisfied that the termination or impending termination of such persons' services or the relinquishment, termination, loss, repudiation, cancellation or variation of his office or employment or of his appointment (or claim to be appointed, to any office or employment) is due to superannuation, ill health or other infirmity; or in the case of a female, the Commissioner is satisfied that she relinquished or terminated her office or services in order to marry.

There are however certain cases dealing with compensation for the loss of office or employment which may briefly be referred to as it is believed that they shed some light on the general principles applicable to the tax treatment of compensation and damages.

In ITC 6 (1 SATC 54), two years prior to the completion of a 5 year service agreement with a company, the company went into liquidation and the appellant's contract was cancelled. In return for his agreement to the cancellation of the contract, the appellant was paid a consideration. The Court held that the receipt was of the nature of income and was

accordingly taxable. This approach has, however, not been followed.

In CIR v Hersov (18 SATC 20; 1952 (1) SA 485A) the facts were that Hersov had held office as a permanent director of Anglo-Transvaal Consolidated Investment Company Limited in respect of which he was entitled to an annual remuneration. Hersov also held directorships in various subsidiary companies in the mining group. Anglovaal sought a listing on the Johannesburg Stock Exchange and, as a condition to the listing, Hersov was required to give up his rights to a permanent directorship. An agreement was accordingly entered into in terms of which Hersov agreed to waive his right to permanent directorship and to vote in favour of the necessary amendments to the company's Memorandum and Articles of Association. A sum of £6 250,00 was paid to Hersov in terms of the agreement. The agreement also provided for certain other matters, including that Hersov would apply for the allotment and issue of 12 500 shares in the company at par ie. £3 125. The market value of the shares at that date was considerably higher. The Appellate Division eventually held that in view of the fact that Hersov would continue to be remunerated should he remain in the service of the company, there was no ground for presuming that the consideration which was passing was given for services rendered or to be rendered. It was held that the true consideration for the allocation of the shares was

the waiver by Hersov of his rights and his agreement to vote in favour of the implementation of that waiver. The receipt was found to be of a capital nature and not subject to tax.

In ITC 463 (11 SATC 196) the taxpayer was the managing director of the company and the holder of certain shares in the company. A dispute arose with other shareholders and it was agreed that the taxpayer would transfer his shares to another shareholder and resign as managing director of the company. In return the taxpayer would receive the sum of £2 000 in cash from the other shareholder and an amount of £25 per month from the company for a period of 10 years. The taxpayer objected to the inclusion of the £25 per month payments in his income tax assessment and the Court allowed his appeal on the basis that the consideration was a payment in respect of his ceasing to have an interest in the company and was accordingly of a capital nature. The judgment is, with respect, not very satisfactory in that it does not deal in any detail with the reason for concluding that the taxpayer's interest in the company was of a capital nature. The major portion of the judgment is devoted to the question of whether the fact that the payments were made on a periodical basis necessarily resulted in those payments being regarded as income (which is an aspect which will be discussed at a later stage).

The approach adopted in both Hersov's case and ITC 463 is in accordance with the decisions of the English Courts, of which it is proposed to mention but two. The first case to be dealt with is that of Chibbett (HM Inspector of Taxes) v Joseph Robinson and Sons (9 TC 48) in which case the respondents were a firm of ship managers who were employed as such by a particular steamship company. Their remuneration consisted of a share in the profits of their client company. That company went into liquidation in 1918 and investments were distributed among the shareholders. Certain National War Bonds were distributed to the respondents "as compensation for loss of office". Thereafter the business of the old company including its remaining assets was transferred to a new company of which new company the respondents were again appointed managers. The respondent taxpayer contended that the amount awarded to it for its loss of office in the old company was a voluntary payment made to them as compensation for the loss of profits of their employment under the old company and was not liable to tax. This argument was upheld by the Court. At page 61 of the judgment Rowlatt, J. said:

> "If it was a payment in respect of the termination of their employment I do not think that is taxable. I do not think that is taxable as a profit. It seems to me that a payment to make up for cessation for the future of annual taxable profits is not itself an annual

> profit at all. ... but at any rate it does seem to me that compensation for loss of an employment which need not continue, but which was likely to continue, is not an annual profit within the scope of the Income Tax Act at all."

A similar result was reached in the case of Duff (HM Inspector of Taxes) v Barlow (23 TC 633). In this case the taxpayer was the managing director of a manufacturing company. This company purchased a subsidiary company in order to secure a supply of raw material and the management of the subsidiary company was largely the responsibility of the taxpayer, together with another director. It was agreed between the taxpayer and the company that the taxpayer would be specially remunerated for his management of the subsidiary company by way of a share in the profits of the subsidiary. The profits of the subsidiary proved to be higher than expected and no additional payment was made to the taxpayer. Instead it was agreed that the original arrangement should be terminated in the interests of the holding company and the taxpayer agreed to accept the sum of £4 000 as compensation for the loss of his right to future remuneration under the earlier agreement. He continued in his capacity as managing director of the holding company. It was held by the High Court of Justice that the compensation received by the taxpayer did not result from a contract of employment nor was it remuneration for services rendered

or to be rendered by him; it was compensation for giving up a right to remuneration. The amount was found not to be taxable.

Clearly the Courts, both in South Africa and in England, regarded the termination of a contract of employment and the subsequent loss of future income as a loss of a capital nature. The rationale underlying these decisions is surely that an individual's income-producing machine is the service which he can render under a contract of employment and that the early termination of such a contract is a sterilisation of the person's capital asset or his income-producing machine. In order to render such payments liable to tax it was accordingly necessary to insert paragraph (d) of the definition of gross income in Section 1 of the Act.

A variation on the theme of payments to employees is to be found in the case ITC 1289 (41 SATC 149). In this case the appellant was employed as a project manager in order to manage sales projects. The employer was dissatisfied with the results of the sales projects managed by the appellant and, without the knowledge of the appellant, caused two letters to be sent. The first letter was addressed to manufacturers stating that the appellant was no longer employed by the company, and the second letter was sent to the staff of the company stating that the appellant had resigned and left the company. A dispute between the

appellant and his employer resulted, which attracted the attention of the press. Eventually an agreement was reached whereby the appellant's employment was terminated and he received a sum of R40 000 from the company, being R10 000 in lieu of salary and R30 000 as "hush money" to avoid adverse publicity which the company would suffer were the appellant to institute action for defamation. It was held that the R30 000 did not relate to services rendered by the appellant but that the payment was as compensation for the attack on his reputation which was of a capital nature. The Court explained the position as follows:

> "The appellant had a reputation of being an outstanding sales promoter which, in my view, is the appellant's ability to earn income and is comparable to his "income-producing machine". The tarnishing of his reputation is, therefore, of a capital nature in that his ability to earn income is diminished. The agreement not to sue is a restraint to claim compensation for his reduced capacity to earn income."

The amount was accordingly not liable to tax. This case again underlines the attitude of the Courts that the ability or capacity of an individual to earn income is an asset of a capital nature and that any diminution of that ability or capacity giving rise to a payment of compensation would

result in that payment of compensation itself being of a capital nature.

A leading case in the field of the tax treatment of damages and compensation received is the Burmah Steamship Company Limited case (supra). The Burmah Steamship Company had purchased a second-hand ship which required repair. Ship-builders were engaged to complete the repairs considered necessary but the repairs were not completed within the time period stipulated. Eventually a sum was paid to the Burmah Steamship Company by way of damages. The damages were calculated on the estimated profits which the ship would have earned had the shipbuilders not been late in completing the repairs. The question of whether the receipt was of the nature of income or capital fell to be decided. The Court argued that if one of the company's vessels had been chartered and the charter breached, the damages recovered would be a revenue item. "The reason would be that the breach of the charter was an injury inflicted on the appellant's trading, making (so to speak) a hole in the appellants' profits ...". The Court then stated that if a vessel was sunk giving rise to a claim for damages, the result would be different. At page 160 the following was stated:

> "I imagine that there could be no doubt that the damages so recovered could not enter the appellants' profit and loss account; because the destruction of

> the vessel would be an injury inflicted , not on the appellants' trading, but on the capital assets of the appellants' trade, making (so to speak) a hole in them; and the damages could therefore - on the same principles as before - only be used to fill that hole".

After referring to the Glenboig case the Court went on to say:

> "It is very relevant to enquire whether the thing, in respect of which the taxpayer has recovered damages or compensation, is deprivation of one of the capital assets of his trading enterprise, or - short of that, a mere restriction of his trading opportunities."

The Court therefore found that the Burmah Steamship Company had not been deprived of a capital asset but simply of a trading opportunity and accordingly the compensation paid for the late completion of the repairs was a proper item for the profit and loss account. In the terminology adopted by the Court, the compensation was received for a hole in the profits of the taxpayer.

In an interesting obiter remark, Lord Sands (at page 161) stated that:

> "If the shipping company had seen their way to present the matter on the footing of an abatement from the contract price, it would have been very difficult for the Revenue to have maintained that the £3000 was anything else but a capital saving."

The cancellation of employment contracts has already been discussed, and the next broad category which falls to be dealt with is the cancellation of other agreements, the most common example being agency contracts. Silke, op. cit, paragraph 3.23, states that:

> "In order for compensation for the cancellation of a trading contract to constitute a sum of a capital nature, it is sufficient if the contract constitutes a substantial part of the business, and the cancellation need not have the effect of destroying or materially crippling the whole of the taxpayer's income-producing structure."

This test is substantially re-stated by Advocate Broomberg in his book "Tax Strategy", 2nd Edition, at page 200. This doctrine has its origin in English case law, the leading cases being Short Brothers Limited v IRC (12 TC 955) and Van Den Berghs (supra). The case of Short Brothers, like the Burmah Steamship Company case, is a case which smacks of the sea. In this case the taxpayer was a shipbuilder. The case

revolved around compensation received pursuant to the cancellation of two contracts. In the first contract the taxpayer had contracted to build two ships but had agreed to cancel the contracts in consideration for a payment of £100 000. In the second instance the company had agreed to build a steamship but before work had commenced, the customer went into liquidation and the taxpayer agreed with the liquidator to cancel the contract in return for compensation of the order of £35 000. The question of whether these payments were subject to tax came ultimately before the Court of Appeal which upheld the decision of Rowlatt, J. to the effect that the receipts were simply trading receipts "in the course of a going business". As the Court pointed out, Short Brothers were in no way restricted from carrying on their trade and the compensation which they received represented simply the profits which they would have made had the contract been proceeded with, and it was therefore this "hole" which was being filled.

In Van Den Berghs' case the facts were that the appellant company was a manufacturer and dealer in margarine and similar products. Their main competitor was a Dutch company and in 1908 an agreement was entered into between the two companies in terms of which they agreed to share their profits, not to enter into any pooling or price arrangements with third parties to the detriment of the two companies, to set up a joint committee to deal with various aspects of the

business, to promote generally the interests of the two companies in the margarine business, and several other points of co-operation. The intention of the agreement was to avoid competition between the two companies. Various supplemental agreements were entered into at a later stage. During the period of the first World War the two companies were unable to compute their profits and an attempt was made to continue with the agreement after the cessation of hostilities. In 1922 the taxpayer computed that the sum of some £449 000 was owed to it by the Dutch company. This was not admitted by the Dutch company and the question went to arbitration. After lengthy and expensive, but inconclusive, arbitration proceedings, a settlement was reached in terms of which the Dutch company paid £450 000 to the appellant company "as damages". The agreements between the companies were also cancelled. The importance of these agreements was referred to by the House of Lords in the following terms:

> "The three agreements which the appellant consented to cancel were not ordinary commercial contracts made in the course of carrying on their trade; they were not contracts for the disposal of their products or for the engagement of agents or other employees necessary for the conduct of their business; nor were they merely agreements as to how their trading profits when earned should be distributed as between the contracting parties. On the contrary, the cancelled agreements

related to the whole structure of the appellant's profit making apparatus. They regulated the appellant's activities, defined what they might and what they might not do, and affected the whole conduct of their business. I have difficulty in seeing how money laid out to secure, or money received for the cancellation of, so fundamental an organisation of the traders' activities can be regarded as an income disbursement or an income receipt. ... in my opinion that asset, the congeries of rights which the appellant has enjoyed under the agreements and which for a price they surrendered, was a capital asset."

The amounts received by the taxpayer were therefore not subject to tax.

Another English case of importance is that of Barr, Crombie and Co Limited v IRC (26TC 406). Under certain agreements, the taxpayer managed the ships of a shipping company for which it received a remuneration on a commission basis. It was specifically provided in the original agreements that if the shipping company should go into liquidation or cease to carry on business, compensation being the remuneration from the period of the date of liquidation until the date of expiry of the agreements would immediately become due to the taxpayer. The shipping company went into liquidation and an amount was duly paid to the taxpayer. The taxpayer

contended that the compensation was in respect of the loss of an agency which was fundamental to its business. In support of this contention it was proved that over 88 per cent of the taxpayer's income was derived from its management agreement with the shipping company. The company was successful in its contentions, and the Court held that the sum was a capital payment and not a trading receipt. The Court stated at page 411 that payment was received as the price of the surrender by the taxpayer of its only important capital asset.

The leading South African case on the termination of contracts is undoubtedly that of Taeuber and Corssen (Pty) Limited v SIR (37SATC 129; 1975 (3) SA 649 AD). The taxpayer in this case acted as an agent and distributor of chemicals, scientific instruments, photographic equipment and the like on behalf of German principals and had done so for a considerable period. Originally the business between the parties was conducted on a basis of good faith but in 1954 a formal agreement was entered into between a German company and the South African company. The contract was an on-going contract subject however to the right of termination at specified intervals. It was specially provided that in the event of termination, the German company would be entitled to impose a restraint of trade on the South African taxpayer to the effect that for a period of 2 years after the expiry of the contract, the taxpayer should not compete

in the sale or supply of chemicals produced by the German supplier. In 1966 the German company formed a subsidiary in South Africa for the purpose of supplying its chemicals to Southern Africa and accordingly the agreement was terminated and the restraint of trade was made operative. In respect thereof compensation was paid to the taxpayer, which payments the Secretary for Inland Revenue included in the company's taxable income. The company objected to this and the Appellate Division eventually held that the restraint had the effect of reducing the scope of the appellant's income-producing machine which constituted a capital asset. Accordingly the compensation paid in respect of such result was a receipt of a capital nature.

The basic principle that in order for compensation in respect of the cancellation of an agreement to constitute a receipt of a capital nature, it is necessary that the agreement must have been a substantial part of the taxpayer's business is illustrated in several other cases. A somewhat unsatisfactory case however is ITC 333 (8 SATC 333) in which compensation was paid to a company which had been formed to carry on business as sole agents for the sale of coal by a certain colliery in respect of the cancellation of the agency agreements. It was held that the amount of compensation had been received in lieu of future income and that it therefore partook of the same nature as income. The case is unsatisfactory in that no attempt is made to analyse

the effect which the cancellation of the agreements had on the business of the taxpayer and the importance of the agreements to the continued viability of the taxpayer was not analysed or even mentioned. The Court approached the question simply on the basis that the amounts were received instead of future income and that therefore the lump sum payment was itself income. It cannot be said on the facts contained in the reported judgment whether the decision was correct or not but clearly the approach of the Court was, with respect, incorrect. A case which suffers a similar deficiency is ITC 527 (12 SATC 430) where compensation paid to the South African agents of an English manufacturing firm for the cancellation of an agency agreement was held to be a receipt of a revenue nature and taxable. The same Judge as in ITC 333 namely, Dr Manfred Nathan K.C., dealt with the matter and, with respect, was guilty of the same misdirection as to the essential enquiry. Despite reference to numerous of the leading English cases on the subject, the Court appeared to regard as relevant only the fact that the amount was being received by way of loss of future profits and no attempt was made to analyse the importance of the agency agreement in the structure of the taxpayer's business.

