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THE INCOME TAX DEDUCTIBILITY OF EXPENDITURE INCURRED BY STOCKBROKING ENTITIES IN EARNING EXEMPT DIVIDENDS

by

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in

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COLLEGE OF BUSINESS AND ECONOMICS

at the

UNIVERSITY OF JOHANNESBURG

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May 2019
DECLARATION

I certify that the minor dissertation submitted by me for the degree Master’s of Commerce in South African and International Taxation at the University of Johannesburg is my independent work and has not been submitted by me for a degree at another university.

Mpho Dibate Christian Lefakane
The dissertation is dedicated to:

My Parents
For affording me with the opportunity to learn and sacrificing to ensure that all of their children have an opportunity to obtain tertiary qualification so that their children’s lives are better than their own. Special thanks to my late father for always pushing me to work hard irrespective of the challenges that my come my direction- *motho wa lekobobo le le ko molokwane, motho wa ga modimosana wa nonyana- ko nonyane etswang masiteng e se kgomo.*

My Family
Bakwena- Let us continue to value education and the success it will bring to the generations to come.

Thato & Lethabo: my boys’ education is the key to your success, continue learning and strive to be the best in all that you do.

To my Moratuwa: thank you for the support, encouragements when I was of a negative mind, you continued to believe that I will complete this dissertation. Lots of love and gratitude to you my sweetheart. I believe that we will continue to grow and accomplish all that we set our minds towards.
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“Education is the passport to the future, for tomorrow belongs to those who prepare for it today” – Malcom X

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ABSTRACT

Stockbroking entities hold shares as trading stock rather than as capital assets. Shares are sold by these entities as part of their normal trading operations at a profit to clients. In situations where shares held as trading stock are unsold and a dividend is declared, stockbroking entities receive the dividend. This results in a portion of the expenditure being non-deductible in terms of s23(f) of the Income Tax Act No 58 of 1962 (hereafter “the Act”). The application of s23(f) to stockbroking entities creates a problem as it results in a limitation of expenditure where incidental dividends are earned. No consideration is given to the fact that stockbroking entities hold shares as trading stock and sell those shares to clients at a profit.

This study applied a doctrinal research method to conduct a systematic exposition of s23(f) of the Act by using case law. The objectives of the study were to investigate whether the disallowance of stockbroking expenditure in terms of s23(f) of the Act is appropriate where the core business of stockbroking entities is the buying and selling of shares at a profit. Secondly, the study considered the example of stockbroking entities in India and investigated the treatment of expenditure incurred by entities which held shares as trading stock. It was ascertained whether there were any principles from the Indian tax court judgements which could be implemented by South Africa.

The study revealed similarities and differences in the treatment of expenditure incurred by stockbroking entities in South Africa and India. Legislation and court cases in the two countries were presented to demonstrate the deductibility principles where stockbroking entities earn dividends on shares held as trading stock. The focus was on principles which could be used to provide guidelines from which stockbroking entities could determine the deductibility of expenditure where dividends received were incidental. Recommendations were then made for South African legislation based on the findings of the treatment applied in India.
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CHAPTER 1

INTRODUCTION

1.1 Background

The core business of stockbroking entities is the buying and selling of shares (Guide to America’s Top Stockbrokers, 2007). These entities act as agents – they buy and sell shares on behalf of clients. In some cases, stockbroking entities buy and sell shares as a dealer for their own benefit (ibid). Stockbroking entities thus act in a dual capacity, that is, they act in the role of a dealer as well as broker. This is commonly referred to as a “broker dealer”. Section 3(a)(4)(A) of the United States Securities Exchange Act of 1934 (hereafter “the Exchange Act”) defines a ‘broker’ as any person involved in carrying out transactions in securities on behalf of others. As a broker, the stockbroking entity does not own the securities that it buys or sells. The stockbroking entities earn commission from clients for performing this service. Section 3(a)(5)(A) of the Exchange Act defines a ‘dealer’ as any person involved in the business of buying and selling securities for their own account. As a dealer, the stockbroking entity buys securities with the expectation that the security will in future increase in value and sell at a profit to clients (Guide to America’s Top Stockbrokers, 2007). The shares held by the dealer are treated as trading stock. As a dealer, the stockbroking entity may earn incidental dividends on the unsold shares held as trading stock.

For expenditure such as the cost of shares, traders’ salaries and other operating expenses (hereafter “stockbroking expenditure”) of stockbroking entities, to qualify as a deduction, they must satisfy the requirements of the general deduction formula s11(a), read together with s23(g) of the Income Tax Act No. 58 of 1962 (hereafter “the Act”). Additionally, the deductibility of the stockbroking expenditure must not be prohibited by s23(f) of the Act.

Section 23(f) of the Act states that no deduction will be allowed for “any expenses incurred in respect of any amounts received or accrued which do not constitute income”. Income as defined in s1 of the Act, “means the amount remaining of the gross income of any person for any year or period of assessment after deducting any
amounts exempt from normal tax under part I of chapter II”. Paragraph k of the gross income definition includes in gross income any amount received or accrued by way of a dividend or a foreign dividend. However, s10(1)(k) of the Act exempts from normal tax the receipt and accrual of dividends subject to certain exclusions. Dividends received by the stockbroking entities on unsold shares are included in gross income in terms of paragraph k of the Act and exempted by s10(1)(k) of the Act. Therefore, these dividends do not form part of income.

Since dividends are exempt and do not form part of income, the stockbroking expenditure attributable to the dividends will not qualify for a deduction in terms of s23(f) of the Act. The receipt of dividends on unsold trading shares does not emanate from activities undertaken by the stockbroking entities that are directly linked with the earning of the dividend income.

1.2 Research question and objectives

Stockbroking entities may earn incidental dividend income on shares held as trading stock. As stated above, stockbroking expenditure incurred is disallowed in terms of s23(f) of the Act as it is linked to the earning of dividends. Stockbroking expenditure is disallowed to the extent that it relates to dividend income without determining whether there are costs that are directly linked with the receipt of dividend income. The mere fact that the stockbroking entities received dividends, an assumption is drawn that expenditure is incurred to earn exempt dividend income.

The research question is whether the stockbroking expenditure should be subjected to an apportionment in terms of s23(f) of the Act where incidental dividends are received on shares held as trading stock?

The objectives of the study are to investigate:

1. Whether the disallowance of stockbroking expenditure in terms of s23(f) of the Act is appropriate where the core business of stockbroking entities is the buying and selling of shares at a profit.

2. How stockbroking expenditure incurred where stockbroking entities hold shares as trading stock is treated in India and to ascertain whether there are
any principles originating from Indian tax courts judgements that could be implemented by South Africa.

1.3 Rationale

In CIR v Nemojim (Pty) Ltd (1983), the court stated that where the taxpayer did not trade in shares, the expenditure cannot be deducted in full. Furthermore, the court stated that there are vital differences between the company buying all the shares in a dormant company with a view to dividend stripping and a situation where it buys shares in companies to make a profit on their resale and incidentally also receive whatever dividends that may be declared on the shares while it holds them. Therefore, stockbroking expenditure is disallowed to an extent that incidental dividends are earned. This disallowance thus necessitates an investigation into the application of s23(f) of the Act to stockbroking expenditure. In addition, an understanding is sought as to whether s23(f) of the Act applies where there is no stockbroking expenditure that can be linked to the earning of dividend income.

