

Short notes on: DEDUCTIONS FROM TAXABLE INCOME – A BRIEF OUTLINE OF THE GENERAL DEDUCTION FORMULA

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Introduction

Whether or not expenses incurred by a taxpayer can be deducted from his/her gross income will depend on the results of a thorough analysis of the general deduction formula. The general deduction formula is contained in section 11(a) read with section 23(g) of the Income Tax Act 58 of 1962 (the Act). While section 11(a) provides positively for what may be deducted, section 23(g) provides negatively for what may not be deducted. Therefore, an amount claimed as a deduction must satisfy both sections. Always bear in mind that deductions can only be claimed during the year of assessment in which they are incurred.

Essential elements

The essential elements of the general deduction formula may be summarised as follows:

- Carrying on any trade
- Deducted from the income
- Expenditure and losses
- Actually incurred
- In the production of income
- Not of a capital nature

- To the extent not laid out for the purposes of trade.

All these requirements must be met for an expense or loss to be deductible. Failure to meet any of the requirements will result in a disallowance of the expenditure for taxation purposes.

Carrying on any trade

The Act permits a deduction only if the taxpayer is engaged in carrying on a trade.

'Trade' is defined in the Act as follows:

'trade' includes every profession, trade, business, employment, calling, occupation or venture, including the letting of any property and the use of or the granting of permission to use any patent, design, trade mark, copyright or any other property which is of a similar nature.

Deducted from the income

'Income' is defined as gross income less exempt income.

Expenditure and losses

There is no significant difference between the term 'expenditure' and the term 'losses'. In order for a deduction to be made, there must be settlement of a liability, in cash or otherwise, whether or not the liability may have been incurred voluntarily or not.

Actually incurred

In the Port Elizabeth Electric Tramway Company v CIR 1936 CPD 241 case,

Watermeyer AJP held that:

The words of the statute are 'actually incurred' not 'necessarily incurred'.

The use of the word 'actually' as contrasted with the word

'necessarily'

may widen the field of deductible expenditure. For instance, one man may conduct his business inefficiently or extravagantly, actually incurring expenses which another man does not incur; such expenses, therefore, are not 'necessary' but they are actually incurred and are therefore deductible.

This means a liability does not need to have been paid for it to have been incurred by the taxpayer. As long as the liability has actually been incurred, it may be deductible. In other words: once it has become due and payable.

In the production of income

In the case of CIR v Genn & Co (Pty) Ltd 1955 (3) SA 293 (A), Schreiner JA held

that:

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 operation provided they are so closely connected with it that they

may be regarded as part of the cost of performing it.

Therefore, a link must be established between the expenditure and the trade.

Proving this link can sometimes be very difficult for the taxpayer. This explains the plethora of case law relating to this particular element of

the general deduction formula.

Not of a capital nature

In terms of section 11(a), expenditure and losses of a capital nature may not be allowed as a deduction from a taxpayer's income even if all the other requirements of the general deduction formula have been met. There are numerous tests to determine whether or not expenditure and losses are of a capital nature. It is accepted that each case needs to be judged on its own facts when it comes to disputes surrounding this aspect. One of these tests, and perhaps the one that explains the concept best, is that of an 'enduring benefit'. If an enduring benefit arises for the taxpayer from the expenditure, then it will usually be of a capital nature. Examples include the purchase of a factory or a piece of machinery to be used in the factory. To the extent not laid out for the purposes of trade This essential element allows for apportionment in the sense that a deduction may be allowed to the extent that it relates to trade expenditure and disallowed to the extent that it does not.

Conclusion

The seemingly complex provisions of the general deduction formula are used to prevent abuse by taxpayers by making sure only that expenditure and only those losses actually incurred in connection with the taxpayer's business should be allowed as deductions from his/her taxable income.

Bear in mind, also, that there are particular rules that apply

to particular kinds of expenditure. Therefore, these rules need to be considered in addition to the general rules outlined in the general deduction formula.

As a taxpayer, if you are uncertain whether particular expenditure will be allowed as a deduction, you should consult a tax practitioner before incurring the expenditure to establish what the taxation implications will be.

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