A far more satisfactory analysis is to be found in ITC 1259 (39 SATC 65) where the taxpayer was a trust company which carried on the business of executors, trustees, liquidators,

administrators, etc. It had concluded a management contract with C. Limited in terms of which it undertook to manage extensive properties held by C. Limited. The obligations flowing from the agreement were such that the taxpayer was required to expand its staff, establish new branches and expand existing branches. Control of C. Limited changed and the management agreement was cancelled. Compensation was paid and the usual question arose as to whether the amount received was capital or not. It was found by the Court that the management agreement formed a substantial permanent part of the appellant's income-producing structure and that the receipt was therefore of a capital nature. The Court referred to the various English authorities and said that whether the rights and advantages surrendered on the cancellation of a contract were such as to destroy or materially cripple the whole structure of the recipient's profit making apparatus was essentially a question of degree. The test then stated by Silke and quoted above, was set out at page 69 of the Judgment from which it is clear that compensation paid for the parting by the recipient of a substantial part of its business undertaking (not necessarily the whole of its business) is sufficient to render compensation in respect thereof capital in nature.

The above tests were re-stated in ITC 1341 (43 SATC 215), a case in which the taxpayer company provided share transfer and similar services primarily to two groups of companies.

Although similar services were provided to other customers as well, this did not form a significant part of the taxpayer's business. The one group of companies terminated its services with the taxpayer and it was found by the Court that the services rendered to that group of companies constituted some 20% of the taxpayer's business. This, held the Court, was a sufficiently material dislocation of the taxpayer's business to render the compensation payable for such termination capital in nature. A material part of the taxpayer's business had been destroyed, an important "limb of the fruit-bearing tree was chopped off" and this could not be regarded as an ordinary incident in the course of business.

It appears therefore that in South African law the loss of a fifth of a taxpayer's business will be sufficiently substantial to constitute such a capital loss. The English Courts however appear to be somewhat more difficult to satisfy and seem to require a greater degree of loss before accepting such a loss as a capital loss. In Anglo-French Exploration Co Limited v Clayson (Inspector of Taxes) (1956 (1) AER 762) the loss of one agency out of eight contracts was held to be a normal trading risk and that the compensation payable was therefore a trading receipt. In the course of its judgment the Court stated that such receipts would be regarded as being received in the ordinary course of trade "unless the transaction involves a parting by the recipient

with a substantial part of its business undertaking". Reference was also made to Fleming's case (33 TC 57) where Lord Russell appeared to indicate that a substantial part of its business undertaking was one in respect of which the loss of which would be "such as to destroy or materially cripple the whole structure of the recipient's profit making apparatus."

In the case of Kelsall Parsons and Co v IRC (21 TC 608) the receipt of an amount of compensation in respect of the loss of an agency was held to be a revenue receipt despite the fact that the agency which had been terminated in some years yielded as much as half the total gross commission received by the taxpayer. Although the agency was admittedly an important one, the Court was not of the view that its loss was other than an ordinary loss to be expected in the normal course of business.

Other cases dealing with compensation payable due to the cancellation of contracts are:

Verrinder Limited v CIR (1949 (2) SA 147 T) where it was held that an ex gratia lump sum payment made to a company in respect of the termination of a contract in terms of which it had the sole right to purchase goods from an overseas company and to advance the sale of such goods in South Africa, had been made in recognition of past services by the

company and to compensate it for loss of future profits, formed part of the company's gross income.

Sabine (HM Inspector of Taxes) v Lookers Limited (38 TC 120) where the taxpayer was a motor dealer and a major distributor of Austin motor vehicles. The format of the distribution agreement was changed which resulted in the taxpayer being far less secure regarding renewals of the agreement than it had been in the past. Compensation was paid to the taxpayer in respect of the alterations to the contract. After some difficulty the Court reached the conclusion that the agreement "in effect laid down the conditions under which Lookers had to trade and earn their profits." The variations to the contract were of a material nature substantially affecting the trade of Lookers and accordingly the receipt was a capital receipt.

Finally reference may be made to the case of Jesse Robinson and Sons v IRC (12 TC 1241) in which compensation was paid in respect of the cancellation of contracts for the sale of yarn. It was contended on behalf of the taxpayer that the amounts paid were damages for breach of contract and not trading receipts or profits. The Court, however, held that the amounts were indeed trading receipts and profits.

A further category, or perhaps sub-category, are amounts payable as a result of the cancellation of lease agreements.

It is trite tax law that the receipt of rental payments is a receipt on revenue account. When a lease agreement is cancelled the question, of course, arises whether the compensation paid to the lessor still retains an income character or whether it acquires a capital nature. The decided cases clearly indicate that the receipt of compensation in such circumstances is a revenue receipt. In ITC 312 (8 SATC 154) the taxpayer let portions of a building owned by it. Portion of the building was let under a 5 year lease, however some 2 years before the termination date the lessees sought to cancel the lease. The taxpayer permitted the cancellation on payment of the rental for the remaining period after allowing a one-third discount. After some correspondence an amount less than two-thirds of the remaining rentals was settled upon and the lease was cancelled. This sum was included by the Commissioner for Inland Revenue in the income of the lessor, to which it objected. The Special Tax Court confirmed the assessment, holding that the payment arose out of the contract of lease and was therefore a receipt on income account. Similarly in ITC 1279 (40 SATC 254) the lessor taxpayer had leased premises for a period of 20 years. The leased premises were let for the purpose of conducting the business of a bottle store and it was a term of the lease that the lessee would not apply for a transfer of the liquor licence to other premises without the consent of the lessor. After some seven years, the lessee wished to remove the liquor licence

and sought the lessor's permission. After some negotiation a figure of R15 000 was settled on being the amount which the lessor required to permit the cancellation of the lease and the removal of the liquor licence. The taxpayer adopted the attitude that this amount was a capital accrual as the removal of the liquor licence had, so the taxpayer alleged, affected its ability to let other shops in the shopping centre as the bottle store had been an attraction or, alternatively, compensation for alterations to the premises consequent upon the removal. It was found by the Court that the sum of R15 000 represented the capitalised value of future rentals and that the sum was consequently in the nature of revenue, not capital.

The same approach in regard to the cancellation of lease agreements has been adopted by the English Courts. For instance in the case of Greyhound Racing Association (Liverpool) Limited v Cooper (HM Inspector of Taxes) (20 TC 373) the appellant acquired a racing track, originally on lease but it thereafter purchased the property. The racing track was leased by the appellant to another company in consideration of a percentage of the gross takings, subject to certain minimum payments. The lessee was placed in voluntary liquidation and it was agreed that the lease agreement would be surrendered if a new company were formed to take over the track at a lower rental and also that a sum equal to the difference between the old and the new rentals

was paid to the appellant. It was argued on behalf of the appellant that this amount was of a capital nature in respect of the diminished value of the goodwill of the company for the period in question. This argument did not find favour with the Court which held that the sum was a trading receipt and subject to tax. The Court stated:

> "The question as to what receipts are revenue and what are capital has given rise to much difference of opinion; but it is clear, in my opinion, that, if the sum in question is received for what is in truth the user of capital assets and not for their realisation, it is a revenue receipt, not a capital."

The compensation paid was held to be no more than a lump sum payment in place of future rentals.

A variation on the theme is to be found in ITC 175 (5 SATC 180) where a lease was cancelled at the instance of a lessor and the compensation was paid to the lessee. The Commissioner sought to include this amount in the income of the lessee as being an amount received by him as a premium or like consideration in respect of a grant of the right to use the premises. The Court, however, held that the amount received for the surrender of a right of occupation could not be taxable as such in as much as the payment was not in

respect of occupation by a lessee but the cessation of such occupation. The amount was accordingly not subject to tax.

The above cases are clearly all in accordance with the general principles governing the tax treatment of the receipt of compensation or damages, in that compensation for the loss of rental is clearly designed to fill a hole in income and not in capital.

Analogous to compensation received in respect of the loss of an asset or contractual right, are payments received as compensation for restraints of trade. Several cases of this type merit consideration. In ITC 254 (7 SATC 56) the taxpayer had a business which consisted of two branches, namely a manufacturing and a sales branch. The taxpayer entered into an agreement with a competitor in terms of which the manufacturing branch was closed down in consideration for a monthly payment of £60,00. The agreement was for an initial period of 2 years and thereafter for an indefinite period, subject to cancellation on 6 month's notice by either party. The taxpayer maintained that the payments which it received were capital amounts, with which contention the Court agreed in the following terms (at page 57):

> "It seems clear to the Court that the transaction in effect was one which constituted this money a receipt

> of a capital nature. The appellants were not earning their income in the way in which they had previously done, and in effect, they ceased to earn income from this particular business in the normal way. It does not appear to the Court that this was portion of a scheme of profit-making, which they had adopted, but rather that they surrendered a scheme of profit making which had been in vogue in consideration of a certain payment."

The Court found support for its decision in the Glenboig case. It should be noted that although the taxpayer was in receipt of a monthly payment, it was nevertheless held to be a capital amount. This aspect will be discussed further.

Within this category of payment also fall the so-called "oil company" cases. For instance, in ITC 772 (19 SATC 301) the taxpayer conducted the business of a garage and service station. In the particular year of assessment in question, it had received an amount of £1500,00 from an oil company pursuant to an agreement with the company in terms of which the taxpayer agreed to purchase from the oil company all the petrol and lubricants required for the purposes of its garage and service station business and to display and expose for sale only the products of the oil company in question. The agreement also provided that should the taxpayer wish to sell or lease the premises the oil company

would have a right of pre-emption in those respects. The agreement was for a period of 5 years with a right of renewal for two further periods of 5 years each. The Court held that the true effect of the contract was to restrict the taxpayer's previously unfettered right to trade. This, held the Court, constituted part of the taxpayer's machinery for producing income or profit-making apparatus. Even although the agreement was for a temporary period, for that period there was a sterilisation of a portion of the taxpayer's capital assets. The payment was accordingly capital in nature. A similar result is to be found in the Australian case of Dickenson v Federal Commissioner of Taxation (7 AITR 257). This case was also one where the taxpayer had a garage and service station business and agreed with Shell to deal only in Shell products. It was also agreed that the taxpayer would not, for a period of 5 years, within a radius of 5 miles from his existing service station become interested in a service station other than one in which Shell products were exclusively sold. Compensation was paid by Shell to the taxpayer. The Court adopted the same line of reasoning as that applied in ITC 772, stating (at page 267):

> "It appears to me that the sum or sums were paid as the quid pro quo for an effective tie of the appellant's business to one wholesale vendor of petrol. The appellant's business constituted a profit yielding

> organisation of a different structure under his control and he received the money as part of an inducement to change a feature in it. ... there is nothing recurrent in the nature of the payment. It is not a normal or natural incident of carrying on such a business and it does not represent a purpose for which such a business is carried on. I think therefore that the sum ought not to be treated as a profit of the existing business."

The compensation payments were therefore held to be of a capital nature.

The English Courts have adopted the same approach in dealing with payments in restraint of trade. As an example of this the case of Margerison (HM Inspector of Taxes) v Tyresoles Limited (25 TC 59) may be cited. In this case the respondent company carried on the business of "tyresoling" which was a process for renovating old tyres. It entered into agreements with various motor traders in terms of which it erected and operated a tyresoling plant at the premises of the motor traders in return for a monthly payment. The company also agreed not to situate another tyresoling plant or canvass for orders within certain prescribed areas in relation to each trader with which it had a contract, in return for which it received a lump sum payment on commencement of the agreement. The Court held that the

restraint imposed on the company was a parting by the company of a portion of its capital resources and as such the lump sum payment received was capital.

That concludes the analysis of the major categories of receipts or accruals of compensation and damages and it remains only to discuss briefly certain miscellaneous cases which do not fit neatly into the above broad categories. The first of these cases is ITC 899 (23 SATC 497) where the facts were that the appellant had sold his farms together with implements and other movables to a particular purchaser. The purchaser was unable to meet the obligations in terms of the contract and after some negotiation the sale was cancelled. Compensation was paid to the seller under three headings, namely depreciation on implements, capital reduction and interest on the sale price. The first two items were held by the Court to be receipts of a capital nature whereas the amount received in respect of interest was held to constitute a receipt on income account.

ITC 880 (23 SATC 234) dealt with a case where a lender permitted the early repayment of a loan in return for the payment of £1500,00 as consideration therefor. The Court found that this amount took the place and the colour of the interest lost and accordingly formed portion of the tax-payer's income. This case is analogous to the cases where compensation is paid to a lessor for the early termination

of a lease, such compensation being regarded as amounts in lieu of future rentals. In ITC 880 the amount paid was regarded as being in place of future interest.

A somewhat unusual case is that of Miller v CIR (18 SATC 347; 1952 (4) SA 765 T) where the appellant taxpayer had been a partner with two other persons in certain interests. The partnership was dissolved and a certain Mr Horwitz agreed to procure the release of his former partners from certain obligations which they had undertaken. Being unable to procure their release within the period stipulated, it was agreed that Horwitz would pay to his former partners (one of whom was, of course, the taxpayer) a certain monthly sum until such time as the releases were effected. The amounts received from Horwitz by the taxpayer were subjected to tax and he appealed to the Transvaal Provincial Division against this assessment. The Court held that the penalty payments in question "bore the imprint of income" and were not of a capital nature. This case is unusual in that the amounts paid to the taxpayer were not in respect of any loss which the taxpayer had actually suffered but constituted a penalty for the late fulfilment of certain obligations. The decision of the Court is no doubt correct as it cannot be said that the taxpayer's income-producing machine had in any way been affected.

The final case to discuss in this section of miscellaneous cases is ITC 723 (17 SATC 496) where the taxpayer entered into an agreement with a builder and certain associates to take over an option to take up shares in a landowning company with a view to developing the land and sharing the profits. The taxpayer was actually a wholesale merchant. The builder failed to transfer the option to the company and an action for damages was brought by the taxpayer and the associates, which action was settled, the taxpayer eventually receiving the sum of £1000,00. The balance of this amount, after allowing for certain expenditure, was included by the Commissioner in the taxpayer's income. The Court found that the amount in question was income on the basis that the transaction out of which the claim for damages arose was a transaction entered into for the purpose of a profit making scheme and would have resulted in income and not in a capital gain or loss. The damages were therefore paid in respect of loss of income and not loss of capital. The result is, it is respectfully submitted, correct and in accordance with the general principles applicable to receipts of payments of damages.

It remains only to discuss the question, which has been touched on briefly from time to time above, whether the manner of calculating compensation or damages to be paid in any way affects whether the amount arrived at is income or capital; in other words, does the fact that damages are

calculated with relation to profits necessarily result in the amount arrived at being of a revenue nature? It is also proposed to discuss briefly whether the fact that a payment is a lump sum payment or paid in several instalments in any way affects the issue.

One may begin by referring once again to the leading case of Glenboig where it was said (op. cit. at 409):

> "It is, no doubt, true that the measure by which the amount of compensation is fixed may be, and in the case we are now dealing with was held by the learned arbiter to be the profits which the railway company prevented the appellant's from making by the appellants being prohibited from working the reserved minerals. That, in my opinion, is beside the real question". And again at page 412: "True the appellant's Counsel pointed out that the sum was awarded by the learned arbiter as being equivalent to his estimate of the capitalised amount of profits of which, by the embargo, they were deprived. Ergo, it was contended, that the sum is for loss of profits, and is not of the nature of capital. In this argument, there is, I think, a double fallacy."

The true test, the Court stated, was to determine what the amount was really paid for and from what it arose. This was reaffirmed in the Burmah Steamship Company case (op. cit. at

page 160). See also Barr, Crombie and Co Limited (op. cit at page 410) where it was stated that:

> "Although annual payments in the nature of profits may be used as the measure by which to calculate the sum which is to be paid, the resultant sum is not thereby made itself an annual payment or a profit."

It will be noted that in all of the above three quoted cases, although the compensation in question was calculated with reference to profits or remuneration, the sum was found to be in each case of a capital nature.

The same principle exists in South African law as is clear from the case of ITC 1341 (op. cit) where it is held that although there was a close relationship between the agreed compensation and the loss of profits which flowed from the termination of the agreement, not too much significance should be accorded to that since the use of expected profits to value a capital asset is a normal principle of valuation.