India has tax provisions that are similar to s23(f) of the Act and their courts have extensively considered the deductibility of stockbroking expenditure incurred by entities that trade in shares, along with other passive investors in shares. India was chosen for the study due to the similarities of their legislation to s23(f) of the Act and the abundance of tax cases dealing with the deductibility of expenditure where dividends are earned. Furthermore, both India and South Africa are member countries of five major emerging national economies council referred to Brazil, Russia, India, China and South Africa (BRICS). The existence of the guidance in India supports the rationale to further review the South African legislation on the treatment of stockbroking expenditure to determine whether there are principles in India that could be adopted in South Africa.

1.4 Contribution of the study to practice

The study identifies differences between stockbroking entities trading in shares, passive investors in shares and holding companies with regard to the activities undertaken in earning dividends. The study may be useful to the South African Revenue Service (hereafter “SARS”) and the National Treasury in understanding the operations of stockbroking entities and the incongruity that exists in the application of
s23(f) of the Act to the stockbroking expenditure where incidental dividends are earned on shares held as trading stock. The findings may also assist members of the South African Institute of Stockbrokers (hereafter “SAIS”) in lobbying for amendment to the application s23(f) of the Act to stockbroking expenditure incurred to the extent that stockbroking entities earned incidental dividend income on shares held as trading stock.

1.5 Limitation and delimitation of the study
Since the core business of stockbroking entities is buying and selling shares, the study is undertaken from the perspective that stockbroking entities buy shares with the intention to sell them at a profit rather than holding on to them as a capital asset. Therefore, the earning dividend revenue is subsidiary to the commercial operations of stockbroking. The study does not focus on passive investors in shares; it only refers to them to indicate the difference in strategy. For the purposes of this study, it is assumed that stockbroking entities will not hold shares as trading stock for a period longer than three years. As a result, provisions of section 9C of the Act will not be dealt with.

1.6 Methodological approach
A qualitative method is used to address the research objectives. Qualitative research is primarily exploratory in nature (Robinson, 2002). An exploratory study is described by Robinson (2002) as a process of seeking new insights, asking questions and assessing a phenomenon in a new way. The study thus seeks to assess whether s23(f) of the Act can be applied in a different way in order to provide new insights on how the provisions should be applied in relation to stockbroking entities.

A doctrinal method is adopted to conduct the research. Doctrinal research is defined by Hutchinson and Duncan (2012) as providing a systematic exposition of the guidelines governing a specific legal grouping or examining the association between rules and explaining areas of difficulty. According to Hutchinson and Duncan (2012), a doctrinal method involves a two-part process. Firstly, the sources of the law must be located, namely, s23(f) of the Act; then the text in the section of the Act is interpreted and analysed. The first part of the process entails determining the objective reality, that is, a statement of law contained in the legislation or established common law principle. The second step, once the law has been located, is the
interpretation and analysis within a specific context (ibid). The process followed in the study entails reading and analysing s23(f) of the Act and evaluating and summarising tax court cases in India and South Africa relating to the topic. The study will focus on an exposition, analysis and interpretation of the legal rules contained in s23(f) of the Act, s14A of the Indian Income Tax Act, 1961 (43 of 1961), as amended by the Finance Act, 2017, (hereafter “Indian Act”) as well as the judicial judgements relating to the tax deductibility of stockbroking expenditure incurred by stockbroking entities that earned non-taxable income.

In McKerchar (2008), doctrinal research is defined as “the systematic process of identifying, organising and synthesising statues, judicial decisions and commentary”. It is seen as a library-based task, focused on reading and conducting intensive scholarly analysis (ibid). The study scrutinises the legislation and tax court judgements dealing with the tax deductibility of expenses incurred in the production of income by stockbroking entities.

The method chiefly involves a literature review which examines secondary sources on the topic at hand. The following will be considered:

- The tax legislation and court judgements in South Africa and India on the deductibility of expenditure incurred to earn exempt income will be studied to identify principles which could be applied to stockbroking entities earning incidental dividends on shares held as trading stock.

- The information gathered in the study will be presented in the form of persuasive arguments based on both countries’ legislation and case law. A conclusion will then be reached.

1.7 Ethical considerations

According to Stevens (2013), researchers should make every effort that their methodology and findings are open for discussion and review by peers. Furthermore, they should ensure that the selected research method is based on informed professional expertise. Additionally, they should fully acknowledge all previous research as a source of information, data, concepts and methodology to ensure reporting and dissemination are carried out in a responsible manner.
This study ensured factual correctness, avoided distortion, falsification, suppression or misinterpretation of data. It was conducted according to the required professional standards, all the material from previous studies was credited and acknowledged and no information was fabricated.

1.8 Chapter outline

The study is structured as follows:

Chapter 1: An introduction and background to the study is presented, the research objectives and design are discussed.

Chapter 2: The requirements of the general deduction formula and the South African case law impacting on the deductibility of expenditure are presented.

Chapter 3: Section 23(f) of the Act and South African tax case law are analysed to determine the requirements for a deduction to be allowed under legislation.

Chapter 4: This chapter analyses Indian tax legislation and Indian tax case law to outline the principles of s14A of the Indian Income Tax Act, 1961 (as amended by the Act of 2017) that applies to non-deductibility of expenditure incurred in earning non-assessable income.

Chapter 5: A conclusion is reached based on the findings from Chapters 2, 3 and 4 and recommendations are made on how stockbroking entities could approach the application of the general deduction and s23(f) of the Act to their expenditure.
CHAPTER 2

THE GENERAL DEDUCTION FORMULA

2.1 Introduction

This study focuses on the deductibility of expenditure incurred by the stockbroking entities against income; therefore, it is vital to outline the requirements to be met for stockbroking expenditure to be allowed as a deduction. This chapter outlines the principles of the general deduction formula. This formula encompasses s11(a) of the Act, which indicates which expenditure may be deducted (the positive test), as well as s23(g), which specifies what expenditure may not be deducted (the negative test) (CIR v Nemojim (Pty) Ltd, 1983). This chapter focuses on the application of the general deduction formula on stockbroking expenditure. Chapter 3 will focus on the deductibility of stockbroking expenditure incurred where exempt dividends are earned by stockbroking entities.

The basic principle in determining the taxpayers’ taxable income is to permit the deduction of expenditure and losses from income (income is defined in Chapter 1) if they satisfy the requirements of s11(a) and s23(g) of the Act. For the purposes of this chapter, only s11(a) and s23(g) of the Act (general deduction formula) will be outlined.

