Deductibility of legal expenses

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For purposes of determining the taxable income derived by any person from carrying on a trade, s11(c) of the Income Tax Act, No. 58 of 1962 (Act) provides for the deduction of legal expenses which arise in the course of or by reason of a taxpayer’s ordinary trading operations. More specifically, any legal expenses actually incurred by a taxpayer in respect of any claim, dispute or action at law arising in the course of or by reason of the ordinary operations undertaken by the taxpayer in the carrying on of its trade will be deductible.

In order for a taxpayer to be able to deduct legal expenses (which include the services of legal practitioners, expenses incurred in procuring evidence or expert advice, court expenses, witness expenses, taxing expenses, expenses of sheriffs or messengers of the court and other expenses of litigation which are of an essentially similar nature to any of the said expenses), such expenses must:

i. be in relation to any claim, dispute or action at law;

ii. arise in the course of or by reason of the ordinary operations undertaken by the taxpayer in the carrying on of its trade; and

iii. not be of a capital nature.

These requirements are discussed in more detail below.
Claim, dispute or action at law

The phrase claim, dispute or action at law is not defined in the Act. However, the meaning of this phrase was considered in *ITC 1419 (1986) 49 SATC 45*, where the taxpayer incurred expenditure on securing legal representation before a commission of enquiry appointed under s417 of the Companies Act, No. 61 of 1973. The Commissioner for the South African Revenue Service (SARS) argued that the word dispute referred to a defined and readily identifiable dispute between the parties. The court did not find it necessary to decide the issue as commissions appointed under the said s417 are appointed by a court of law. However, the view was expressed that the word dispute covers any disagreement as a result of which parties require legal assistance.

Arise in the course of or by reason of the ordinary operations of a taxpayer in carrying on a trade

For purposes of s11(c), it is not a requirement that the legal expenses should have been incurred in the production of income. It is submitted that all that is required is that the legal expenditure must arise in the course of or by reason of the taxpayer's ordinary trading operations.

The term trade is given a very wide meaning in s1 of the Act and includes every profession, trade, business, employment, calling, occupation or venture, including the letting of any property and the use of or the grant of permission to use any patent as defined in the Patents Act, or any design as defined in the Designs Act, or any trade mark as defined in the Trade Marks Act, or any copyright as defined in the Copyright Act, or any other property which is of a similar nature.

The phrase arising in the course of or by reason of ordinary operations undertaken by him in the carrying on of his trade has been considered by our courts and has been interpreted to mean that the deductibility of legal expenses in terms of
s11(c) does not depend on the purpose of the expenditure, but rather the causal connection of the relevant events with the taxpayers trade.

For example, in the case of *ITC 1710 (1999) 63 SATC 403*, an employee of the taxpayer who was the owner of a farm producing grapes, had, while working in the vineyards, negligently set a neighbours farm alight causing severe damage thereto. In an action for damages brought against the taxpayer, the court had found that the employee in question had acted within the course and scope of his employment and the taxpayer was accordingly liable for the damages caused by the employee as a result of the fire. The taxpayer, in order to defend the legal action, had incurred legal expenses and the issue to be decided by the court was whether such expenses were deductible in terms of s11(c) of the Act. It was found that the expenses in issue were connected with work performed by the employee on the farm, as part of the taxpayers business and that there was a sufficient causal connection with the taxpayers farming operations. Accordingly, it was held that the legal expenses incurred by the taxpayer were deductible in terms of s11(c) of the Act.

In *ITC 1837 71 SACT 177*, the taxpayer, a premier of a province, had made remarks at a press conference that resulted in him being successfully sued and ordered to pay damages for defamation. It was held that the claim for damages arose in the course and scope of his employment as premier and was sufficiently closely related to his ordinary trading operations to establish the requisite causal connection between such expenditure and those trading operations. The legal expenses incurred in defending the claim were accordingly deductible in terms of s11(c) of the Act.

**Not of a capital nature**

The question of whether or not expenditure is of a capital nature, depends on the facts of each case. For example, what
may be capital expenditure in the case of one taxpayer may be revenue expenditure in the case of another. A useful test, which has been applied and endorsed in a number of South African judgments (such as *New State Areas Ltd v Commissioner for Inland Revenue* 1946 AD 610 and *Commissioner for Inland Revenue v George Forest Timber Co Ltd* 1924 AD 516) is to ascertain whether the expenditure has been incurred to create, acquire or improve an income-producing asset, in which case the expenditure will be of a capital nature. As with most capital/revenue matters, there is seldom tax certainty and one has to form a view based on a myriad of tax cases with contrasting principles and decisions. Some of these cases are summarised below.

In *ITC 1241* (1975) 37 SATC 300, a company that was a scrap-metal merchant had erected a crushing machine on hired land zoned by the local municipality for general residential purposes. The municipality then gave notice calling for the removal of the machine but the company took no action. The municipality consequently instituted proceedings in the Supreme Court for an order directing the company to remove the machine. In an attempt to gain time and continue the profitable use of the machine for as long as possible, the company decided to use all legitimate means of resisting the granting of an order for the removal of the machine. At the same time, the company attempted to find a suitable alternative site for the machine.

The court, having regard to the fact that the purpose and effect of the expenditure was to delay as long as possible the granting of an order compelling the removal of the machine, held that (at 306):

The legal expenses incurred did not create or enhance any asset, they did not bring about any advantage for the enduring benefit of trade, and they were more closely related to the appellants income-earning operations than to its income-earning structure. [T]he appellant took a calculated risk, and
the expenditure was in truth no more than part of the cost incidental to the performance of the income-producing operations.

The court accordingly concluded that the legal expenses incurred were not of a capital nature and were deductible under s11(c) of the Act.

In *ITC 1677 (1999) 62 SATC 288*, a certain D had applied for an interdict against the taxpayer, a publishing company, on the basis that the taxpayer had published two textbooks which constituted an infringement of Ds copyright. The court had to decide whether legal expenses incurred by the taxpayer were of a capital nature.

The court rejected the taxpayers argument that the expenditure did not give rise to any asset or to any advantage of an enduring nature on the basis of the decision in *Secretary for Inland Revenue v Cadac Engineering Works (Pty) Ltd* 1965 (2) SA 511 (A). In that case, Cadac was manufacturing cookers under licence from the patent holder and asked the patent holder to institute legal proceedings against another firm, Homegas, which had started to market cookers in competition with Cadac. Cadac undertook to indemnify the patent holders for its legal expenses. The court held that the legal expenses were of a capital nature as they were directed at preserving and perhaps expanding the field in which the taxpayers business operated. This was further the case, as the expenditure had been incurred by Cadac to eliminate the competition of Homegas. It was therefore not deductible.

Based on this reasoning in Cadac, the court in *ITC 1677* held that the taxpayers litigation was instituted to preserve an asset and protect the taxpayers market. The legal expenses were therefore capital in nature and not deductible.

**Conclusion**

In light of the above, to the extent that the requirements of
s11(c) are met, legal expenses should be deductible. However, it is important for taxpayers to bear in mind that such deduction is limited to so much thereof as:

a) is not of a capital nature;

b) 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 under s11(a) of the Act;

c) 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

d) is not incurred in respect of any dispute or action at law relating to any such claim as is referred to in b) or b) above — in other words, where legal expenses are incurred on a claim, the claim must be either for the taxpayer to pay damages or compensation deductible in terms of s11(a) of the Act or for the taxpayer to derive an amount that will be included in its income.