To turn now to the method of payment, it is clear that the mere fact that compensation or damages is paid as a lump sum does not necessarily constitute that amount capital. See for instance ITC 6 (op. cit) where a lump sum payment was held to be income. Reference was made to the case of

Hancock v General Reversionary and Investment Company Limited (7 TC 358) where it was said:

> "It seems to me to be as impossible to hold that the fact that a lump sum was paid instead of a recurring series of annual payments alters the character of the expenditure as it would be to hold that if an employer made a voluntary arrangement with his servant to pay the servant two years' salary in advance instead of paying each year's salary as it fell due, he would be making a capital outlay."

Similarly in ITC 312 (op. cit) the lump sum payment made in respect of the cancellation of the lease was found to be of a revenue nature. As was stated in the Tyresoles Limited case (op. cit at page 36):

> "There is no magic here in the distinction between a lump sum and a periodical sum. The question is: what is the nature of the sum? And although the fact that there is a lump sum paid once and for all rather tends to colour the question and to make one inclined to regard it as of a capital nature, that, in my opinion, is apt to be misleading."

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It is clear therefore that a lump sum may be income.

On the other hand, is it possible to regard a periodical sum as capital? This question was answered in the affirmative in ITC 463 (op. cit) where a monthly payment for 10 years was held nevertheless to be a capital amount. Reference was made by the Court to the English case of Jones v Commissioner of Inland Revenue (121 LT 611) which was approved in Deary v Deputy Commissioner of Inland Revenue (1920 CPD 541) where it was said:

> "A man may sell his property for a sum which is to be paid by instalments, and when you see that that is the case, that is not income nor any part of it ... A man may sell his property for what is an annuity - that is to say he causes the principal to disappear and an annuity to take its place. If you can see that that is what it is, then the Income Tax Act taxes it. Or a man may sell his property for what looks like an annuity, but you can see quite well from the transaction that it is not really the transmutation of a principal sum into an annuity, but it is a principal sum, the payment of which is being spread over a time and is being paid with interest, and it is all being calculated in a way familiar to accountants and actuaries, although taking the form only of an annuity .. when you break up the sum and decide what it really was."

A similar result was obtained in ITC 254 (op. cit) where periodical payments in restraint of trade were found to be capital. Silke, (op. cit page 83, Note 36) seems to express some doubt as to the correctness of this case and queries whether the form of the consideration should not perhaps have altered the result. It should, of course, be noted that paragraph (a) of the definition of gross income in Section 1 of the Act includes in gross income "any amount received or accrued by way of an annuity". The term "annuity" is not defined in tne Act although there are numerous cases which have attempted such a task. In ITC 761 (19 SATC 103) the main characteristics of an annuity were said to be that it is an annual payment; that it is repetitive and that it is chargeable against some person. The Appellate Division has had the following to say:

> "Used in regard to payments, the word ("Annuity"), from its very nature, postulates the element of recurrence, in the sense of annual payments (even if made, say, quarterly during the year) and this element of necessary annual recurrence cannot be present unless the beneficiary has a right to receive more than one annual payment." - R v Watermeyer (1965 (4) SA 431 A; 27 SATC 117).

It is submitted however that the remarks quoted above from Jones' case nevertheless remain valid. If an amount paid in

periodical instalments is nothing more than an instalment of a principal capital sum, then the mere fact that it is made on an instalment basis should not necessarily convert the amount into an annuity or otherwise render it liable to tax. See also ITC 115 (4 SATC 66). In general see Silke, (op. cit, paragraph 4.3).

Finally, it should be noted that the receipt of an amount by way of damages or compensation may represent a recoupment of previously deducted expenditures or capital allowances and therefore fall to be included as income in terms of Section 8 (4) of the Act.

In conclusion of this chapter therefore, it may be said that where an amount is received by way of compensation or damages in respect of the loss or sterilisation of a capital asset or the loss or destruction, whether of the whole of or of a substantial part of, the income-producing machine of the taxpayer's business, the amount will be capital. In other cases the amount will be regarded as income. Although different terminology and varying tests have been applied in the different categories of cases which have been analysed above, it is submitted that the general principle remains the same throughout.

Chapter 3 - The deductibility of damages and compensation paid

In chapter 2 the taxability of damages or compensation received or accrued has been examined and it is now necessary to consider the other side of the coin, namely whether the payer of damages or compensation to another person may deduct the amounts so paid from his income. The Courts have enunciated certain tests in attempting to answer this question and it will be seen that the approach has not been altogether consistent. In an attempt to analyse the various decisions, it is proposed to follow a basis of analysis broadly similar to that adopted in chapter 2, namely the division of cases into general categories so that cases of a similar general nature may be compared. It is hoped that by analysing the cases on this basis, a test applicable to cases of a similar nature may be discovered.

The deductibility of all items is governed by Section 11 of the Act as read with Section 23. In particular Section 11(a) states that:

> "There shall be allowed as deductions from the income of a person 'expenditure and losses actually incurred in the Republic in the production of the income,

> provided such expenditure and losses are not of a capital nature'."

Together with Section 11 must be read Section 23, and in particular Section 23(g) where it is provided that no deductions shall be made in respect of "any monies claimed as a deduction from income derived from trade, which are not only or exclusively laid out or expended for the purposes of trade."

It is beyond the scope of this paper to attempt to analyse all the constituent elements of these two Sections, except insofar as they may be appropriate to the determination of the question of the deductibility of damages or compensation paid, but certain introductory remarks on the general interpretation of these Sections may be apposite.

The distinction between the words "expenditure" and "losses" as they occur in Section 11(a) has been highlighted and in Joffe & Co vs CIR (1946 AD 157, 13 SATC 354) Watermeyer, C.J. at page 360 of the judgment in the SATC reports said in regard to the word "losses":

> "In relation to trading operations the word is sometimes used to signify a deprivation suffered by the loser, usually an involuntary deprivation, whereas

expenditure usually means a voluntary payment of money."

Furthermore, provided an expense has been actually incurred, in the sense that a liability to make payment has arisen, such an expense is deductible (see Port Elizabeth Electric Tramway Co. Limited vs CIR - 1936 CPD 241,8 SATC 13). It should also be noted that the expenditure or losses must be actually incurred in the Republic of South Africa. Possibly the major distinguishing test for the deduction of expenditure and losses is that they must have been incurred "in the production of the income" and furthermore the monies must have been "wholly or exclusively laid out or expended for the purposes of trade". These words will be examined in some detail in analysing the various cases applicable to the payment of compensation and damages and accordingly it is not proposed to deal with them at this stage.

Finally, in order to rank as a deduction an expenditure or loss must not be of a capital nature. Again these words have enjoyed some attention in the cases relating to damages and compensation but it is appropriate to state at this stage the oft cited test on the distinction between capital and revenue expenditure and losses enunciated by Watermeyer, C.J. in the case of New Estate Areas Limited vs CIR (1946 AD 610, 14 SATC 155). At page 184 of the SATC reports the Chief Justice stated that expenditure or losses may be

incurred in the actual operations or work of a business or alternatively in the acquisition or improvement of the means of production. He then went on to say:

> "Both these forms of expenditure can be described as expenditure in the production of the income but the former is, as a rule, current or revenue expenditure, and the latter is, as a rule, expenditure of a capital nature. As to the latter the distinction must be remembered between floating or circulating and fixed capital. ... The expenditure of a capital nature, the deduction of which is prohibited under Section 11(2) (now Section 11(a)), is expenditure of a fixed capital nature, not expenditure of a floating capital nature, because expenditure which constitutes the use of floating capital for the purposes of earning a profit, such as the purchase price of stock-in-trade, must necessarily be deducted from the proceeds of the sale of stock-in-trade in order to arrive at the taxable income derived by the taxpayer from that trade. The problem which arises when deductions are claimed is therefore usually whether the expenditure in question should properly be regarded as part of the cost of performing the income-earning operations or as part of the cost of establishing or improving or adding to the income-earning plant or machinery ... The conclusion to be drawn from all of these cases seems to be that

the true nature of each transaction must be inquired 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."

A further test which has been frequently cited is that laid down by Innes, C.J. in CIR vs George Forest Timber Co Limited (1924 AD 516, 1 SATC 20). At pages 526 to 527 of the Appellate Division report, it was said:

> "Now, money spent in creating or acquiring an income-producing concern must be capital expenditure. It is invested to yield future profits; and while the outlay does not recur the income does. There is a great difference between money spent in creating or acquiring a source of profit, and money spent in working it. The one is capital expenditure, the other is not. ... The reason is plain; in the one case it is spent to enable

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> the concern to yield profits in the future, in the other it is spent in working the concern for the present production of profit. The definition is statutory; but is recognises the basis distinction between the two classes of outgoings."

The distinction between expenditure of a capital or a revenue nature has been pertinently considered by the Court in several cases dealing with the payment of compensation and damages. In ITC 727 (18 SATC 91) the taxpayer was a partner in a firm of consulting engineers. In the year of assessment in question, the taxpayer claimed a deduction of £300 in respect of an item headed "compensation for error". It was held by the Special Court that the firm had been under no obligation to make the payment, which had arisen when the boundaries of a lot were not observed in the construction of certain buildings as a result of which some foundations had to be demolished and rebuilt. The Court found that it could not say that there was any liability on the firm of engineers to make the payment and that it had, in fact, been motivated by a desire to preserve its good name and the payment had therefore been made ex gratia. This the Court said, was "clearly an outlay of a capital nature" and was therefore not deductible.

Other cases dealing with the question of the deductibility of compensation and damages paid which have revolved around

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Other cases dealing with the question of the deductibility of compensation and damages paid which have revolved around

the question of capital and revenue are, inter alia, ITC 1267 (39 SATC 146) and ITC 1076 (28 SATC 31). A similar approach on the revenue and capital question can be discerned in the attitude of the English Courts (in this respect see Morgan vs Tate and Lyle Limited ((1954) 2 AER 413). The facts of these cases will be dealt with later.

Thus far the general elements for the deductibility of all expenses and losses have been dealt with; it is now possible to deal specifically with the question of the deductibility of damages and compensation paid. As previously stated it is proposed to do this by categorising the cases under general headings and examining the approach adopted in each such category. The first category to be dealt with are those cases in which damages were paid as a result of delictual or tortious liability. This is by far the single largest category of cases and furthermore contains the leading cases on this particular subject.

The leading case, not only in the field of the deduction of compensation and damages, but also in regard to the deductibility of expenditure or losses as a whole, is undoubtedly the Port Elizabeth Electric Tramway Company Limited case (supra). The facts of this case are simply stated. A driver of one of the company's trams lost control of his vehicle and collided with a building, injuring himself. Compensation was claimed under the Workmen's

Compensation Act and after legal proceedings, the company was ordered to pay an amount of damages. Costs in resisting the legal proceedings were also incurred. The question then arose whether the company was entitled to deduct the damages it had paid as well as the legal costs it had incurred from its income and the question eventually fell for decision before the Cape Provincial Division. At page 244 of the judgment the Court said that there are three qualifications for expenditure to be allowable as a deduction, namely the expenditure must be actually incurred, it must not be of a capital nature and it must be incurred in the production of income. Furthermore as long as it is "actually" incurred it need not have been incurred "necessarily". The Court had little difficulty with the first two qualifications in this case finding that clearly the expenditure had actually been incurred and that it was not of a capital nature insofar as its purpose "was not that of acquiring an income-producing concern" and that the expenditure could possibly be recurrent.

The Court then turned to the third qualification namely, was the expenditure incurred in the production of income and furthermore was it wholly and exclusively made for the purposes of trade. The Court then analysed various decisions in the course of which the following test was laid down at pages 245 and following:

"Now, as pointed out above, income is produced by the performance of a series of acts and attendant upon them are expenses. Such expenses are deductible expenses provided they are so closely linked to such acts as to be regarded as part of the cost of performing them. ... A little reflection will show that two questions arise (a) whether the act to which the expenditure is attached is performed in the production of income and (b) whether the expenditure is linked to it closely enough. Though at first sight it would appear that only acts necessary to earn the income and expenditure necessarily attendant upon such acts should be deducted; but this is not so.

As pointed out above businesses are conducted by different persons in different ways. The purpose of the act entailing expenditure must be looked to. If it is performed for the purpose of earning income then the expenditure attendant upon it is deductible. ... It follows that provided the act is bona fide done for a purpose of carrying on the trade which earns the income the expenditure attendant on it is deductible. It seems, however, that this statement may require qualification in one respect. If the act done is unlawful or negligent and the attendant expense is occasioned by the unlawfulness or possibly the

negligence of the act then probably it would not be deductible ...

The other question is what attendant expenses can be deducted? How closely must they be linked to the business operation? Here, in my opinion, all expenses attached to the performance of a business operation bona fide performed for the purpose of earning income are deductible whether such expenses are necessary for its performance or attached to it by chance or are bona fide incurred for a more efficient performance of such operation <u>provided they are so closely connected with it that they may be regarded as part of the cost of performing it</u>." (My underlining).

Turning to the facts, the Court then applied the test it had just stated and found that the employment of drivers was necessary for the business of the Tramway Company and that such employment carried with it as a necessary consequence a potential liability for compensation if the drivers were injured in the course of their employment. The liability was inseparable from the employment of drivers and accordingly, the Court found, the damages which had been paid were deductible. The question of the deduction of the legal costs however, the Court found was to be dealt with on a different footing and were in fact not deductible. The reason for this was that "in the present case they were

expended in resisting a demand for compensation, this is not an operation entered upon for the purpose of earning income" (page 248).

The test laid down can be summarised as follows: Expenditure attendant upon an act bona fide done for the purpose of carrying on a trade which earns the income is deductible provided that the expenditure is so closely connected with the act that it may be regarded as part of the cost of performing it.

The Court also appeared to suggest that unlawful or negligent acts would render any expenditure connected with those acts non-deductible. This view has however been challenged and in ITC 815 (20 SATC 487 at 491) it was said:

> "Negligence in itself affords no reason why a loss caused by it should be held to be non-deductible. And there is no reason in principle why it should make any difference whether the negligence is that of employees or of the taxpayer himself. Negligence is an element of inefficiency, and an inefficient taxpayer is taxed upon the income which he actually earns and not upon that which he should have earned had he been efficient. Whether or not a loss caused by negligence would be deductible would depend upon the facts of the particular case and upon such matters as the nature and

degree of the negligence and the character of the business."

It is submitted that this is the correct approach and that there is no reason why the test as set out in the Port Elizabeth Tramway's case cannot be applied equally validly to negligent acts as to any others. The approach of the Courts on this question has not been consistent but apparently the practice of the Revenue Authorities is to allow the deduction of expenditure incurred as a result of the negligence of the taxpayer or his employees if accidents are a necessary result of the operations of the taxpayer (see Silke, op. cit., paragraph 7.27).

A similar case to the Port Elizabeth Tramway's case and which predated it, was ITC 8 (1 SATC 57) where the taxpayer, also a tramway company, had paid compensation for injuries to persons and damages to property resulting from collisions, broken trolley wires and excavations in roadways and from accidents due to passengers alighting while the trams were still in motion. Legal expenses had also been incurred. The Court adopted similar reasoning to that which would be applied in the Port Elizabeth Tramway's case and said that the expenditure had to an extent been "inevitable". At page 58 the Court referred to the various items of expenditure and said:

"The occurrences they represent were not extraordinary or abnormal. They were incidental and pursuant to the course of the operations which produced the profits and formed a necessary risk undertaken to earn the profits. Such being the case they were losses incurred on income account."

Adopting a different approach to that adopted in the Port Elizabeth Tramway's case however, in this case the Court found that the legal expenditure was equally inevitable and was also deductible.