2.2 The general deduction formula

An in-depth analysis of the general deduction formula is required to ascertain whether expenditure and losses incurred by stockbroking entities are deductible from income. To claim a deduction of expenditure, the requirements of s11(a) and s23(g) of the Act listed below should be satisfied. In determining the deductibility of expenditure for tax purposes, the courts emphasise that s11(a) and s23(g) of the Act must be read together (Port Elizabeth Electric Tramway Co Ltd v CIR, 1936).

Section 11 of the Act reads as follows:

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

Section 23 of the Act states that:

“….no deductions shall in any case be made in respect of the following matters, namely-

(g) any moneys, claimed as a deduction from income derived from trade, to the extent to which such moneys were not laid out or expended for the purposes of trade;…."

The elements of the general deduction formula are:

- carrying on any trade
- expenditure and losses
- actually incurred
- during the year of assessment
- in the production of income
- not of a capital nature
- no deduction is allowed to the extent not laid out for the purposes of trade.

The deductibility of expenditure and losses under the general deduction formula requires that all the elements listed above be met. Therefore, the non-deductibility of the expenditure and losses for taxation will be as the result of the failure by stockbroking entities to fully satisfy the requirements laid out in the general deduction formula. The next paragraphs will discuss all the elements of the general deduction formula and their applicability to stockbroking entities.

2.3 Carrying on any trade

It is a precondition for the deductibility of all the items in s11(a) to s11(x) of the Act that a ‘trade’ be carried on by the taxpayer. Where the taxpayer is carrying on a trade, a deduction of the expenditure and losses incurred will be allowed. Section 1 of the Act defines ‘trade’ to:

“….include 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
An examination of the specific aspects of trade must be undertaken, such as:

• Are the activities continuous? If so, there may be an existence of trade carried on by the taxpayer.
• Is the generation of trade profits a long-term objective? If so, such trade may constitute the carrying on of a trade (ITC 1529, 1991).

It was held in Burgess v CIR (1993) that ‘trade’ as defined ought to be given an extensive interpretation. The ‘trade’ definition is not necessarily exhaustive; it is intended to embrace every profitable activity (ITC 770, 1954). Despite the broader meaning of the expression, all the activities that may yield revenue are not contained within the term ‘trade’, namely, passive income such as interest, dividends, annuities or pensions (ITC 1275, 1978).

The retention of investments does not imply a continuance of trade even though the investments were acquired when trade was carried on (ITC 1476, 1989). The court in COT v Estate G (1965) held that the taxpayers’ business activities should be examined in their entirety to establish whether trade was carried on.

In ITC 1476 (1989) it was stated that if a taxpayer does not trade in shares, there is no active step and it may not be regarded as having carried on a trade. However, in terms of SARS Practice Note 31(1994), it is SARS practice to allow for the deduction of interest where a taxpayer has borrowed funds to acquire shares.

Trade as defined includes a business; the activities of buying and selling of shares by stockbroking entities constitute a business. An examination of the activities of stockbroking entities – which are the buying and selling of shares – established that they constitute trade. The earning of dividends by stockbroking entities does not disqualify the activities of buying and selling of shares as trade. Stockbroking entities retain shares as trading stock for selling such shares at a profit, not to retain as an investment; therefore, they meet the carrying on of trade requirement. The activities of stockbroking entities are continuous, and the long-term objective of the business is the selling of shares at a profit. Active steps are taken by stockbroking entities to sell shares held as trading stock at profit. Stockbroking entities’ activities are not
undertaking to earn passive income; shares held are sold with a profit motive, therefore they meet the carrying on of trade requirement. The buying of shares with the purpose to sell at a profit constitutes a business, thus stockbroking entities’ activities of buying and selling shares qualify as a trade. Once the stockbroking entities satisfy the requirements of the carrying on of a trade, they may endeavour to deduct certain expenditure and losses.

2.4 Expenditure and losses

It was held in Joffe & Co (Pty) Ltd v CIR (1946) that ‘losses’ refers to deprivation suffered by the taxpayer, resulting in an involuntary payment of money (*ibid*). In CIR v Felix Schuh (SA) (Pty) Ltd (1994), it was stated that expenditure denotes the payments or expenses incurred or paid voluntarily while losses implies involuntary deprivation occurring unexpectedly. The distinction between these two concepts was further discussed in Stone v SIR (1974), Solaglass Finance Company (Pty) Ltd v CIR (1991) and Burman v CIR (1991), where it was confirmed that expenditure was voluntary whilst losses were involuntary. Involuntary expenditure is incurred where the value of shares held by stockbroking entities as trading stock decreases, resulting in a loss due to the sale of those shares at less than the amount they were originally bought for by the entity. Voluntary costs of stockbroking entities are incurred to meet operational requirements such as rent, salaries and other expenditure required for the business to function. Therefore, the criterion is met with respect to stockbroking entities.

2.5 Actually incurred

The words ‘actually incurred’ refer to a final and unconditional liability to settle an amount even if the actual payment is paid in future years (Edgars Stores Ltd v Commissioner of Inland Revenue, 1988). In Nasionale Pers Bpk v KBI (1986) it was stated that where there is no definite or absolute liability during the year of assessment to pay an amount, expenditure has not actually been incurred. The use of the word ‘actually’ as compared with word ‘necessarily’ widens the definition to include expenses, even though they may not necessarily be expenditure. However, as long as they are actually incurred, they will be deductible (Port Elizabeth Electric Tramway Co Ltd v CIR, 1936).
Stockbroking expenditure paid by the stockbroking entities is allowed as a deduction once there is an unconditional obligation to settle the expenditure. For instance, stockbroking entities may, at the end of the tax year, owe money for shares purchased on credit that forms part of its trading stock or for services rendered not yet paid. Such, expenditure is deductible in the year in which it was actually incurred. The deductibility of stockbroking expenditure (excluding variable remuneration per s7B of the Act) is not dependent on whether the expenditure has been paid. Consequently, there must be an unconditional obligation to settle the expenditure for it to be actually incurred and deductible. Unconditional stockbroking expenditure (excluding variable remuneration per s7B of the Act) actually incurred by stockbroking entities may be deductible.

2.6 During the year of assessment

Section 11(a) of the Act does not contain the requirement that expenses must be claimed during the year of assessment in which they were incurred. However, the courts have held that deductible outlay is constrained to that incurred in the year of assessment (Concentra (Pty) Ltd v CIR, 1942). The general rule is that no expenditure incurred in a year of assessment may be deducted in the ensuing years of assessment (Sub-Nigel Ltd v CIR, 1948). In Caltex Oil (SA) Ltd v SIR (1975) it was stated that deductions not claimed in the correct year of assessment will be forfeited.

Stockbroking expenditure incurred is claimed as a deduction in the year of assessment in which it was incurred. Stockbroking expenditure (other than variable remuneration subject to s7B of the Act) not claimed as a deduction in the correct year are forfeited by stockbroking entities.

2.7 In the production of income

For expenditure and losses to qualify in terms of s11(a) of the Act as a deduction from income, they must have been incurred in producing income. Expenditure or losses incurred by a business must be closely related to the income-earning activities for expenditure to be incurred in producing income (Port Elizabeth Electric Tramway Co Ltd v CIR, 1936). The principle laid down is that revenue is produced by performing a series of acts, and expenses are consequent upon these acts. As
such, expenses are deductible on condition that such acts are closely linked to the business to be regarded as part of the outlay of executing those acts (ibid). The two questions that need to be answered affirmatively to qualify for a deduction are: (i) whether the act the expenditure is connected to is performed to produce income and (ii) whether the expenditure is linked to the act closely enough (ibid). The purpose of the act necessitating the spending must be considered and where it is undertaken with the income earning resolve, the outlay associated with it will be deductible (ibid).

It follows that where the act is bona fide performed for the purpose of trade carried on in the generation of income, the deduction of associated expenditure will be permitted (Uhser's Wiltshire Brewery v Bruce, 1915). Watermeyer AJP, in Port Elizabeth Electric Tramway Co Ltd v CIR (1936), stated that the other questions to be considered are: “What associated expenditure can be deducted? How closely must they be linked to the business operations?” Every expenditure associated with the performance of activities of a bona fide business is deductible if incurred with the purpose of generating profits. This is irrespective of whether the expenditure is essential for such activities or connected to it by coincidence or is genuinely incurred for the more resourceful performance of such business activities (ibid). If the expenditure is so closely connected with the business operations, then it may be regarded as part of the cost of performing it (ibid).

Schreiner JA, in CIR v Genn & Co (Pty) Ltd (1955) held that bona fide business expenditure associated with the performance of the activities that are carried on for revenue generation is deductible. This is notwithstanding the fact that such expenditure is necessary for its performance or linked to it by coincidence (ibid).

For stockbroking expenditure to qualify as a deduction, the two questions below must be answered affirmatively: (i) whether the act the expenditure is connected to or is performed to produce income? In other words, are the duties performed by traders, back office staff employed by stockbroking entities carried out in the generation of profit from sale of shares? (ii) whether the expenditure is linked to the act closely enough? The cost that relates to the employment of traders, back office staff and other operational cost (stockbroking expenditure) incurred by stockbroking entities is closely linked with the activities of buying and selling shares at a profit,
therefore the two questions are answered positively. Stockbroking expenditure is 
*bona fide* incurred by stockbroking entities for the purpose of buying and selling of 
shares held as trading stock at a profit. Stockbroking expenditure is essential for the 
activities of stockbroking entities and is genuinely incurred for the buying and selling 
of shares. Therefore, stockbroking expenditure is incurred in the production of 
income which arises from the sale of shares held as trading stock.

2.8 **Not of a capital nature**

Expenditure and losses incurred by a taxpayer are not permitted as a deduction 
under s11(a) of the Act if they are of a capital nature. In New States Area Ltd v CIR 
(1946), the court stated that in determining the capital or revenue nature of the 
expenditure associated to a transaction, an examination of its true nature is required 
and the important factor in this regard is the purpose of the expenditure. Expenditure 
incurred in acquiring or creating revenue-producing assets as opposed to money 
spent on working it, is of a capital nature and not deductible (CIR v George Forest 
Timber Co Ltd 1924).

Expenditure incurred in respect of floating or circulating capital, i.e. trading stock, is 
of a revenue nature whilst expenditure that relates to fixed capital is capital in nature 
(New States Area Ltd v CIR, 1946). Floating capital expenditure represents 
deductible costs, i.e., the purchase of trading stock for which a s11(a) of the Act 
deduction may be claimed (*ibid*). The costs incurred in acquiring a right to trade, on 
the other hand, are fixed capital which is not deductible (*ibid*).

The cost of shares held as trading stock, salaries and other operational costs 
incurred by the stockbroking entities are not fixed capital, the expenditure is incurred 
in order to facilitate the profitable sale of shares held as trading stock, therefore they 
are revenue in nature. Shares held by stockbroking entities are purchased for the 
purpose of selling them as part of trade or profit-making scheme therefore constitute 
floating capital.

2.9 **To the extent not laid out for the purposes of trade**

The preface to section 11 of the Act contains the requirement that a taxpayer must 
be carrying on a trade to be allowed a deduction. In addition, s23(g) of the Act
disallows a deduction of “any monies to the extent to which such monies are not laid out or expended for the purpose of trade”.

In De Beers Holdings (Pty) Ltd v CIR (1986), it was stated that profit realisation is not the hallmark of a business transaction or activity. Furthermore, to gain an advantage from a commercial perspective, a trader may sell goods at a loss (*ibid*). To satisfy s23(g) of the Act, it must be shown that the expenditure relates to the taxpayer’s trade, to justify the conclusion that, despite the lack of a profit motive, the monies paid out under the transaction where expensed for purposes of trade (CIR v Nemojim (Pty) Ltd, 1983).

The term ‘trade’ in the statement ‘for the purpose of trade’ is not particularly qualified; however, it must be taken to be restricted to the genuine trade operated by the taxpayer (Solaglass Finance Company (Pty) Ltd v CIR, 1991). To determine whether the expenditure was laid out for purposes of trade, an examination of the nature of operations undertaken, the nature of the costs and the proximity or detachment of the connection between the outflow and the benefit derived by the business is necessary (*ibid*).

In Joffe & Co (Pty) Ltd v CIR (1946), the court held that expenditure essentially associated with undertaking the business operations that constitute the carrying on of the income-generating trade would be deductible. Furthermore, all costs that are not close to the trading operations yet *bona fide* incurred for carrying on trade, provided such outflows are solely and entirely made for the business and are not of a capital nature, will be deducted (*ibid*).

The realisation of profit is the hallmark of stockbroking entities’ transactions of the buying and selling of shares at a profit. However, in some cases shares are sold at a loss where the market price has dropped to less than the original purchase price. Stockbroking expenditure incurred should still satisfy the requirements of s23(g) of the Act as they were incurred for trade despite a possible lack of profit on sale of the shares. Stockbroking entities’ business of buying and selling of shares is a genuine trade operated to earn profits. Cost of shares, traders’ salaries and other operational costs incurred relate to the stockbroking entity’s activities of buying and selling shares and are incurred for purpose of trade. In applying the principles in Solaglass
Finance Company (Pty) Ltd v CIR (1991) to the activities undertaken by the stockbroking entities, it is clear that cost of shares, traders’ salaries and other operational costs incurred are connected to the activities of selling shares. Thus, stockbroking expenditure incurred is closely linked to such activities and is necessary for the generation of profits from the sale of shares held as trading stock. The stockbroking expenditure incurred by stockbroking entities is closely linked to share trading activities and is *bona fide* expenditure incurred in the process of selling shares held as trading stock at a profit to clients. Therefore, the stockbroking expenditure incurred fulfils the requirement of trade as outlined above.

2.10 Conclusion

This chapter dealt with some of the general guidelines laid down by the courts on the application of the general deduction formula. All the relevant factors should be considered to determine whether expenditure is deductible. The chapter outlined that expenditure must be laid down for the purpose of trade to fulfil the requirements of the general deduction formula. Stockbroking entities are in the business of selling shares to clients at a profit; the business they undertake satisfies the requirements of carrying on a trade. Additionally, voluntary and involuntary stockbroking expenditure will meet the expenditure and losses requirement. It was outlined that stockbroking expenditure payable by the stockbroking entities will be allowed as a deduction once there is an unconditional obligation to pay the expenditure.