Another leading case in this field is Joffe's case (supra) which was a decision of the Appellate Division. The facts in this case were that the taxpayer was an engineering firm which had contracted to carry out the steel reinforcement necessary for a cantilever hood. The reinforcing steel rods for the support of the hood had been displaced from their proper position during the operations of pouring concrete and as a result of this displacement, the structure was weakened and collapsed, killing a plumber who was working beneath it at the time. Action was instituted against the taxpayer on behalf of the dependants of the plumber and it was found that the taxpayer had been negligent as it should have taken proper precautions to ensure that the steel rods were not displaced and damages were awarded in favour of the plumber's dependants. Legal costs were also incurred by the

taxpayer in defending the action and it was further required to pay the costs of the successful litigants. The taxpayer sought to deduct the damages and the costs.

The judgment of the Appellate Division was delivered by Watermeyer, C.J. (who, co-incidentally had been the judge to deliver the decision in the Port Elizabeth Tramway's case). After stating the statutory provisions applicable, the Court went on as follows:

> "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.
>
> The damages paid out in this case do not pass that test. They were paid out to discharge a debt or legal liability to the plumber's dependants, arising out of the Appellant's negligence in performing a trading operation. There is nothing in the stated case to suggest that such negligence, and the consequent liability which such negligence entailed, were

> necessary concomitants of the trading operations of a reinforced concrete engineer; nor was it shown that the liability was incurred bona fide for the purpose of carrying on any trading operation. Consequently, according to the interpretation which I have suggested above, the payment of the damages was not made for the purposes of trade."

The Court then went on to analyse the meaning of the word "loss" but found, in any event, that for the same reasons as have been quoted above, even if the damages were regarded as a "loss" they were not deductible. It had been conceded by counsel that if the deductibility of the damages was not allowed, then the costs would also not be deductible. The taxpayer accordingly failed in all respects.

It is submitted that the decision in Joffe's case is somewhat difficult to reconcile with that in the Port Elizabeth Tramway's case as although it is no doubt correct to say that negligence is not a "necessary concomitant" of the business of an engineer, negligence in such a context is not totally unheard of and furthermore the act or omission giving rise to the claim for damages was undoubtedly incurred in the course of the taxpayer's income-earning operations and was a result of those operations. It is respectfully suggested that the Court applied an unnecessarily strict approach.

In both the Port Elizabeth Tramway and the Joffe cases, substantial reliance was placed on English authorities. The leading English case of Usher's Wiltshire Brewery vs Bruce (1915 AC 433) was relied upon. In this case the deduction of certain expenditure, which had been incurred in respect of certain tied houses in order to improve the trade of a brewery company, was allowed as the expenses were incurred wholly for the purposes of trade.

Reliance was also placed upon the House of Lords decision in Strong and Company vs Woodifield (Surveyor of Taxes) (1906 AC 448, 5 TC 215). This case also concerned a brewery company which owned an inn. A customer sleeping in the inn was injured by a chimney which fell upon him and the brewery company was compelled to pay damages and costs resulting from the fall of the chimney as it was found that that was due to the negligence of its servants who had failed to see that the premises were ir proper repair. At page 215 of the Tax Cases report the following famous test, which has been frequently referred to in subsequent English, South African and various Commonwealth decisions, was laid down by the Lord Chancellor:

> "In my opinion, however, it does not follow that if a loss is in any sense connected with a trade, it must always be allowed as a deduction; for it may be only remotely connected with the trade or it may be

connected with something else quite as much as or even more than with a trade. I think only such losses can be deducted as are connected with it in the sense that they are really incidental to the trade itself. They cannot be deducted if they are mainly incidental to some other vocation, or fall on the trader in some character other than that of a trader. The nature of the trade is to be considered. To give an illustration, losses sustained by a railway company in compensating passengers for accidents in travelling might be deducted. On the other hand, if a man kept a grocer's shop, for keeping which a house is necessary, and one of the window shutters fell upon and injured a man walking in the street; the loss arising thereby to the grocer ought not to be deducted. Many cases might be put near the line, and no degree of ingenuity can frame a formula so precise and comprehensive as to solve at sight all the cases that may arise. In the present case, I think that the loss sustained by the Appellants was not really incidental to their trade as innkeepers, and fell upon them in their character not of traders but of householders."

The test adopted here was that an expenditure or loss would be deductible if it was "incidental" to the trade, bearing in mind the nature of the trade. The difficulty, as the

Lord Chancellor so correctly points out, is in applying the test to the facts of each case.

The approach adopted by the Australian Courts in cases of this nature is illustrated in the case of The Herald and Weekly Times Limited vs Federal Commissioner of Taxation (2 Australian Tax Decision 169). In this case the taxpayer, the publisher of an evening newspaper, sought to deduct payments which it had made by way of compensation for claims for defamation, as well as costs recovered from it and its own legal costs. The Court reasoned as follows:

> "None of the libels or supposed libels was published with any other object in view than the sale of the newspaper. The liability to damages was incurred, or the claim was encountered, because of the very act of publishing the newspaper. The thing which produced the assessable income was the thing which exposed the taxpayer to the liability or claim discharged by the expenditure. ... but this expenditure flows as a necessary or a natural consequence from the inclusion of the alleged defamatory matter in the newspaper and its publication. ... The question whether money is expended in the production of assessable income cannot be determined by considering only the immediate reason for making a payment and ignoring the purpose with which the liability was incurred. ... The money was

spent to answer the claims, and whether it was expended wholly and exclusively in the production of income, must depend upon the manner in which the claims were incurred. When it appears that the inclusion in the newspaper of matter alleged by claimants to be defamatory is a regular and almost unavoidable incident of publishing it, so that the claims directly flow from acts done for no other purpose than earning revenue, acts forming the essence of the business, no valid reason remains for denying that the money was wholly and exclusively expended in the production of assessable income." (Pages 171 - 172).

The Court accordingly held by three judges to two that the expenditure was deductible. It is submitted that the decision was correct.

Another case of interest, also involving the payment of amounts in respect of allegations of defamation, is that of G. Scammell and Nephew Limited vs Rowles ((1939) 1 AER 337). The somewhat complex facts of this case were that Mr Barrs, a shareholder and director of Scammell's, acquired a controlling interest in another company known as Blue Belle Motors Limited. The existing shareholder and director of Blue Belle Motors, Mr Toms, was treated by the new board of the company as though he were no longer a director. Certain transactions then took place between Scammell and Blue

Belle Motors resulting in certain amounts being owed by Blue Belle Motors to Scammell, which amounts were secured by the issue of debentures by Blue Belle Motors. Mr Toms then brought a minority action seeking certain relief, including the setting aside of various agreements between Scammell and Blue Belle Motors. A counter-action for slander was instituted by Mr Barrs and other directors against Mr Toms for certain allegations which he had made. The two actions were eventually compromised, various agreements were terminated but Blue Belle Motors agreed to pay certain amounts still outstanding and Scammell paid an amount to Mr Barrs of £7 500 in settlement of the slander action. Scammell also paid certain amounts to Mr Toms in respect of costs he had incurred in the action and had itself incurred certain costs in preparing the deed of compromise.

Scammell sought to deduct these amounts. The Court found that the compromise was motivated by a desire on the part of Scammell to protect its trading interest, in that if Mr Toms had succeeded in his action the recovery of the trading debts owing to it by Blue Belle Motors would have been highly problematical. It was accordingly in order to secure its business position that Scammell had agreed to make the various payments concerned. The deduction of the various amounts was therefore proper.

Returning to the South African authorities on the question of the deductibility of damages and compensation, the next case to be considered is that of Weinberg vs CIR (1946 CPD 429, 14 SATC 210). The taxpayer in this case was the proprietor of a motor garage. The owner of a particular car paid for the garaging of the car, for having it dusted and polished and for the service of an employee of the garage calling at his house to take the car to the garage. The employee of the garage however, in using the car in an unauthorised manner for his own purposes, had an accident and damaged the car. As a result of this, damages and costs were awarded against the taxpayer which he then sought to deduct from his income. The test enunciated in the Port Elizabeth Tramway's case was enunciated and it was said that before the taxpayer could deduct the sums in question it would have to be shown that the damaging of the car "was the inevitable or practically inevitable result of the contract which Appellant had with Oliver or of the business Appellant carried on" (page 436). This was found not to be the case as the act was not performed in the production of income and the deduction was therefor disallowed. Similarly the deduction of the costs was disallowed.

In ITC 233 (6 SATC 259) the facts were that a person was killed by cargo falling from a net attached to a crane while a vessel was being unloaded, the taxpayer being a stevedore. A dependant's action was instituted which was settled, the

Appellants paying a capital sum and costs. The Appellants then sought to deduct these amounts and the Court, relying on the decision in Strong vs Woodifield held that the deduction was allowable. The Court found (at page 260) that:

> "In the business of loading and unloading it is a very likely, and indeed almost foreseeable consequence, if not an inevitable consequence, that packages or other articles may fall out of nets handled by stevedores and injure passers-by, just as in the case of a building bricks or similar articles may fall from the building during the course of building operations and injure passers underneath".

The Court therefore found that the injury was an incidental of the business and that the deduction was permissible. (Broomberg, op. cit., page 205, is in error when he cites this case as an instance in which the deduction was not allowed).

On the other hand however, in ITC 30 (2 SATC 51) the cost of analysing a sheep dip which had been supplied by the taxpayer to certain of his customers and which had given rise to a claim for damages on the grounds that the sheep had been poisoned by the dip, was disallowed. The reason for disallowing the deduction was that "the analysis was

undertaken solely in view of a claim for damages, and with a view to a possible settlement of the case, it was not an ordinary operation undertaken for the purpose of the business." It is respectfully submitted that this case was not correctly decided in that the costs of analysis were sufficiently incidental to the business of supplying sheep dip to render such costs a proper deduction.

In ITC 83 (3 SATC 142), a baker was sued for damages caused by excessive smoke emitted from the bakery chimney. Damages and costs were awarded against the baker (the taxpayer) which the taxpayer then sought to deduct. It was held, on the authority of Strong vs Woodifield that the loss had fallen upon the taxpayer as owner of the building rather than as baker and that the connection between the damages and the bakery business was too remote to justify the deduction.

A case in which damages were regarded as a capital loss was ITC 185 (5 SATC 273). In this case, the taxpayer, who was a farmer, owned certain sheep dogs which had attacked and destroyed certain of his neighbour's sheep resulting in a payment of compensation by the taxpayer to his neighbour. The Court held that the loss was not incurred in the production of the taxpayer's income and must be regarded as a capital loss.

Another case dealing with nuisance was ITC 191 (5 SATC 358) where the taxpayer carried on the business of manufacturing chemicals, in the course of which it discharged waste effluent onto certain land in its neighbourhood. Neighbours of the taxpayer complained and the local health authority required the company to abate the nuisance or close the factory. The company taxpayer then incurred costs in studying methods of disposing of the effluent without creating a nuisance. Furthermore, a flood occurred resulting in effluent being washed onto the lands of certain neighbouring agriculturalists and actions being instituted against the company. Further expenses were incurred by the company in obtaining expert evidence, inter alia, in dealing with this action. The company therefore sought to deduct the costs it had incurred in investigating the disposal of the effluent so as to comply with the requirements of the health board and also the expenditure relating to the action for damages. Both sets of expenditure were disallowed, the expenditure relating to the disposal of the effluent being found to be expenditure of a capital nature and that related to the action for damages as being insufficiently connected with the company's income-earning operations.

Another case which, it is submitted, was incorrectly decided was ITC 1058 (26 SATC 305) In this case the taxpayer was a manufacturer which had been held liable for damages arising out of a collision between a motor car driven by a third

party and a railway trailer parked on a public road running past the factory of the taxpayer. The accident had occurred as the railways had delivered a load of raw materials to the taxpayer. The trailer, on which the goods were loaded, had been left in the road outside the taxpayer's premises. The goods had been off-loaded by servants of the taxpayer and the trailer had been moved further away from the entrance and left standing partly on the tarred portion of the road. The trailer was badly lit and during the night a car had collided with the rear of the trailer as a result of which damages were awarded against the taxpayer. The deduction of these damages which had been paid was disallowed by the Court, it being held that the case was quite different to that of the Port Elizabeth Tramway's case. In that case it was said (at page 310) that:

> "The employment of drivers was necessary for carrying on the business of the company, and the employment of drivers carried with it, as a necessary consequence, a potential liability to pay compensation if such drivers were injured in the course of their employment. If that should not be done the company would not get drivers at all and the business would come to a halt. It is money laid out wholly or exclusively for the purposes of trade. But the third party who happens to drive past the factory at night is not essential to the

> Appellant's trade. Money laid out to compensate him is not for the purposes of trade."

The Court's reasoning in this respect is, with respect, unsatisfactory since the relevant act which gave rise to the payment of the damages claim was not the driving past the factory by the third party but the collision with the trailer. The trailer had been left on the roadway in the course of the taxpayer's business and it is submitted that the Court completely misconceived the correct application of the test and reached the wrong conclusion. Ironically, the Court allowed the deduction of the legal costs incurred by the taxpayer in resisting the action for damages, finding that the deduction of the legal costs was permissible in terms of the then Section 11(2)(b) bis in that the costs had been incurred "by reason of the ordinary operations" of the taxpayer's trade. This Section has now been replaced by Section 11(c) in the present Act and will be dealt with later.

In SIR vs Raubenheimer (1969 (4) SA 314 A, 31 SATC 209) the Respondent was a farmer. On his farm was a patch of weed which Raubenheimer was required by the Department of Agriculture to eradicate. Furthermore, Raubenheimer obtained a large portion of his income from cattle farming and the weed reduced the grazing value of the infested area and accordingly it was also in his interest to eradicate the

weed. It was common practice to destroy the type of weed in question by burning and this was done by Raubenheimer on a day when he considered the weather favourable. However a strong wind sprang up and the fire went out of control causing serious damage to neighbouring farms and plantations. Actions for damages were instituted and eventually settled by Raubenheimer paying amounts in compensation to the various claimants. The deduction of the compensation paid was allowed by the Special Court in terms of Section 11(c), oddly enough, as being expenditure incurred in respect of a dispute or legal proceedings arising in the course of or by reason of the ordinary operations undertaken by the taxpayer in the carrying on of his trade. This was upheld by the Appellate Division.

Section 11(c) has since been amended to restrict its scope but it is believed that the decision in Raubenheimer's case is instructive as to the general principles applicable in the deductibility of damages and compensation paid.

A case already mentioned in the discussion of deductions of a capital or revenue nature, is that of ITC 1076 (supra). The taxpayer carried on the business of a manufacturer of motor springs and instituted an action for unfair competition against a competitor resulting out of certain advertisements published by, and other actions on the part of, the competitor. The action was settled and the

competitor agreed to refrain for a period of six months from using advertisements relating to motor car suspension coil springs. The taxpayer sought to deduct the legal costs which it had incurred in the action thus far. The Court found that the intention of the action was to obtain recompense for the unlawful erosion of its profits and that if the taxpayer had recovered damages, those would have related to loss of profits and would have been taxable (page 32). The Court therefore found as follows at page 33:

> "In our view, therefore, the expenditure upon the litigation in the present case was incurred primarily to recover loss of income and as such it was part of the costs incidental to the performance of the income-producing operations, as distinguished from the equipment of the income-producing structure. If the litigation had been successful it might ultimately have had a beneficial effect upon the Appellant's goodwill, but primarily it was embarked upon to recover past income, and as such was directly connected with the income-producing operations."

The expenditure was therefore not of a capital nature and the deduction was allowed.

Finally, before leaving the general heading of damages paid in respect of delictual liability, it should be noted that it is the current practice of the Department to allow the deduction of damages paid by hairdressers to customers who suffer burns and electric shock and also compensation paid by laundry men for damage to or loss of customer's articles. (See Meyerowitz and Spiro, Income Tax in South Africa, paragraph 659).

It may be seen therefore that in all the cases in this section, the approach has been to find a link between the expenditure or loss in question and the income-producing operations of the taxpayer. The application of this test to the facts of each case has been done with varying degrees of success and it is submitted that the test set out in Port Elizabeth Tramway's case still constitutes the test to be applied in cases of this nature.