It was discussed that s11(a) of the Act does not contain the requirement for the expenditure to be incurred in a year of assessment, however, the court has held that such expenditure must be claimed in the year in which it is incurred. Furthermore, it was outlined that the cost of employment of traders and stockbroking expenditure incurred are closely linked with the activities of buying and selling shares at a profit, therefore they are incurred in the production of income.

Lastly, the chapter outlined that stockbroking expenditure incurred by stockbroking entities is close enough to share trading activities and is *bona fide* expenditure incurred in the selling of shares held as trading stock at a profit to clients. Therefore, stockbroking entities are in a position to deduct stockbroking expenditure incurred in
the course of their business against income to the extent that it is not capital in nature. Stockbroking entities fulfil the requirements of the general deduction formula.

The objective of this chapter was to deliberate the requirement of the general deduction formula that must be met for stockbroking expenditure incurred by stockbroking entities to qualify for a deduction. The next chapter will discuss the implications of s23(f) of the Act on expenditure incurred by stockbroking entities and evaluate the relevant tax court cases to ascertain the impact on stockbroking business.
CHAPTER 3

APPLICABILITY OF SECTION 23(f) OF THE ACT TO THE EXPENDITURE INCURRED BY STOCKBROKING ENTITIES

3.1 Introduction

This chapter focuses on the application of s23(f) of the Act in disallowing the stockbroking expenditure incurred where dividends are earned on shares held as trading stock. As stated in Chapter 1, the receipt and accrual of local dividends is exempt from tax under s10(1)(k) of the Act subject to the certain exclusions.

Section 23(f) of the Act provides that there will be no deduction relating to “any expenses incurred in respect of any amounts received or accrued which do not constitute income as defined in section one” (income is defined in Chapter 1). The business activities of stockbroking entities are the buying and selling of shares to clients at a profit. Shares bought by stockbroking entities are held as trading stock. Where these shares are unsold, dividends may be earned by the entity on those shares. The receipt of dividends by the stockbroking entities is incidental to the principal business of buying and selling shares. Stockbroking entities are required in the application of s23(f) of the Act to disallow as a deduction stockbroking expenditure incurred to an extent of earning exempt dividend income. However, currently the limitation imposed by s23(f) is applied to expenditure incurred by the entities even if it cannot be directly linked to earning dividend income. Section 102 of the Tax Administration Act No. 28 of 2011 (hereafter “the TAA”) places the onus of proof upon the taxpayer to submit that an amount of expenditure is deductible. Accordingly, the onus to proof that the stockbroking expenditure is incurred in the production of income subject to tax rests with the stockbroking entities. The following sections will deliberate on tax court cases dealing with the treatment of stockbroking expenditure incurred in the buying of shares.

3.2 Analysis of the relevant South African tax cases

Section 3.2.1 below discusses tax cases that deal with the deductibility of stockbroking expenditure incurred by taxpayers trading in shares and earning
dividend income. Section 3.2.2 discusses the courts’ decisions on the apportionment of expenditure incurred in earning taxable income and exempt income.

3.2.1. Court treatment of expenditure incurred by taxpayers trading in shares

CIR v Nemojim (Pty) Ltd

In CIR v Nemojim (Pty) Ltd (1983), the taxpayer was a dealer in shares who carried out a series of dividend stripping operations. The taxpayer purchased shares in dormant companies which had, over the years, accumulated large reserves of profits available for distribution as dividends. The taxpayer would then cause the company to distribute all its accumulated profits by way of dividends, all of which were paid to the taxpayer (ibid). After the distribution of the dividends by the company to the taxpayer, all the shares of the company were disposed of (ibid). The dividends distributed by the dormant company to the taxpayer were exempt from tax under s10(1)(k) of the Act. The taxpayer included the proceeds from the sale of shares in the gross income and claimed the cost of shares as deductible expenditure (ibid). The issue that arose was whether the taxpayer was eligible to deduct the purchase price of shares in full or whether a portion of the cost of the shares should be limited in terms of s23(f) of the Act as the cost was not expended in the production of income but in producing exempt dividends (ibid).

The taxpayer referred the court to a Scottish case, CIR v Forrest (1924), where it was argued that the purchase of shares to secure a dividend due to be distributed was deemed not the procuring of a dividend but the buying of shares. Consequently, the cost price must be attributed to the shares and not to any dividend that may accrue to the purchaser after the acquisition of the shares (ibid). The taxpayer further raised an argument that if the court was to accept the Commissioner’s apportionment, then it would mean that a similar allotment would have to be made in the case of every ordinary share-dealing company that is not involved in dividend stripping operations (CIR v Nemojim (Pty) Ltd, 1983). The court indicated that it was not convinced that this would necessarily be the case, as there are vital differences between the company buying all the shares in a dormant company with a view to dividend stripping and a company which buys shares in companies (not necessarily
controlling interests) to make a profit on their resale and incidentally receiving whatever dividends that may be declared on the shares while it holds them *ibid*.

The court referred to *CIR v Genn & Co (Pty) Ltd* (1955), where it was held that in determining whether the outlay by a taxpayer constitutes expenditure incurred in the production of income, the overriding factors that must be considered are the purpose of the expenditure and what that expenditure really affects.

The expenditure incurred by the taxpayer in procuring the shares was for the dual purpose of earning dividend income and receiving monies on the resale of the shares after the company had earned dividend income (*CIR v Nemojim (Pty) Ltd, 1983*). The court further indicated that the Income Tax Act (at the time) made no provision for apportionment, however, in *CIR v Rand Selection Corporation Ltd* (1956) it was decided that an apportionment was acceptable in cases where the expenditure was sustained for dual or mixed purposes.

In *CIR v Nemojim (Pty) Ltd* (1983), it was pointed out that the issue was not whether the taxpayer, when buying shares of the dormant companies, could in law be said to have bought the dividends that were later declared, but whether the connection between the expenditure incurred in buying the shares and the receipt of the dividends was adequately close *ibid*. The court held that the expenditure did not wholly pass the dual test of qualifying as a deduction in terms s11(a) of the Act and of not being excluded by s23(f) of the Act. One of the purposes of the expenditure was to earn exempt income in the form of dividends and that purpose was in fact achieved. Therefore, the expenditure was not wholly incurred in the production of income *ibid*. This justified the inference that the expenditure was incurred partly in earning dividends or that the expenditure partly constituted the outlay in selling shares at a profit *ibid*. The court held that an apportionment of the taxpayer’s cost of the shares relating to the dividend stripping operations during the years should be made in accordance with a formula determined by the court *ibid*. The expenditure claimed by the taxpayer was limited by the court in accordance with s23(f) of the Act.

It is clear from the above case that the deductibility of stockbroking expenditure is reliant on whether such expenditure is close enough to the earning of income from the sale of shares rather than from earning incidental dividends. In applying the tests
referred to by the courts, stockbroking expenditure incurred is not closely connected with earning dividends; rather the expenditure is incurred by earning profits from the sale of shares. Stockbroking expenditure incurred from activities that are not traditional stock trading activities will not be allowed as a deduction in full. However, where dividends are earned from normal stockbroking operations, stockbroking expenditure should be fully deducted.

**CIR v Standard Bank of SA Ltd**

In CIR v Standard Bank of SA Ltd (1985), the bank borrowed money from customers upon which it paid interest on the deposits received based on the terms set by the bank. The deposits were utilised by the bank in various ways, earning interest, dividends and other forms of returns for the use of the money. Interest receivable by the bank was taxed as part of its gross income and interest incurred was deducted in terms of s11(a) of the Act. The bank utilised some of the deposits received from its clients to subscribe for redeemable preference shares. The bank only participated in a limited number of redeemable preference transactions initiated by its long-standing clients. The bank regarded the redeemable preference transactions as incidental to its main business of borrowing and lending money. The bank earned dividend income on the redeemable preference shares held.

The bank claimed as a deduction for various tax years an amount representing interest paid on monies borrowed. The Commissioner prohibited the deduction of a portion of the interest on the basis that the dividend income earned on redeemable preference shares constituted exempt income in terms of s10(1)(k) of the Act. Therefore, a proportion of the amount of interest paid to depositors was not deductible, having been treated as expenditure not incurred in the production of income.

The court referred to CIR v Nemojim (Pty) Ltd (1983), where it was stated that the general test that is applied in reviewing the provisions of the general deduction formula applies equally to s23(f) of the Act. Furthermore, it was stated that in deciding whether monies expended by the taxpayer constitute outlay incurred in the earning of income, the overriding factors are the purpose of the expenditure and what the expenditure actually affects (*ibid*). The court indicated that an assessment of the purpose of the expenditure, what it affects and the closeness of the connection
between the costs incurred and the exempt income received or accrued is required (ibid).

The court also referred to CIR v Genn & Co (Pty) Ltd (1955) where it was held that interest paid on money borrowed and used as floating capital in the business of the taxpayer constitutes deductible expenditure. The court confirmed the principles outlined in Financier v COT (1950), where a taxpayer borrows money but does not utilise the borrowed funds to generate income. In such cases, a deduction of interest paid on money borrowed cannot be allowed as expenditure against income borrowed. Conversely, if money is borrowed by a taxpayer to produce income and subsequently, if in the pursuit of a genuine business purpose, the money is invested in an investment not producing taxable income, then interest incurred will still be deductible for income tax purposes (ibid). The test is to determine the purpose for which the money was borrowed (ibid).

In arriving at its conclusion, the court relied on the judgement in CIR v Allied Building Society (1963). The court indicated that the important enquiry is the bank’s purpose for borrowing the monies for which interest was paid to the depositors (CIR v Standard Bank of SA Ltd, 1985). Furthermore, the enquiry was whether the connection between the interest expense and the purchase of the redeemable preference shares was close enough to justify the conclusion that such cost was incurred in the generation of the dividends (ibid). Obtaining floating capital to operate its banking business was the immediate purpose for acceptance of deposit monies by the bank (ibid). It was held by the court that the redeemable preference shares constituted a trivial and immaterial portion of the bank’s total money lending business and was incidental to the main business of the bank. It was further stated that incidental means occurring or liable to occur in fortuitous or subordinate conjunction with something else (ibid). The court held that the deposits were not raised for the sole purpose of purchasing redeemable preference shares. Therefore, a close enough connection to link the purpose of raising the deposits with taking up the preference shares did not exist (ibid). Interest expenditure paid by the bank to depositors was allowed in full as a deduction as the purpose of accepting deposits was not to utilise the funds to earn exempt income.
In view of the above decision, the receipt of dividends by stockbroking entities could be seen as incidental and not material to their business of selling shares at profit. The purpose for which the stockbroking expenditure is incurred is in pursuit of profits from the sale of shares. Furthermore, the stockbroking expenditure incurred is not closely connected to exempt income received. The decision of the court above suggests that the application of s23(f) of the Act to the receipt of incidental dividends should not be similar to that of a person who intends invest in shares to earn dividends as primary income.

**De Beers Holdings (Pty) Ltd v CIR**

In De Beers Holdings (Pty) Ltd v CIR (1986), the taxpayer carried on a business as a share dealer earning profits on sale of shares. The taxpayer held a large portfolio of shares as trading stock. The taxpayer bought two shares in Engelhard Hanovia SA (Pty) Ltd (EHSA). The shares were originally acquired by the taxpayer for an amount of R4 158 937.60 and the taxpayer subsequently sold the shares for R1 resulting in a loss of R4 158 936.60. A question arose as to whether the unusual transaction designed to produce a loss was part of the its trading operations. Furthermore, it was questioned whether the cost of shares could be perceived as money wholly and exclusively defrayed for its share-dealing activities (*ibid*). It was confirmed that the procurement of shares is an integral function of the operations of a stockbroker and that the stocks procured form part of trading stock. The operations of a share dealer are buying shares and profiting from reselling those shares.

*"The shares that constitute trading stock, are like groceries in a groceries business. Dissimilar to groceries, if shares are held long enough, they might benefit from dividends declared thereby yielding dividend income. The dividends received will form part of the return, which a share dealer might possibly expect to receive in the share dealing transaction. The dealer buys the shares with the intention of eventually selling the shares as part of a profit-making scheme. This differentiates the dealer’s trade from that of an investor in shares that buys shares to hold them as capital assets to obtain a return in the form of dividends (*ibid*).”*

The taxpayer bought the shares with the intention of benefitting from the distribution of a liquidation dividend rather than selling the shares as part of its trade (*ibid*). The court held that the transaction entered by De Beers Holdings (Pty) Ltd was not a normal share-dealing activity and was different from the normal trading method of the company as a share dealer. The court held that the cost incurred in buying the
shares in EHSA did not pass the test laid down in s23(g) of the Act. Therefore, it was held that the cost of the shares was not deductible (*ibid*).

It is clear from the above case that where stockbroking entities buy shares as income-producing assets, those shares will not form part of its trading stock. The expenditure incurred in buying such shares will not be allowed as a deduction. The purpose for which the stockbroking entity acquired the shares has to be assessed to ensure it is for a profit-making scheme and for the purpose of its trade as a stockbroker.

### 3.2.2. Apportionment of expenditure incurred for earning taxable income and exempt income

**CIR v Rand Selection Corporation Ltd**

In the CIR v Rand Selection Corporation Ltd (1956), the taxpayer carried on business of share dealing and held investments in shares as capital assets. The taxpayer earned dividends and income, as defined in s1 of the Act. Certain expenditure incurred by the taxpayer for both income and dividend revenues was sought to be deducted against income (*ibid*). The court held that the expenditure was incurred by the company in the production of the total sum received. The portion of that amount consisted of dividends therefore part of the expenditure incurred towards its production was not allowable as a deduction in the calculation of the company's income subject to tax (*ibid*).