The doubt as to the deductibility of legal expenses, flowing in a large measure from the remarks of Watermeyer, A.J.P. in the Port Elizabeth Tramway's case were resolved by the inclusion of a specific Section in the Act permitting the deduction of such legal expenses. This deduction is now contained in Section 11(c) of the Income Tax Act which permits the deduction of:

"Any legal expenses (being fees for the services of legal practitioners, expenses incurred in procuring evidence or expert advice, Court fees, witness fees and expenses, taxing fees, the fees and expenses of Sheriffs or Messengers of Court and other expenses of litigation which are of an essentially similar nature to any of the said fees or expenses) actually incurred by the taxpayer during the year of assessment in respect of any claim, dispute or action at law arising in the course of or by reason of the ordinary operations undertaken by him in the carrying on of his trade: provided that the amount to be allowed under this paragraph in respect of any such expenses shall be limited to so much thereof as -

(i) is not of a capital nature; and

(ii) is not incurred in respect of any claim made against the taxpayer for the payment of damages or compensation if by reason of the nature of the claim or the circumstances any payment which is or might be made in satisfaction or settlement of the claim does not or would not rank for deduction from his income under paragraph (a) or (b); and

(iii) is not incurred in respect of any claim made by the taxpayer for the payment to him of any amount which does not or would not constitute income of the taxpayer; and

(iv) is not incurred in respect of any dispute or action at law relating to any such claim as is referred to in paragraph (ii) or (iii) of this proviso."

Proviso (ii) was clearly inserted to cater for the decision in Raubenheimer's case and the decision in that case would appear to indicate that the scope of deductibility in terms of Section 11(c) is somewhat wider than that otherwise afforded in terms of Section 11(a) or 23(g). It is however not intended to analyse the provisions of Section 11(c) in this paper (but see Silke, op. cit., paragraph 8.76).

Analogous to the cases dealing with damages or compensation payable in respect of delictual liability, is the line of cases dealing with amounts which become payable to customers or clients as a result of the misappropriation of funds by an employee or partner of the taxpayer. (It is pleasant to note that in the reported cases monies are never "stolen" but are only "misappropriated"). The approach adopted in these cases is interesting and it is proposed to analyse the development of this approach by dealing with the South

African decisions in chronological order and thereafter comparing the decisions of certain foreign Courts.

The South African decision which started the ball rolling was that of Lockie Brothers Limited vs CIR (1922 TPD 42), a case in which a manager of the taxpayer embezzled certain sums of money belonging to the company. It was held that the amount embezzled could not be deducted but the two judges who heard the case appeared to differ in their reasons. Mason, J. held (at page 44) that the words "in the production of income" mean "in connection with the business is that deductions are to be allowed for any losses or outgoings actually incurred in the course of and by reason of the ordinary operations undertaken for the purpose of conducting the business, not being losses or outgoings of a capital nature."

The judge found as a fact that the taxpayer could only conduct its operations by means of servants such as the manager who has embezzled the funds and that such an embezzlement was a risk incidental to all businesses "just as the taking of money from the till, the pilfering of stock, the negligent handling of goods or the negligent conduct of business are well known common sources of loss." The learned judge then went on, in a passage which has since been repeated in many subsequent cases, as follows:

"But there is a distinction between negligent handling of goods and embezzlement; the handling of the goods is a necessary incident of the business and negligence in that respect does not alter the nature of the transaction, but embezzlement is quite a different thing. It is not an operation undertaken for the purposes of the business. This may be illustrated by the differences between negligence and crime in its relation to the liabilities of the master. If the servant by negligent driving on his master's business injures a person, the master is liable; if, however, the injury was inflicted in an attempted murder, the master is not liable; the one is an act performed for the purpose of his occupation; the other is not."

On this basis therefore the learned judge found that the deduction was not permissible. De Waal, J. on the other hand found on the basis that the loss was a loss of a capital nature and for that reason was not deductible. At page 48 he said:

> "Once the company's assets are converted into money it becomes portion of its capital for reinvestment, if so desired, in other purchases of rice, and any withdrawal of such capital, whether authorised or not, not for the purposes and objects of the company, would not be a loss or outgoing; and in the case of an illegal or

> criminal abstraction from such funds, the loss to the owner of such monies becomes a loss of a capital nature."

The deduction in Lockie's case was therefore disallowed for two reasons, it was held by one judge that it was not in the production of income and by the other that it was a loss of a capital nature.

The next case in this line of cases was ITC 184 (5 SATC 268) where a clerk in a firm of accountants embezzled certain funds of a client. It was agreed that the firm would be responsible for a proportion of the amount stolen and the Appellant firm sought to deduct this proportionate share from its income in the year of assessment in question. Relying on the Lockie Brothers' case, it was found that the deduction was not permissible as the loss was not in the production of income. It was said by the Court at page 270 that "the production of the income and the defalcations of the employee have no relationship whatsoever." The amount also did not rank as a deduction as a bad debt. The next case to fall for decision was ITC 815 (20 SATC 487) where the deduction of two separate amounts were sought. The first amount related to the loss of certain trust monies held by a firm of attorneys which, as a result of fraudulent misrepresentation, had been loaned to a party who was subsequently convicted of forgery and from whom the amount

of the loan could not be recovered and was made good by the firm. The second amount represented losses arising from the embezzlement of funds by employees of the firm.

After remarking that the fact that the compensation was paid as a result of negligence was no bar to its being deductible (see the passage already quoted above) the Court went on to review various decisions relating to the deductibility of damages and compensation. In the course of this it referred to an unreported case of the Special Court where a stockbroker was permitted to deduct losses of scrip due to the negligence of office boys. In dealing with the first amount in question, i.e. the funds lost as a result of the bad investment, the Court found (at page 493) that "the risk of loss in the manner in which this was incurred was a necessary incident of the business being carried on by the Appellant and his partners. As the income of the partnership was earned in part by the investment of money on behalf of clients the loss was incurred in the course of an operation directly to the production of income, and therefore falls within the fundamental rule referred to above."

The loss on the first amount was therefore held to be deductible. In dealing with the second amount, the Court was bound by the decision in Lockie Brothers and an attempt to distinguish the Lockie Brothers' case on the basis that

the funds which were embezzled in the present instance were trust funds, failed due to lack of evidence in this respect. The second amount was therefore held to be not deductible.

Shortly thereafter, the question of the embezzlement of trust monies in fact fell for decision. In ITC 894 (23 SATC 475) the facts were that an employee of a firm of attorneys had misappropriated funds held in trust on behalf of clients. The amounts stolen were repaid by the partners to the clients concerned and the partners sought to deduct these amounts from their income. Once again the Court relied on the decision in Lockie Brothers and adopted the view that the loss was not incurred in the production of income. Furthermore, the Court was of the view that the fact that the money embezzled was trust money was immaterial (see page 477). In addition the Court stated that the loss was in any event of a capital nature.

In a Rhodesian decision, X vs COT (23 SATC 297, 1960 (2) SA 682), a firm of attorneys incurred a loss when it instructed a certain stockbroker to sell certain stock and the broker sold the stock but misappropriated the purchase price, whereupon the attorneys' firm had to make good the loss to the deceased estate which had owned the stock. It was held that the loss had been incurred as a result of negligence on the part of the Appellant firm but that the loss had been incurred in the course of the firm's business and was

directed towards the production of the firm's income. Furthermore, the fact that the money had been misappropriated by a broker employed by the firm did not convert the loss into a loss of a capital nature. The deduction was accordingly allowed.

In ITC 952 (24 SATC 547) an excellent analysis of the position thus far is to be found. In that case a partner in a firm of attorneys had misappropriated certain funds which the remaining partner was then required to make good. As usual, the luckless attorney sought to deduct these amounts from his income and after reviewing the various South African decisions to date as well as referring to numerous decisions of the English, Australian and New Zealand Courts, Fieldsend, J.C.R. said at page 551:

> "In the light of these cases it seems that the essential fact to be determined is whether the dishonest removal of funds was a reasonably incidental risk to the production of assessable income in the locality at the time. If it can be said that this was the position then it seems to follow that the loss was suffered for the purposes of the trade or in the production of the income. This seems to accord with the reasoning in such a decision as Curtis vs J & G Oldfield Limited (41 TLR 373), where at 374 Rowlatt, J. said: 'It was necessary to consider, therefore,

whether the loss was a loss in trade. It was true that if a person, in conducting a business, had to employ subordinates, and owing to the negligence or dishonesty of an employee some of the receipts did not find their way into the accounts, that would be a loss connected with or arising out of the trade, and could be deducted. But that was not the position in the present case. Mr Oldfield was the managing director, and in charge of the whole business of the company. There was no evidence that the loss was a loss in trade. All that was known was that Mr Oldfield made away with profits which had been paid over to the company, and this he was able to do by virtue of the position he held.' This would seem to offer a sound reason for the decision in Lockie Brothers' case, namely that one does not reasonably expect a senior manager or managing director to make away with his employer's funds, and that such a risk is not reasonably incidental to the trade, as the petty larcenies of servants and the leakages through carelessness or dishonesty to which the revenues of most profit earning organisations are exposed: Ash vs COT (1 AITR at 453).

Applying the law to the facts of the Appellant's case I do not think that it can be said that the defalcations of a partner in an attorneys' firm can be said to be the kind of casualty, mischance or misfortune which is

> a natural and recognised incident of the business. If a distinction is to be drawn between ordinary servants, and managers or managing directors, for which there appears to be authority, it seems to me that, a fortiori, a partner is in quite a different position to an ordinary servant. For this reason alone it seems to me that the appeal in this case cannot be allowed."

The deduction was therefore disallowed. This is however the first case in the South African Courts in which a distinction between the stealing of funds by senior or managerial staff or partners has been distinguished as being different in nature to the stealing of funds by junior or clerical staff.

The latest, and with respect, the best analysis of the problem is that of Beadle, C.J. in the Rhodesian case of COT vs Rendle (26 SATC 326, 1965 (1) SA 59). In this case the victim of theft was a chartered accountant, whose clerk misappropriated certain funds owing to clients of the accountant. The amounts in question were repaid to the clients and costs of investigating the fraud and of seeking legal advice were also incurred. The question of the deductibility of the amounts repaid and of the various expenses fell to be decided and the reasoning of Beadle, C.J. is worth following in some detail. The learned judge began his analysis by dividing expenditure into two

categories, namely "designed expenditure" and "fortuitous expenditure". He then said (at page 329):

> "The deduction of designed expenditure (so far as the law is concerned) presents little difficulty. Provided it is designedly and bona fide incurred wholly and exclusively for the purpose of trade, it is deductible, no matter how rash or unnecessary the expenditure might be. It is not for the Commissioner to direct how a taxpayer should run his business.
>
> The deduction of fortuitous expenditure, however, presents a very difficult legal problem. The decisions in the cases are not always consistent, and the reasoning of different judges in the same cases are often by no means harmonious."

Various cases were then cited and he then stated the following as a general test (at page 330):

> "All expenses attached to the performance of a business operation bona fide performed for the purpose of earning income are deductible whether such expenses are necessary for its performance or attached to it by chance or are bona fide incurred for the more efficient performance of such operations provided they are so closely connected with it that it would be proper,

natural or reasonable to regard the expenses as part of the cost of performing the operations. ...

The fortuitous expenditure with which the instant case is concerned falls within the second category, that is, expenditure attached to the performance of the business operation 'by chance'.

In deciding whether such an expenditure is deductible, it seems to me the enquiry must be whether the 'chance' of such expenditure being incurred is sufficiently closely connected with the business operations. The enquiry is not whether the actual expenditure itself (should it ever eventuate) is sufficiently closely connected. If the expenditure itself had to be a necessary concomitant of the business before it could be deducted, it could hardly be called 'chance expenditure'. The word 'chance' is singularly inappropriate when describing an event which is bound, or almost bound, to happen. If such chance expenditure is to be deductible, if it is closely enough connected with the business operation, and is still to retain its character of 'chance expenditure', it can only be the 'chance' or the 'risk' of it being incurred which must be the link connecting it with that business operation ... (At page 333) all the cases dealing with this subject indicate that before fortuitous expenditure can

> be deducted, it must be so closely connected with the business operation concerned as to be inseparable from it or necessarily incidental to the carrying on of that business. ... In the circumstances, I am satisfied that the fortuitous expenditure incurred by the Respondents in this case were sufficiently closely connected with the Respondent's business operations as to be regarded as part of the cost of performing those operations."

The argument was also raised that the deduction of funds embezzled by the taxpayer's own employees was not permissible. In this respect, Beadle, C.J. found that ITC 184 had been incorrectly decided and that overseas authority did not support the proposition. The decision in ITC 815 could be explained as the Court had been bound by the decision in the Lockie Brothers' case and the distinction of that case suggested in ITC 952 had not been argued. The argument was therefore rejected, as was the argument that the loss was of a capital nature as the risk of theft was always there, the risk of expenditure was therefore not a "once and for all" risk of payment and the expenditure did not "bring into existence an asset for the enduring benefit of the trade".

The deduction was therefore allowed.

The approach adopted in Rendle's case is reflected in the decisions of foreign jurisdictions. In Curtis vs J & G Oldfield Limited (94 LJ KB 655) the losses suffered by a company due to the defalcations of the managing director was found to be not a loss connected with or arising out of the trade and therefore not a proper deduction. In the case entitled In Re A Taxpayer (3 Australian Tax Decisions 79) - a New Zealand decision - the losses suffered by a solicitor arising out of the theft of funds by a managing clerk were allowed as a deduction. The following test was stated (at page 80):

> "You have not to look at the object for which the money was paid - you have to look back to find out where the liability to pay the money first arose, and if the source of the liability and the source of the production of the income was identical, then the amount may be deducted ..."

It would appear that Australian attorneys are often as unlucky in their choice of partners as their South African counterparts for in the case of Ash vs COT (1 AITR 447) the partner of a solicitor stole funds of clients, resulting in the remaining partner having to make good the loss. The deduction of the loss was disallowed by a High Court comprising three judges for three separate reasons. Latham, C.J. found that the payment was in the nature of an outgoing

of capital and the loss was a capital loss. Rich, J. found (at page 453) that the payment was "the working off of a damnosa haereditas of the taxpayer's dead partnership. It has no connection with the present practise of his profession." Dixon, J. appeared to adopt reasoning similar to that of Rich, J. although not identical. The learned judge found that the amount paid to the clients was a personal liability of the taxpayer secured over certain of his capital assets and that its discharge was a matter quite independent of his continuing to practise and quite unconnected with the earning of future income (see page 455).

Solicitors in New Zealand are equally as unlucky as those in Australia and South Africa. In COT (NZ) vs Webber (6 AITR 291) a solicitor, who carried on the business of lending out monies deposited with him by clients on behalf of his clients, was induced by his bookkeeper to lend money to the bookkeeper which was never repaid. It was found that the solicitor had been negligent and that he was responsible to reimburse his client. The Court distinguished the English, Australian and South African decisions on the basis that the deduction formula in the New Zealand Statute was materially different to those in the other countries and then went on to say at page 299:

"Where, therefore, in New Zealand a claim is made in respect of a loss, as distinct from an expenditure, it seems to me that the enquiry must be simply whether the loss was incurred in the course of producing the assessable income. ... Here I have no difficulty at all in deciding that the loss suffered by Respondent was one really incidental to the carrying on of his practice. A substantial part of the income which he derived from that practise admittedly came from transactions closely resembling the one in which the loss now in question was sustained. It is, I think, clearly demonstrated that the loss arose from one of a series of transactions, the total of whose resultant income constituted a substantial part of Respondent's income."

The loss was furthermore found not to be a capital loss and the deduction was allowed.

Thus far the cases dealt with have concerned the loss of funds due to theft either by an employee of a particular concern or by a partner thereof. However, the deductibility of amounts stolen by third parties has also been considered. In Charles Moore and Co (WA) (Pty) Limited vs Federal Commissioner of Taxation (6 AITR 379) a company suffered a loss when certain employees who were on their way to bank the store's takings were robbed on their way to the bank.