Based on the conclusion reached above, where stockbroking entities are engaged in holding shares on a capital account and trading shares as part of their profit-making business, the expenditure incurred by the business should be apportioned. The apportionment will seek to limit expenditure that relates to the activities linked to the holding of shares as investment. In contrast, expenditures that relate to the buying and selling shares at a profit might be fully deducted where incidental dividends are earned.

**ITC 1589**

In ITC 1589 (1993), the Zimbabwean special court considered an objection by the taxpayer against the disallowance of expenditure partially related to dividend revenue. The Commissioner calculated the expenditure not deductible using a
formula. The taxpayer’s objection was that the amounts of expenditure expended for the fortitude of earning the dividend income would have been minimal, therefore the amount calculated using the formula was unfair (ibid). The court held that it would not be possible to lay down a generic rule on how to apportion the expenditure, other than to state that all circumstances must be considered, and a fair and reasonable apportionment must be applied (ibid). For example, on the one hand, a percentage allocation calculated on what the different sources of revenue bear to the total income might be suitable. However, such an apportionment might be completely biased in cases where the majority of the amounts spent are expenditure utilised solely for the operations of the taxpayer’s business which are intended at revenue generation. The operations may have unfortunately earned a much smaller amount of income, from activities that incurred little expenditure but earned quite large, non-taxable income (ibid). In such instances, apportioning the majority of the costs to the non-taxable income would be unfair (ibid).

On the analysis of the above case, an apportionment applied to expenditure should be fair and reasonable. An apportionment should be applied to actual expenditure incurred by the stockbroking entities that can be linked to the earning of dividend income to achieve the principle of fairness and reasonableness. However, stockbroking entities do not incur expenditure to earn dividends income; the dividends are incidental to the business of selling shares at a profit, therefore an apportionment of their expenditure might be unfair and unreasonable.

**Commissioner for the South African Revenue Service v Mobile Telephone Networks Holdings (Pty) Ltd**

In the Commissioner for the South African Revenue Service v Mobile Telephone Networks Holdings (Pty) Ltd (2014), the Mobile Telephone Networks Holdings (hereafter “MTN”) was a holding company owning subsidiary companies from which it earned interest and dividends. MTN incurred audit fees and other professional consulting fees during the years of assessment for operations of the holding company. The audit fees and other professional consulting fees were incurred in relation to the revenue earned by MTN which is dividend income and interest revenue. In raising the assessment for the holding company, the Commissioner utilised the ratio of dividend income to total income to apportion the audit fees. The Commissioner rejected the bulk of the expenditure on the basis that an average of
95% of the revenue earned by MTN was dividend income for years under audit. The portion disallowed was not taken as the expenditure incurred in the production of income and limited in terms of s23(f) of the Act. MTN sought to demonstrate to the court and Commissioner that the bulk of the expenditure was not incurred to earn dividend income, looking at a number of transactions accounted for dividend income versus those accounted for interest and other income. MTN’s argument was that dividends are booked once a year after the declaration by the subsidiary company as compared to interest that must be booked monthly as the terms of the loan required that it be paid more frequently.

The court was required to determine whether the expenditure incurred by MTN for the professional consulting and audit, disallowed by the Commissioner, was incurred in the generation of income in terms of s11(a) of the Act and to consider whether the expenditure disallowed was of a capital nature. The court indicated that the yardstick or benchmark must be the amount of work undertaken and not the value of the dividends received; dividends should not be the measurement (Commissioner for the South African Revenue Service v Mobile Telephone Networks Holdings (Pty) Ltd, 2014). A direct causal link need not be displayed or shown by the taxpayer, other than the proximity of the connection between the expenditure and the revenue (ibid). The court referred to Joffe & Co (Pty) Ltd v CIR (1946) where it was held that expenditure had to be a necessary concomitant of the revenue producing operations and once it was a necessary concomitant, the costs incurred are deductible.

The court further referred to SIR v Guardian Assurance Holdings (SA) Ltd (1976) where it was held that “where expenditure was outlaid for dual or mixed purpose, an apportionment of such expenditure has been approved in principle by South African courts and courts in other countries”. The court also referred to ITC 1017 (1963) where it was held that it is not enough to state that minimal time and effort was placed in managing the property company, unless it can be determined how much time was dedicated to the operations, for any such apportionment can only be on a comparative basis. In the MTN case, the court held that “any apportionment must be profoundly weighted in favour of the disallowance of the deduction of the expenditure given the major role played by MTN’s equity and dividend operations as opposed to its limited income earning operations”. The court further indicated that “a 50/50
apportionment is not reasonable and allocated 10% of the expenditure as deductible”.

It is evident from the MTN case that where stockbroking entities hold shares as investment in subsidiary companies, the expenditure linked to earning dividends from such holdings cannot be allowed as a deduction against income. However, the benchmark to determine whether the expenditure of a stockbroking entity is deductible should be the amount of work performed to earn the dividend income rather than the value of dividends received. Where shares are held as trading stock, no work is undertaken by stockbroking entities in earning the dividend income. Stockbroking entities do not incur expenditure that can be directly linked with the earning of dividend income. Stockbroking expenditure is directly linked with the earning of taxable income; therefore, the expenditure should be considered for a full deduction.

3.3 Conclusion

In this chapter, various cases were discussed covering the apportionment of expenditure where income earned by the taxpayer is exempt from taxation. It was established that an apportionment is acceptable in situations where expenditure is incurred for dual or mixed purposes. A fair and reasonable formula should be used in the apportionment of expenditure. The chapter further discussed the point that expenditure incurred purely to earn exempt income should not be allowed as a deduction from income.

It is clear from De Beers Holdings (Pty) Ltd v CIR (1986) that a stockbroker entering a buy-and-sell transaction with a profit motive will be able to include the cost of shares as part of the trading stock. It was also discussed in CIR v Nemojim (Pty) Ltd (1983) that there is a difference between a company that buys the shares with a view to earning dividend income and a stockbroking entity that buys shares to make a profit on their resale to the market, and incidentally also receives whatever dividends on the shares while it holds them. Based on CIR v Nemojim (Pty) Ltd (1983), it can be construed that expenditure of a stockbroking entities engaged in normal share trading might be fully deducted.
In Commissioner for the South African Revenue Service v Mobile Telephone Networks Holdings (Pty) Ltd (2014), it was held that expenditure incurred for mixed purposes should be apportioned. It was further stated that the yardstick should be the amount of work performed by the taxpayer instead of the value of dividends received. There is no work performed by stockbroking entities in earning the dividends; they are subsidiary to the holding of shares as trading stock. Therefore, expenditure incurred by stockbroking entities may be considered for a full deduction as they are not associated with the earning of dividend income.