It was held that the banking of cash takings was a necessary part of the operations of the company and that loss by robbery was a risk inherent in the procedure adopted in banking the takings. Furthermore it was not a loss of a capital nature. The deduction was therefore allowed. See also Goldband Services Limited vs Inland Revenue Commissioner (NZ) (8 AITR 193) where a service station was robbed of certain cash takings which had not yet been banked. It was found that the loss was a reasonably incidental risk to the production of assessable income in the circumstances and, applying Moore's case, the deduction was allowed.

It would appear in South African law that losses due to thefts by third parties or junior staff are deductible. However, losses as a result of thefts by partners or senior staff are not deductible. It is suggested, with respect, that the distinction is untenable and that all such losses should be deductible as the possibility of loss by theft is an inherent risk in all business. It would appear that the distinction was introduced into our law in an attempt to distinguish the Lockie Brothers' case and since then has become established as a principle. The other authority which is relied on for the proposition, namely Curtis vs Oldfield, cannot support the analysis on a close reading of the judgment. It would appear that in that case the real reason for the decision was that there was no evidence

before the Court that the loss was of a trading nature. It is to be hoped therefore that the unrealistic distinction in our law between losses occasioned by theft by junior and senior staff will disappear in the fullness of time. Not only is it an unsatisfactory distinction, but there is no clear authority as to exactly where the line is to be drawn between junior and senior staff.

Having dealt with cases embodying a criminal element insofar as theft is concerned, it would be appropriate to deal briefly with the deductibility or otherwise of amounts paid by way of fines and penalties, the deductibility of which depend upon the same tests as the deductibility of payments of compensation or damages. In this respect, two English cases have been decided which have essentially similar facts, namely Commissioners of Inland Revenue vs Warnes and Company Limited ((1919) 2 KB 444) and CIR vs Alexander von Glehn & Company Limited ((1920) 2 KB 553). In both these cases the taxpayers were exporters charged with a contravention of the Customs (Warpowers) Act of 1915 in that they were unable to produce evidence to the satisfaction of the Commissioners of Customs and Excise that certain exports of theirs had not reached enemy territory. In both cases the taxpayers were found guilty of the offence and penalties were payable. In neither case was the deduction allowed, the reason given in both cases being that the loss was not a "commercial loss". In Von Glehn's case it was said at page

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569 that "it is not a commercial loss, and I think when the Act speaks of a loss connected with or arising out of such trade it means a commercial loss connected with or arising out of the trade. ... Now it cannot be said that this disbursement was made in any way for the purpose of the trade or for the purpose of earning the profits of the trade."

In South Africa a similar approach has been adopted in regard to criminal penalties, and deductions in respect of the payment of fines for speeding or parking offences or contraventions of price control regulations etc. are as a rule disallowed (see, for instance, ITC 1212 (36 SATC 108) and ITC 1199 (36 SATC 16)). This approach would appear to be correct and in any event there is, no doubt, an unwillingness for policy reasons to permit the deduction of fines or penalties imposed by way of criminal sanctions for income tax purposes.

In this context however it is interesting to note the decision in Smith vs SIR (30 SATC 35) where the taxpayer was an accountant and auditor, and as part of his practice held certain offices in a company. The company was placed into liquidation and the taxpayer and certain other persons were charged with fraud and various contraventions of the Companies and Insolvency Acts. They were found not guilty and discharged. In defending himself against the charges,

the taxpayer incurred certain expenses which he sought to deduct from his income in the year of assessment ended 1961 in terms of the then equivalent of Section 11(c). It was conceded that the expenditure fell within the wording of that Section, and the only point for consideration by the Appellate Division being whether the expenditure was of a capital nature. This was found not to be the case and the Court held (Holmes, J.A. dissenting) that the deduction was permissible.

A case similar in certain respects to Smith's case is ITC 215 (6 SATC 133) in which case a company had incurred certain expenditure in preparing a lease and also in defending certain of its employees who had been charged with cruelty towards the animals used by the company in the course of its business, which was that of cartage contractors. Without giving any reasons, the Court found that both of these items were "not allowable as current expenditure" (page 135) and disallowed their deduction. In the light of Smith's case it is submitted that the decision is not correct.

The next category of decisions to consider is that in which a deduction is sought in respect of damages or compensation paid resulting from a breach of contract. The first case to be dealt with in this section is ITC 658 (15 SATC 498). The taxpayer in this case was a partner in a firm of building

contractors. The firm obtained the contract for the erection of a block of flats in accordance with certain specifications. The contract was completed but sometime later it was found that the external walls of the building revealed dampness and it was discovered that the walls had not been erected according to the specifications. A claim was instituted against the firm of building contractors which was settled by the firm making a compromise payment. The taxpayer sought to deduct the amount of the damages paid and certain legal costs incurred. This deduction was disallowed for various reasons. Firstly it was held that the expenditure had not been incurred in producing the income for the year under review and was accordingly not allowable (see page 500). (This is of course not good law and it is now accepted that it is not necessary to match the expenditure of one year with the income of the same year - see Sub-Nigel Limited vs CIR (supra)). This, fortunately, was not the only ground for dismissing the appeal and the Court then referred to the Port Elizabeth Electric Tramway's case and Joffe's case and found at page 502 that "in the present case there is nothing to suggest that negligence in observing the details of the plans and specifications, and the liability consequent thereon, are the inevitable or necessary concomitants of the trading operations of a building contractor."

In ITC 661 (15 SATC 509) a manufacturer failed to deliver certain goods in accordance with the terms of a contract and was sued for breach of contract. The taxpayer was found to be liable for damages and costs. The Court refused to allow the deduction of either the damages or the costs and applied the test of the Port Elizabeth Tramway's case in reaching its decision. It held that the expenses did not relate to the business operations of the company and were in fact quite separate from the business operations. It was stated that the expenditure was linked to an act of defending a breach of contract and that is not a normal business operation (at page 511). This may have been a correct statement in the context of this case but phrased as a general proposition it is clearly not correct since clearly cases in which the defence of a breach of contract action may arise where such action is indeed part of the normal operations of the company. The argument was also advanced by counsel for the Appellant that since the damages would be taxable in the hands of the recipient in this case, they should be deductible in the hands of the payer. This argument was rejected by the Court, quite correctly it is submitted, since the two issues are completely separate and are determined in accordance with completely separate tests. It is believed however that the Court approached the case from too narrow a viewpoint and that the approach adopted by Beadle, C.J. in Rendle's case is far preferable, i.e. it is the risk of a loss being incurred rather than the payment

itself which should be looked to. Accordingly if the non-delivery of the goods in this case was due to a strike at the manufacturer's plant and there was a history of labour unrest in the particular industry concerned, it is submitted that the damages paid for non-delivery as a result thereof could indeed rank as a deduction. It is not apparent, however, from the reported decision in this case why the manufacturer did not deliver the goods as required, which is unfortunate as it is believed that this in fact was the crux of the case and should have been the proper matter for enquiry.

It is however the practice of the Revenue authorities to permit a deduction for compensation paid in respect of the cancellation of a contract for the sale of goods in the ordinary course of business as also for compensation paid for the cancellation of a contract for the purchase of goods in order to avoid a loss on resale owing to trade conditions (see Silke, op. cit., paragraph 7.27).

In ITC 49 (2 SATC 122), the principal business of the taxpayer was the sale of petrol lamps. These were sold subject to a guarantee and, on a lamp exploding and causing injury to a purchaser, an amount was found to be payable in terms of the guarantee and in a Court action damages and costs were awarded against the taxpayer. It was held by the Special Court that the expenditure was incurred in the

course of the business of the taxpayer, arose out of that business and accordingly was deductible.

Damages payable for the repudiation of a contract for the hire of a series of films was held to be deductible but the costs of defending an action were found not deductible - ITC 461 (11 SATC 191). The reason for the disallowance of the deduction of the legal costs were the remarks made by Watermeyer, A.J.P. in the Port Elizabeth Electric Tramway's case where it was held that costs incurred in resisting a demand were not deductible. There was however ample authority to the contrary (see for instance ITC 49 (supra) or ITC 233 (supra) and the Court need not have come to the conclusion to which it did in this respect.

A case in which the Court conceded that the taxpayer was entitled to the deduction which he sought in principle but failed to obtain it in that the necessary facts were not established was COT vs Cathcart (27 SATC 1, 1965 (1) SA 507). Here the taxpayer was an architect who designed a particular building. As a condition of his employment, the taxpayer was required to give a guarantee that the building would be waterproof. The Court found that this guarantee had been given in order to secure the work which earned the income and that an inherent risk of giving the guarantee was that an amount would be payable in terms thereof (see page 4). Adopting the reasoning of Rendle's case, the Court

found that in principle amounts payable under the guarantee should be deductible; at page 5 it being said:

> "If, therefore, an architect or a building contractor gives a guarantee that a building to be designed or built by him will be free of certain defects, then it seems to me that if those defects do occur in the building, then the reasonable cost of remedying them is properly deductible."

However, said the Court, only the costs of remedying the actual defect would be deductible and any consequential losses which the architect may have had to pay were not deductible. There was no evidence before the Court as to whether the amount was paid in terms of the guarantee and, if so, what proportion of the amounts so paid represented the costs for fulfilling the guarantee and what amount represented consequential loss to the owner of the building. As the taxpayer had failed to prove that he had paid by virtue of his liability in terms of the guarantee he had failed to discharge the onus of proving that the amount was properly deductible and the appeal by the Commissioner was allowed.

In SIR vs John Cullum Construction Co (Pty) Limited (1965 (4) SA 697 A) the taxpayer wished to be released from a finance agreement which it had with another company which it

considered to be too onerous. The agreement was accordingly cancelled, the taxpayer paying an amount in compensation for the early termination of the agreement. The taxpayer cancelled the agreement in the hope of obtaining finance for building schemes on better terms elsewhere but failed to do so. Accordingly a new agreement with the same company in respect of which it previously had the agreement was entered into, but on terms more favourable to the taxpayer. As a result of the rearrangement of its affairs, the income of the taxpayer increased and it sought to deduct from its income the compensation paid for the cancellation of the first contract. It was agreed that the new arrangement was to the advantage of the taxpayer and counsel for the Secretary relied solely on the argument that the expenditure was of a capital nature and for that sole reason not deductible; the other requirements for deductibility were conceded. Steyn, C.J. held that the question of whether a deduction is of a capital nature or not is a question of finding of fact and not of law (see page 708) and permitted the deduction. The majority judgment delivered by Williamson, J.A. found, on considering the various tests enunciated by the Courts from time to time as distinguishing capital from revenue, that the expenditure in question was not of a capital nature. The deduction was accordingly allowed.

In the course of reaching its decision the Court referred to numerous cases including Noble Limited vs Mitchell ((1926) 43 TLR 102) where a payment to procure the retirement of a director whose continued connection with the company was considered to be harmful was allowed as a deductible expense. An apparently conflicting case of Associated Portland Cement Manufacturers Limited vs IRC ((1946) 1 AER 68) in which payments made to two directors for their resignation as such were disallowed was distinguished on the basis that in this case the two directors also agreed to a restraint of trade which converted the payment into one of a capital nature.

Support for the finding of the Court was found in the decision of Anglo-Persian Oil Co Limited vs Dale ((1932) 1 KB 124), which case also concerned the payment of compensation for the early termination of a contract regarded as onerous by the taxpayer. The contract in question in this case was an agency agreement and after cancellation of the contract the taxpayer itself began to fulfil the functions previously undertaken by its agent, which was found to be to the advantage of the taxpayer. The deduction of the amount paid by way of compensation was allowed. At page 732 Lawrence, L.J. said:

> "It is not open to doubt that under ordinary circumstances where a trader, in order to affect a

> saving in his working expenses, dispenses with the services of a particular agent or servant, and who makes a payment for the cancellation of the agency or service agreement, such a payment is properly chargeable to revenue; it does not involve any addition to or withdrawal from fixed capital; it is purely a working expense. The fact that the payment includes a sum in consideration of the agent or servant agreeing not to compete with his principal or employer after the determination of his employment (a stipulation frequently met with in these cases) does not alter the character of the payment."

The various usual tests applied to distinguish capital from revenue were then applied and it was found that no asset of an enduring benefit was brought into existence and the learned judge concluded at page 734 that:

> "The contract to employ an agent to manage the taxpayer's business in Persia, however, in no sense forms part of the fixed capital of the taxpayer, but is a contract relating entirely to the working of the taxpayer's business, the method of managing which may be changed from time to time. Neither the contract itself nor a payment to cancel it would, in my opinion, find any place in the capital accounts of the taxpayer."

Thus far in this section cases dealing with breach of contract in general have been discussed. It is however possible to identify certain sub-categories within the field of contract as a whole. The first of the sub-categories is lease.

In ITC 819 (21 SATC 71) the taxpayer acquired certain premises in which it wished to carry on its trade. The tenant was however entitled to twelve months' notice to vacate the premises in terms of the Rents Act. The taxpayer accordingly agreed to pay the tenant an amount of £1 000 by way of compensation for the tenant agreeing to vacate the premises eight months earlier than he was in fact obliged to do. Without giving reasons the Court held that the payment was manifestly of a capital nature and was not deductible. A similar result was obtained in ITC 843 (21 SATC 431) where the taxpayer owned a building with a number of separate rooms which were let out as residential apartments. In order to improve the building's attractiveness to tenants, it was desired to install facilities for the provision of meals and to this end the taxpayer wished to obtain occupation of adjoining premises, also owned by it, which contained kitchen and dining room facilities. These premises were let to a tenant who, however, agreed to vacate the premises in return for payment of certain compensation. After this had all been done, the taxpayer let both buildings to another company to run as a boarding house.

But citing the passage from the New State Areas judgment which is quoted above in this chapter, the Court found that the compensation had been paid for the purpose of "acquiring an advantage for the enduring benefit of the trade" (see page 432). The deduction was accordingly not allowed.

Both ITC 819 and ITC 843 were referred to by the Appellate Division in Palabora Mining Company Limited vs SIR (1973 (3) SA 819 A, 35 SATC 159). At page 172 of the SATC report, ITC 819 was explained on the basis that the taxpayer had purchased an encumbered capital asset and that the sum paid to the tenant eliminated the encumbrance and thus formed part of the total cost of the capital asset acquired. Similar considerations, it was said, applied to ITC 843. Silke (op. cit. at page 354) states, in regard to ITC 843, that "it is doubtful whether the point was correctly decided".

A conflicting case which it is indeed difficult to reconcile with ITC 819 and ITC 843 is ITC 1267 (39 SATC 146). The taxpayer in this case was a property owning company which had leased certain land at a particular rental. Some three years prior to the expiry of the lease, it came to the attention of the taxpayer that the lessee was able to take early occupation of other premises which it would otherwise only have occupied on termination of the lease. In view of the fact that rental for comparable properties had risen

considerably, the taxpayer negotiated the early termination of the lease with the lessee and in return for the lessee vacating the premises paid compensation of R25 000. The taxpayer then re-let the property at higher rentals which resulted, even after taking the compensation paid into account, in a net profit to the taxpayer. The question of whether the compensation payment was deductible was then required to be considered and the Court considered the various authorities, including the passage from New State Areas case mentioned above. The Court did not consider however either ITC 819 or ITC 843. A case relied on in ITC 843, namely ITC 790 (20 SATC 96), was however distinguished. In ITC 790 the taxpayer carried on the business of a general dealer and also derived income from the letting of property. It wished to obtain occupation of property for purposes of its own trade and to this end ejected a tenant who was in occupation of the property and in the process incurred certain expenses. It was held that these expenses would be regarded as capital expenditure as the object of the proceedings was to secure a capital asset. The Court, at page 150 of the judgment distinguished this case on the basis that the property in ITC 790 was required for the taxpayer's own business whereas in the present case the taxpayer simply wished to re-let the property at a higher rental. The Court therefore came to the conclusion that the compensation which was paid did not affect the taxpayer's income-producing structure, that no new asset or expanded

field of operations was created and that, in the circumstances, there was a direct and close link between the expenditure in issue and the taxpayer's income-earning operations. The expenditure was therefore deductible.

Despite Silke's reservations concerning the correctness of ITC 843, it is noteworthy that the Appellate Division expressed no criticism of the decision in referring to is in the Palubora case. It is also difficult to support the basis upon which ITC 790 was distinguished in ITC 1267, since in both cases the building in question constituted a capital asset in the hands of the taxpayer. It is submitted that the correct approach to cases of this nature should be to enquire whether the compensation is more closely related to the lease (in which case the payment would be of a revenue nature) or to the building which is the subject of the lease (in which case it would be of a capital nature). On this analysis there would indeed be no conflict between the decisions in the various cases mentioned in this section, all of which would be correct on the facts of each particular case.

A further sub-category which may be dealt with under the general heading of contract are payments made in respect of restraints of trade. This aspect has, of course, already been considered in chapter 2 from the point of view of the recipient of a payment in respect of restraint of trade and

it is now desirable to examine the situation from the point of view of the person making the payment and also the question of damages resulting from a breach of restraint of trade. The first case to be dealt with deals with the latter aspect, namely whether the damages paid as a result of a breach of restraint of trade are properly deductible or not. The case in question is ITC 1310 (42 SATC 177) where, in acquiring a one-third share in an accountancy practice, the taxpayer had agreed to a restraint of trade which would become applicable on the termination of the partnership. The partnership terminated and the taxpayer commenced a new practice in breach of the restraint of trade clause. An action was instituted by the remaining partners and damages for breach of contract were awarded by an arbitrator. Evidence was laid before the Court that the taxpayer had taken the risk of being found in breach of the restraint of trade clause as it had been necessary for him to earn an income and that he had resisted the action brought against him in order to protect his income. This evidence was accepted by the Court and the deduction of the damages and the legal costs was permitted. The argument that the payment was of a capital nature was rejected by the Court as there was no evidence that the arbitrator had taken the goodwill of the taxpayer into account in assessing damages and in any event the payment had been made for the purpose of earning income.

The second case in this section is Atlantic Refining Company of Africa (Pty) Limited vs CIR (1957 (2) SA 330 A). The Appellant was a wholesale supplier of petrol and petroleum products which had entered into the usual type of agreements with proprietors of retail distributing stations in terms of which such retailers would distribute only the product supplied by the Appellant. It had become common in the industry for persons in the position of the Appellant to make loans to the retailers with which it had agreements for the period of each "tie" agreement. The Appellant had done this and several loans had gone bad causing substantial loss to the Appellant, which it sought to deduct. The Court re-stated the tests already quoted above in the New State Areas case and the George Forest Timber case and then sought to apply the tests to the case in question. On page 335 the Court applied the test to the facts as follows:

> "The object which the Appellant had in view in entering into these contracts is obviously of paramount importance and is clear. It was designed to acquire rights which would ensure the promotion of the sale of its commodities, thus extending and improving its business with the resultant increase in its income. The activities of the retailer were consequently fettered by a comprehensive set of restraints which safe-guarded the interests of the wholesaler almost as effectively as if it had operational control of the

retail business. All possibility of a competing supplier obtaining an advantage in the "tied" business was excluded and for a defined period an asset was acquired, and the value of which depended upon the volume of business transacted by the retailer. ...

The money lent was obviously earmarked for use in the furtherance of the interest of the retailer's business, and the successful operation of which enured to the mutual benefit of lender and borrower.

The money devoted to the loan is thus not expended in the course of an ordinary commercial money-lending transaction wherein the reward which moves the lender is the expectation of the payment of interest. ...

> The money so lent forms part of the means employed by the retailer, either directly or indirectly, in the conduct of his business activities and, apart from special circumstances or special provisions in the Act, will constitute an investment of a "capital" nature, the loss or deterioration of which will not be a permissible deduction."

The same reasoning would obviously apply a fortiori to the actual payments made in restraint of trade themselves which would similarly not be deductible.

The above case concludes the category of cases dealing with payments made pursuant to a breach or a termination of a contract, and it is submitted that the correct test to apply in cases of this nature is to ascertain whether the contract, in respect of which the payment has been made, is sufficiently closely linked with the income-earning operations of the company to permit the payment to qualify as a deduction. It is the contract in respect of which the payment is made rather than the payment itself which must be looked to.

The next category to be dealt with are cases dealing with expenditure incurred when protecting the business of a taxpayer. Although, strictly speaking, these cases do not deal with the question of damages or compensation, the principles applied in these cases are of application in the field of damages and compensation and the cases to be quoted have been relied on heavily in reaching decisions in the field of compensation and damages. The only South African decision in this category is African Greyhound Racing Association (Pty) Limited vs CIR (1945 TPD 344) where the taxpayer sought to deduct legal expenses which it had incurred in making representations before a Commission enquiring into the question whether dog racing should be abolished or its activities curtailed. The Transvaal Provincial Division cited the cases of Port Elizabeth Electric Tramway and Joffe and in reaching its decision

relied upon the English case of Ward and Company vs COT (1923 AC 145, 399 TLR 90) where it was said in dealing with a similar case that:

> "We find it quite impossible to hold that the expenditure was incurred exclusively, or at all, in the production of the assessable income. It was incurred not for the production of income, but for the purpose of preventing the extinction of the business from which the income was derived, which is quite a different thing."

For the same reasons the expenditure in this case was disallowed by the Court.

Ward's case was a New Zealand case which went on appeal to the Privy Council and dealt with the question of whether expenditure incurred in printing and distributing anti-prohibition literature by a brewery company was deductible.

A referendum was to be held on whether or not prohibition of liquor should be introduced in New Zealand and the brewery company conducted a campaign in opposition to this. For the reasons given in the quote above, the deduction was disallowed. The Court went on to say at page 149:

"The expenditure in question was not necessary for the production of profit, nor was it in fact incurred for that purpose. It was a voluntary expense incurred with a view to influencing public opinion against taking a step which would have depreciated and partly destroyed the profit-bearing thing. The expenses may have been wisely undertaken, and may properly find a place, either in the balance sheet or in the profit and loss account of the Appellants; but this is not enough to take it out of the prohibition in Section 86, sub-section 1(a) of the Act. For that purpose it must have been incurred for the direct purpose of producing profits."

A similar decision was taken in Morgan (The Inspector of Taxes) vs Tate and Lyle Limited (supra), a case which dealt with expenditure undertaken by a sugar refining company on an anti-nationalisation campaign which included advertising, film making, film showing, the issue of pamphlets, rationing books, bookholders, photographs and recordings. Interestingly enough, however, in this case the Law Lords reached the conclusion that the money was "wholly and exclusively laid out or expended for the purposes of the trade" and was deductible (two Lords dissenting). It was accepted by the Court that the purpose of the expenditure was to prevent the seizure of the "business and assets" of the company (see page 416). It was recognised that

nationalisation could have taken place, not by the seizure of the assets of the industry, but by expropriating the shares in the existing company which clearly would have raised other considerations. Although this was a possibility, the Court appeared to have accepted that the company had not seriously considered this possibility and that its campaign had been directed to the preservation of the assets of the company. Furthermore, counsel for the Crown had not relied on a capital argument but solely on the prohibition in rule 3(a) which provided that money has to be laid out wholly and exclusively for purposes of trade to be deductible. The Court accordingly was not asked to consider a capital argument and was concerned solely with the interpretation of the rule in question. The decision in Ward's case was in any event distinguished on the basis that the language of the New Zealand statute was different to that under the English Act. An argument was advanced that the trade was something completely separate from the company's business and that the nationalisation of the trade would not affect the trade itself since it would remain intact and would continue with the same assets and machinery as before. This argument was rejected by the majority judges who found that the rule meant "the trade of the company" and not a trade as an isolated entity. An argument along these lines however appeared to find favour with the dissenting minority judges, but it is submitted and an analysis of the minority judgment makes it clear that,

although the question of capital vs revenue was not raised, the minority judges in effect found that the expenditure was of a capital nature. The minority judges also approved the decision in Ward's case and felt it was of application to the present case (see pages 434 and 438 of the judgment). It is not clear from the reported judgment why the argument on capital was not pursued by the Crown as that argument had succeeded in both Ward's case and the African Greyhound Racing Association case and, as appears from the minority judgments, found some favour with at least two of the judges in the House of Lords. On the arguments presented however, the decision is undoubtedly correct.

An interesting side-light emerges from the judgment of Lord Reed relating to whether the reasoning underlying the purpose for expenditure has any bearing on the question. His Lordship said at pages 424 - 425:

> "People often have more than one reason for forming a purpose, and I think that the facts found in the case indicate that the directors had two main reasons. They believed that nationalisation would be disastrous to the industry and that it would cause loss to the shareholders. Whether their beliefs were right or wrong is quite immaterial. The question whether their purpose can be held to come within the terms of rule 3(a) does not depend on whether or not their purpose

was misconceived. The shareholders purpose and reasons are set out in the resolution of September 15 and there is nothing in the case to indicate that its terms do not reflect their real purpose and reasons. Their purpose was to prevent the assets of the company being seized and the reasons were that such seizure would harm the workers, consumers and themselves alike. Again, it does not matter whether those reasons were good or bad."

The question of whether the test of purpose in these circumstances is subjective or objective does not yet appear to have enjoyed the attention of the Courts in South Africa but it is submitted that the reasoning of Lord Reed has much to recommend it and would be in line with the attitude already evinced by the South African Courts that it is not for the Courts to prescribe whether a business is to be run efficiently or otherwise or to penalise by increased tax the inefficient running of a business. (See the Port Elizabeth Electric Tramway's case at page 244).

A further category which should be dealt with in this chapter are payments made to protect "the good name" of a taxpayer. In ITC 1002 (25 SATC 231), the facts were that the taxpayer was an accountant who administered the affairs of his clients including those of a particular widow. He recommended to the widow that she invest in certain

companies which he had established which she then did. The company did not prosper and doubts were expressed by the widow to the taxpayer as to the administration of her funds by him. The dispute between the taxpayer and the widow was settled by the taxpayer agreeing to purchase from the widow certain shares in the one company which the widow had purchased together with a payment of a sum in respect of interest and to repay to the widow her investment in the other company. The deduction of the amount in respect of the purchase of shares was disallowed because the transaction took the form of the purchase of shares by the taxpayer and the Court was not prepared to go behind the ostensible form of the transaction. (Presumably the Court regarded this acquisition as an acquisition of a capital nature but this is not clear from the judgment). In regard to the amount payable as a refund of the one investment which had gone bad, the Court permitted the deduction of this amount. The Court found that there was no evidence indicating that the taxpayer had been negligent in his handling of the affairs and although he may have had a moral obligation to relieve the widow of her investment, it could not be said that he was legally obliged to do so. The Court went on to say at page 234:

> "On principle it seems to me that expenditure to protect the good name of a trader or a professional man

in his trade or profession can be a legitimate deduction. ...

Consequently, on the facts as I find them, it seems to me that there is a sufficiently close link between expenditure incurred in settling a claim arising out of allegations of misconduct in the matter of the administration of the widow's affairs, and the carrying on of the Appellant's business to hold that such expenditure would be expenditure wholly and exclusively incurred by the taxpayer for the purposes of his trade. It was clearly in the interests of the Appellant in his business as an accountant to settle a matter of this sort without publicity, and the matter he was settling was a matter connected with - indeed, part and parcel of - his trade.

On the authorities I have already referred to and on the case of Morgan vs Tate and Lyle Limited ..., I do not think that such expenditure can properly be said to be capital expenditure."

One of the cases relied on in ITC 1002 was the English case of Golder (Inspector of Taxes) vs Great Boulder (Proprietary) Gold Mines Limited ((1952) 1 AER 360). The taxpayer in this company faced actions for fraud in relation to prospectuses issued by companies in which the taxpayer had

been involved in its business of company promotion. The taxpayer did not admit the allegations which had been made but in order to avoid the risk of an action as well as the heavy costs which would be involved, agreed to settle the various actions and made payments amounting to some £25 000 as well as incurring legal costs of some £2 500. The allegations of fraud or negligence were never proved and the Court came to the following conclusion at page 363:

> "A trade of company promotion was carried on and profits earned by the sale of assets to the company which had been promoted. There was no evidence establishing that such a trade had been abandoned. Arising out of that trade a claim for damages was made against the company which would seriously affect its reputation as a company promoter if the claim succeeded. The company settled with its adversaries for reasons thus described by a director of the company:
>
> 'In seeking a settlement, the board had had in mind the very large and serious liability in costs with which the company would be faced, even if it won the actions, and in costs plus damages, if it lost. Those had been the main considerations. It was a question of saving money, and they had

> thought it cheaper to settle for £25 000 than to run a risk.'
>
> With that evidence before them the Commissioners held that the £25 000 and the attendant costs were disbursements made wholly and exclusively for the purposes of the trade. I cannot say they were bound in law to hold the other way, and I, therefore, am unable to sustain the Crown's appeal."

From the passage quoted above it is not clear to what extent the protection of the good name of the company concerned weighed with the Court but it would certainly appear to have been a factor taken into consideration by the Court in reaching its conclusion.

A final case to deal with in this chapter is CIR vs Stellenbosch Farmers Winery (1945 CPD 377). This case does not fit happily into any of the general categories discussed in this chapter but does have certain points in common with the previous two cases discussed. In this case the SFW had successfully opposed an application by a competing firm to register a trade mark of a sherry which the SFW had successfully marketed. It was found that the validity of SFW's own labels was not in issue and that its application was based on nullifying the competition of a rival. It was clearly established that the successful opposition of the

trade mark application had a beneficial effect on the business of SFW as sales in the particular product concerned increased after SFW's successful action. As the Court said at page 388:

> "Its main purpose, therefore, in expending this money was not to protect its design but to oust the rival competition and so maintain and increase its profits, and in carrying out this objective it incurred the legal costs it now seeks to deduct."

At page 385 the remarks of Watermeyer, A.J.P. in the Port Elizabeth Electric Tramway's case relating to legal costs was criticised, the Court stating:

> "May I say, with the greatest respect to the learned judges who decided that case, that I incline to the opinion that on the question whether these legal costs were an allowable deduction too narrow a view was taken of the matter and that in the light of the authorities that have been cited to us in this case, I think they should have been allowed as a deduction. They were, in my opinion, directly connected with the earning of the income. If the defence to the claim for compensation had succeeded, the income of the company would pro tanto have been increased. Legal expenditure may be necessarily incurred to prevent a loss of income, and

so be directly connected with the earning of the income. It cannot make any difference in principle whether the litigation succeeds or not."

The Court also found support for its view that the deduction should be allowed in the case of Southern Borax Consolidated Limited ((1940) 4 AER 412), an English case in which the taxpayer incurred legal costs in defending title to certain property. It was held in that case that the expense had been incurred, not in creating any new asset, but in maintaining the title to the company's property and was therefore an expense wholly and exclusively incurred for the purposes of the company's trade and, as such, was properly deductible. (See page 388 of the report). The Court went on to find that the expenditure was not of a capital nature and was properly deductible.

This question would today be dealt with in terms of Section 11(c) of the Act and would, it is clear, be deductible in terms of that Section as well.

In conclusion therefore, it may be said that the tests applied in determining the deductibility of payments made by way of damages or compensation are substantially the same whatever the underlying reason for the payment might be, whether it be made by way of expunging a delictual liability or by reason of a breach of contract. In applying the test,

however, the distinction between the various categories, it is submitted, becomes of relevance. In dealing with payments of a delictual nature, the test as laid out in the Rendle's case is the proper test for application, namely it is the risk of the event which has given rise to the payment happening which is of relevance, and the link between that risk occurring and the business of the taxpayer is the vital connection. The closer the link, the more likely the payment will rank as a deduction. In contractual cases on the other hand, it is the relation between the contract in respect of which the payment is being made and the business of the taxpayer which is of relevance. It is the place of the contract in the overall structure of the company's operations which is vital and the closeness of that contract to the income-earning operations of the company and its trade as a whole which has to be determined in deciding whether a deduction under Sections 11(a) and 23(g) of the Income Tax Act is allowable. It is submitted that all losses resulting from the theft of monies should be deductible and the distinction based on whether the monies in question were stolen by clerical or managerial staff is unrealistic and should be done away with. It is furthermore apparent that payments made in defending the assets of a business will generally be deductible except insofar as the payment is made to protect the entire capital structure of the business in which case it would be a payment of a capital nature.

Before concluding this chapter, brief mention should be made of Section 23(c) of the Income Tax Act which provides that no deductions shall be made in respect of "any loss or expense, the deduction of which would otherwise be allowable, to the extent to which it is recoverable under any contract of insurance, guarantee, security or indemnity." Accordingly even though a payment made by way of damages or compensation may, on the various tests enumerated above, rank as a deduction, to the extent that it is recoverable from any insurance or other such policy as mentioned in Section 23(c), it will not be deductible.

Chapter 4 - The relevance of the incidence of tax in determining the quantum of damages

The leading case in determining whether, in assessing the amount of damages to be awarded in a civil action, the incidence of tax should be considered, is British Transport Commission vs Gourley ((1955) 3 AER 796). The facts of this well known case are that a senior partner in a firm of civil engineers was seriously injured in a railway accident. Although not completely incapacitated, the Respondent's earnings were reduced and damages were awarded to the Respondent. The trial judge settled two alternative amounts of damages, one amount being the figure to be awarded if tax was not to be taken into account and the other figure to be awarded if tax was to be taken into account. The trial judge awarded the former figure. The matter for decision in the House of Lords was simply whether an amount in respect of tax, which would have been payable if the Respondent had himself earned the amount represented by the damages, should be deducted from the damages to be awarded to him.

In Gourley's case it was agreed by the counsel on both sides that the award of damages would not be subject to tax itself (see page 799). At the same reference, the Court stated the

general principle applicable to the assessment of damages as follows:

> "The broad general principle which would govern the assessment of damages in cases such as this is that the tribunal should award the injured party such a sum of money as will put him in the same position as he would have been in if he had not sustained the injuries. ... The principle is sometimes referred to as the principle of restitutio in integrum; but it is manifest that no award of money can possibly compensate a man for such grievous injuries as the Respondent in this case has suffered ... the principle can however, afford some guidance to the tribunal in assessing compensation for the financial loss resulting from an accident, and in such cases it had been referred to as 'the dominant rule of law'."

The Court then went on to review the meagre authority on the issue to date. It was found that the following cases had held that damages should not be reduced to provide for a notional deduction of income tax: Fairholme vs Firth and Brown Limited ((1933) (149 LT 332)); Jordan vs Limmer and Trinidad Lake Asphalt Co Limited ((1946) 1 AER 527); Davies vs Adelaide Chemical and Fertiliser Co Limited (2) ((1947) SASR 67); Blackwood vs Andre (1947 SC 333); Billingham vs Hughes ((1949) 1 AER 684); and W. Wrought Limited vs West

Suffolk County Council ((1955) 2 AER 337). The reason advanced in these cases for maintaining that it was not proper to make a deduction in respect of tax which would have been payable if the damages had been earned, was that the question for liability for tax was res inter alios acta, in other words it had absolutely nothing to do with the assessment of damages and was a separate matter between the State and the person concerned. Allied to this was the feeling that to permit a deduction in assessing damages for a notional tax liability would be to unduly benefit the wrongdoer in that there would be no benefit to the State in permitting the deduction whereas the wrongdoer would benefit in that he would have to pay a smaller amount in damages. Against the line of cases holding that tax was irrelevant in assessing damages, was the solitary decision of M'Daid vs Clyde Navigation Trustees (1946 SC 462) where Lord Sorn had held that to ignore the tax position at the present day would be to act in a manner which was out of touch with reality. The case of Comyn vs AG ((1950) IR 142) which was cited to the Court, although not altogether in point, also seemed to support this.

Going against the weight of authority, the Court found that it was proper to take the incidence of tax into account in assessing the amount of damages to be awarded. It stated at page 800 that "in all such cases the real issue seems to be whether the facts relied on as affecting the measure of

damages are too remote to be taken into consideration." At page 802 it dealt with the various arguments raised against taking tax into account as follows:

> "My Lords, it is, I think, if I may say so with the utmost respect, fallacious to consider the problem as though a benefit were being conferred on a wrongdoer by allowing him to abate the damages for which he would otherwise be liable. The problem is rather for what damages is he liable; and, if we apply the dominant rule, we should answer 'he is liable for such damages as, by reason of his wrongdoing, the Plaintiff has sustained'. I cannot think that the risk of confusion arising if the tax position be taken into consideration should make us hesitate to apply the rule of law if we can ascertain what that rule is. Nor should we be detered from applying that rule by the consistent or inveterate practice of the Courts in not taking the tax position into consideration in those cases in which the Courts were never invited to do so.
>
> My Lords, I agree with Lord Sorn in thinking that to ignore the tax element at the present day would be to act in a manner which is out of touch with reality. Nor can I regard the tax element as so remote that it should be disregarded in assessing damages. The obligation to pay tax - save for those in possession of

> exiguous incomes - is almost universal in its application. That obligation is ever present in the minds of those who are called on to pay taxes, and no sensible person any longer regards the net earnings from his trade or profession as the equivalent of his available income. Indeed, save for the fact that in many cases - though by no means in all cases - tax only becomes payable after the money has been received, there is, I think, no element of remoteness or uncertainty about its incidence."

It was found therefore that the damages awarded should be those calculated after taking into account the tax which would otherwise have been payable. Lord Keith of Avonholm however dissented stating, at page 811, that "it is a strange turn of fortune's wheel that the intricacies and accidents of fiscal legislation should have its repercussions in the assessment of damages in the Civil Courts". A major objection raised by Lord Keith was the difficulty of assessing to what extent a deduction in respect of tax should be allowed. This difficulty was recognised by the majority judges and at page 805 Lord Goddard attempted to deal with the problem as follows:

> "We were not informed what the calculations were which had resulted in this figure. But, in considering special damages in these cases, related tax to be taken

must, as it seems to me, be the effective rate of income tax and, if necessary, surtax, which would have been applicable to the sums in question if they had been earned. That rate depends on the combination of a number of factors that may vary with each case - allowances, reduced rates, surtax rates, other income of the claimant or his wife, charges or reliefs. The task of determining it may not always be an easy one, but, in complicated cases, it is to be hoped that the parties, with the help of accountants, will be able to agree figures. If not, the Court must do its best to arrive at a reasonable figure, even though it cannot be said to be an exact one."

Gourley's case has since been followed in the English Courts and still constitutes good law, as may be seen from the following cases. West Suffolk County Council vs W. Wrought Limited ((1956) 3 AER 216), a case in which business premises were expropriated. There was a delay before the Respondents were able to take occupation of new premises and they were paid compensation for the loss of profits which they had suffered in the interim period due to the interruption of their business. It was held by the House of Lords, following their decision in Gourley's case, that the tax which would have been payable had the profits been earned in the ordinary course of business, had to be taken into account in assessing the damages to be awarded.

Similarly In Re Houghton Main Colliery Co Limited ((1956) 3 AER 300) it was held that the incidence of tax on lump sum compensations paid in lieu of pensions to former employees of a company placed into voluntary liquidation should be determined after taking into account the tax which would otherwise have been payable on the pensions themselves.

It is clear from these cases as also from the remarks in Beach vs Reed Corrugated Cases Limited ((1956) 2 AER 652 at 659 B) that there is no difference in principle in assessing the damages to be awarded in cases of personal injury based in delict and in actions for wrongful dismissal founded on breach of contract.

It cannot be said that the rule has as yet found acceptance in South African law and the position can only be described as open at present. In Pitt vs Economic Insurance Co Limited (1957 (3) SA 284) a decision of the Durban and Coast Local Division, in determining the damages to be awarded arising out of a motor collision, Holmes, J. had the following to say:

> "It seems to me that in a case of this kind the object of awarding compensation for loss of income is to put the Plaintiff financially in a position in which he would have been but for his injuries. If the Court, in making the award, takes no account of evidence relating

to income tax, the Plaintiff might, in the result, be better off than he would have been if he had not been injured - and at the Defendant's expense. I would add, as a matter of interest, that this is now the accepted view in England ... Of course, owing to the uncertainties of the future it is not possible to make any precise calculation in this respect, anymore than it is possible to give mathematical expression to a widow's prospects of remarriage in compensating her for the loss of her breadwinner - Cupid being notoriously incorrigible and unpredictable. But this difficulty of assessment is no reason for not taking such factors into account. A Court's task in estimating damages is always a difficult one. Basically, one has evidence as to all the Plaintiff's affairs, but when, in addition, the future has to be scanned the Court is virtually called upon to ponder the imponderable. However, no better system for assessing damages has yet been evolved, and the Court has to do the best it can with the material available, even if, in the result, its award might be described as an informed guess. I have only to add that the Court must take care to see that its award is fair to both sides - it must give just compensation to the Plaintiff, but must not pour out largesse from the horn of plenty at the Defendant's expense."

The Appellate Division however, has not yet adopted the rule and indeed, on two occasions, has refrained from doing so. The first of these was in the case of Whitfield vs Phillips (1957 (3) SA 318 A), a case dealing with damages for loss of crops following on the repudiation of a contract for the sale of a farm. At pages 345 - 346 of the judgment, Steyn, J.A. expressed some doubt "as to the soundness in our law of the conclusion reached in Gourley's case and of the feasibility of adopting a similar procedure in the assessment of damages" but did not find it necessary to finally decide the issue. The judge went on to say:

"The first proposition, i.e. that the amount awarded will be regarded as a capital accrual, is basic to the whole contention advanced on behalf of the Defendant. Unless it is established, there is no room for the conclusion that with a deduction by way of income tax the Plaintiffs would be in a better position than they would have been in had the contract been performed. Until it is established, the tax which the Plaintiffs would have had to pay on the profit from the crop which they have lost, would be irrelevant, and there would be no cause or foundation for requiring the Plaintiffs to show what the amount of tax (if any) would have been. ... The Defendant did not mention the matter in his pleadings and did not raise it at all before the Trial Court. On the facts before the Court, moreover, I

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> would not be prepared to hold that there is a probability that the award will be regarded by the competent authorities as a capital accrual to the Plaintiffs. ... that will be a matter for the Commissioner and for the Special Court, if there is an appeal, but on the assumption that the facts before this Court will be the facts before the Commissioner, I'm unable to say that that view will probably not prevail."

Thus although certain doubts were expressed as to the validity of the ruling in Gourley's case, it can be seen that the real reason in this case for the Appellate Division refusing to apply the rule was that they were unconvinced that the damages which they would award would not be subject to tax.

(For a discussion of the Pitt's case and the Whitfield's case see 1957 Taxpayer 266 and 1957 SALJ 367). In the latter article, Professor McKerron expresses some doubt as to the reasons advanced by Steyn, J.A. regarding the feasibility of applying the rule in Gourley's case insofar as tax is a question for decision by the Commissioner of Inland Revenue. Professor McKerron points out that the incidence of tax is a question of law upon which any competent Court of law is able to decide. He goes on to say however that the intricacies of determining an appropriate

deduction for tax are so fraught with difficulty that the rule should not be applied. He states at page 368:

> "Considerations of logic and elegantia juris must sometimes give way to considerations of expediency and convenience. In the opinion of the writer this is a matter in which the latter should prevail, and it is to be hoped that this is the view which our Courts will ultimately adopt."

In his book, The Law of Delict, page 119, Professor McKerron repeats that in law the rule in Gourley's case is correct but reiterates his reservations as to its practicability.

In Gillbanks vs Sigournay (1959 (2) SA 11) the Natal Provincial Division in determining damages for loss of future earnings arising out of a motor accident held that in principle the basis of assessment laid down in Gourley's case was correct but felt that the uncertainties of the future make any precise calculation in respect of income tax well nigh impossible, (page 19). However the Court did attempt to take tax into account in assessing damages. The case however went on appeal before the Appellate Division (Sigournay vs Gillbanks - 1960 (2) SA 552 A) where the Court found that as material for making any adjustment on account of income tax was very slender in this case and if such an adjustment was made it might well be widely wrong, the Court

in the circumstances did not take the tax factor into account. It can be seen however that again the rule was not applied for practical reasons rather than as a result of objections in principle. (See also 1959 Taxpayer 94).

Before concluding this chapter, it is desirable to examine two of the more recent English decisions on the application of Gourley's rule to see to what extent the doctrine has developed in English Law. In Parsons vs BNM Laboratories Limited ((1964) 1 QB 95) it was held that where an award of damages is subject to tax in the Plaintiff's hands then the effective tax must be ignored on both sides when assessing the quantum of damages. On the other hand in Shove vs Downs Surgical Plc ((1984) 1 AER 7) the Court said the following at page 9:

> "In Gourley's case the damages awarded were not subject to diminution by taxation in the hands of the Plaintiff. In the instant case the damages to which the Plaintiff is entitled will be taxable in his hands. They will be taxable whether or not I accept all the submissions made on behalf of the Defendants. This has given rise to much debate as to the correct principle to be applied. On one view of such a case it is said that, because the income of which the Plaintiff has been deprived and the damages which he will receive are both taxable, the Court should ignore taxation

altogether. At the other extreme it was argued that the correct principle is to start by estimating the net amount which would have been received by the Plaintiff after the deduction of tax from his gross income. That net amount would represent as realistically as possible his actual loss. Thereafter, in assessing the damages, the Court should take into account the Plaintiff's liability to tax on the damages awarded so that the net amount received should, so far as possible, equal the net or actual loss suffered."

In making its decision, the Court felt that tax should be considered in making the award and accordingly awarded a gross sum so that, after deduction of the tax which would become payable, the net amount left would be the actual amount which the Court considered represented the Plaintiff's net loss. It can be seen that the rule in Gourley's case has been accepted into English law and that the refining of that rule is well advanced. In South African law on the other hand, it would appear that our Courts are reluctant to apply the rule not for reasons of principle, since it would appear to be admitted that the rule is probably correct in law, but for practical reasons in that it is felt that the determination of the possible incidence of tax is so difficult that a meaningful deduction cannot be made. It can only be a matter of time however

before the Appellate Division is compelled to utter on this point.

Chapter 5 - Conclusion

The tax treatment of damages and compensation has been examined from three angles in this paper, whether the receipt or accrual of an amount by way of compensation or damages is taxable, whether the payment of such an amount is deductible and whether the incidence of tax should be considered in determining an award of damages. Certainly in regard to the first two queries one may quote the words of Malan, J.A. in Atlantic Refining Company of Africa (Pty) Limited (supra) at page 334:

> "It would appear that the final word has probably been spoken upon the expoundment of the law which has been stated in very clear and precise language. The difficulty lies in its application to the facts of particular cases."

Although the law on this topic may not have been expounded with quite the clarity and precision referred to by the learned judge (who was in fact referring to the test for capital and revenue) it is clear that the basic tests applicable in each case are firmly established. These tests may not always have been expressed in the clearest terms or with complete consistency but nevertheless, it must be conceded, a fair degree of certainty exists in this regard.

The difficulty, as Malan, J.A. suggests, is not so much in framing a test as in applying it to the facts of the particular cases.

The question of the relevance of tax, in assessing the amount of damages to be awarded, as has been seen, is a question as yet unresolved in South African Law and one fraught with difficulties in application. These difficulties are even more apparent today than in the past, as today there is no certainty as to the rate of tax from year to year and indeed the whole basis of tax may be regarded as altering with the introduction of greater indirect taxes and the probable introduction of fringe benefits tax. It can be seen therefore that in attempting to make a notional deduction for a tax liability in computing damages, the Courts would indeed be doing little more than guessing and any figure so arrived at can only be described as arbitrary to a very large extent.

The tax treatment of damages and compensation, as illustrated by the numerous cases cited in the preceding pages, is a topic which has attracted considerable attention by the Courts, and has resulted in the formulation of a number of tests. Although therefore, in theory, the correct approach to the various problems posed would appear to have been extensively analysed, the continued appearance of cases of this nature indicates that the difficulties of the correct

application of the tests and the endless variations of facts which occur, render problems of this nature far from easy to resolve.

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