In CIR v Standard Bank of SA Ltd (1985), the court viewed the earning of incidental dividends from preference shares as trivial and immaterial to the operations of the bank and held that there was no need to apportion the interest incurred on deposits used to subscribe for preference shares. Similarly, the earning of dividends is trivial and immaterial to the operations of stockbroking entities, namely, selling shares at a profit. The decision supports an argument that if dividends are incidental, they should be treated differently in applying the limitations of s23(f) of the Act.

An argument exists to support the contention that the stockbroking expenditure incurred in earning taxable income through selling shares at a profit is sufficiently and intrinsically connected to the income-producing business activities of stockbroking entities. Therefore, earning dividend income is insignificant and of no importance to the stockbroking business. Additionally, dividends are earned without undertaking any work, thus no expenditure can be directly linked to earning dividends. The next chapter focuses on Indian tax legislation and Indian tax court case treatment of the expenditure incurred by stockbroking entities.
CHAPTER 4

LIMITATION OF DEDUCTIBLE EXPENDITURE INCURRED IN GENERATING NON-ASSESSABLE INCOME IN TERMS OF SECTION 14A OF THE INDIAN INCOME TAX ACT

4.1 Introduction

This chapter focuses on Indian tax rules and tax court cases. The Indian tax legislation has similar provisions to the South African legislation, where expenditure incurred in earning non-assessable income (“exempt income” in the South African context) is not allowed as a deduction. As part of this chapter, a summary of the Indian and South African tax legislation will be outlined.

The various acronyms used in this chapter are listed below.

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Meaning</th>
<th>Explanation</th>
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<tbody>
<tr>
<td>ACIT</td>
<td>Additional Commissioner of Income Tax</td>
<td>ACIT is a rank in the Indian Revenue Service (IRS).</td>
</tr>
<tr>
<td>AO</td>
<td>Assessing Officer</td>
<td>AO is the person who has the right to tax assessment in terms of the Indian Income Act. It is equivalent to a SARS official in South Africa.</td>
</tr>
<tr>
<td>CITA</td>
<td>Commission for Income Tax Appeals</td>
<td>The CITA is the commission tasked with hearing the first level of appeals raised by taxpayers.</td>
</tr>
<tr>
<td>CIT</td>
<td>Commissioner of Income Tax</td>
<td>CIT is a senior rank in the Income Tax Department in India. It is an equivalent of a SARS Commissioner in South Africa.</td>
</tr>
<tr>
<td>DCIT</td>
<td>Deputy Commissioner of Income Tax</td>
<td>DCIT is the rank within the Indian tax department below the CIT.</td>
</tr>
<tr>
<td>ITAT</td>
<td>Income Tax Appellate Tribunal</td>
<td>ITAT is the second appellate authority within the direct taxes. The appeals before the</td>
</tr>
</tbody>
</table>

Table 4.1 below provides a comparison of the Indian tax and the South African tax legislation as well as definitions of certain terms that are defined differently in the two jurisdictions. The purpose of the table is to ensure that the interpretation of the definitions or sections of both countries’ legislation is aligned to avoid confusion. Only definitions and sections relevant to the study are outlined in the table below.

Table 4.1: Summary of relevant Indian and South African income tax legislation

<table>
<thead>
<tr>
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<tbody>
<tr>
<td>&quot;Definitions&quot;</td>
<td>1. &quot;Interpretation&quot;</td>
</tr>
<tr>
<td>2. In this Act, unless the context otherwise requires,—</td>
<td>1) In this Act, unless the context otherwise indicates—</td>
</tr>
<tr>
<td>… (7) &quot;assessee&quot; means a person by whom any tax or any other sum of money is payable under this Act, and includes— …</td>
<td>&quot;taxpayer&quot; means any person chargeable with any tax leviable under this Act;</td>
</tr>
<tr>
<td>… (9) &quot;assessment year&quot; means the period of twelve months commencing on the 1st day of April every year;</td>
<td>&quot;year of assessment&quot; means any year or other period in respect of which any tax or duty leviable under this Act is chargeable, and any reference in this Act to any year of assessment ending on the last or the</td>
</tr>
</tbody>
</table>
... (24) "income" includes—

(i) profits and gains;

(ii) dividend; …

... (45) "total income" means the total amount of income referred to in section 5, computed in the manner laid down in this Act; …

twenty-eighth or the twenty-ninth day of February shall, unless the context otherwise indicates, in the case of a company or a portfolio of a collective investment scheme in securities, be construed as a reference to any financial year of that company or portfolio ending during the calendar year in question.

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

"taxable income" means the aggregate of—

a) the amount remaining after deducting from the income of any person all the amounts allowed under Part I of Chapter II to be deducted from or set off against such income; and

b) all amounts to be included or deemed to be included in the taxable income of any person in terms of this Act;

"Previous year" defined.

3. For the purposes of this Act, "previous year" means the financial year immediately preceding the assessment year:

Provided that, in the case of a business or profession newly set up, or a source of income newly coming into existence, in the said financial year, the previous year shall be
the period beginning with the date of setting up of the business or profession or, as the case may be, the date on which the source of income newly comes into existence and ending with the said financial year.

**Scope of total income.**

5. (1) Subject to the provisions of this Act, the total income of any previous year of a person who is a resident includes all income from whatever source derived which—

(a) is received or is deemed to be received in India in such year by or on behalf of such person; or

(b) accrues or arises or is deemed to accrue or arise to him in India during such year; or

(c) accrues or arises to him outside India during such year:

Provided that, in the case of a person not ordinarily resident in India within the meaning of sub-section (6)* of section 6, the income which accrues or arises to him outside India shall not be so included unless it is derived from a business controlled in or a profession set up in India.

(2) Subject to the provisions of this Act, the total income of any previous year of a person who is a non-resident includes all income from whatever source derived which—

(a) is received or is deemed to be received

**“gross income” in relation to any year or period of assessment, means,**

i. in the case of any resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such resident, or

ii. in the case of any person other than a resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such person from a source within the Republic, during such year or period of assessment, excluding receipts or accruals of a capital nature, but including, without in any way limiting the scope of this definition, such amounts (whether of a capital nature or not) so received or accrued as are described hereunder, namely— …

k) any amount received or accrued by way of a dividend or a foreign dividend; …
in India in such year by or on behalf of such person; or

(b) accrues or arises or is deemed to accrue or arise to him in India during such year.

<table>
<thead>
<tr>
<th>Dividend income.</th>
<th>'dividend' means any amount transferred or applied by a company that is a resident for the benefit or on behalf of any person in respect of any share in that company, whether that amount is transferred or applied –</th>
</tr>
</thead>
<tbody>
<tr>
<td>8. For the purposes of inclusion in the total income of an assessee, —</td>
<td>(a) by way of a distribution made by; or (b) as consideration for the acquisition of any share in, that company, but does not include any amount so transferred or applied to the extent that the amount so transferred or applied –</td>
</tr>
<tr>
<td>(a) any dividend declared by a company or distributed or paid by it within the meaning of sub-clause (a) or sub-clause (b) or sub-clause (c) or sub-clause (d) or sub-clause (e) of clause (22) of section 2 shall be deemed to be the income of the previous year in which it is so declared, distributed or paid, as the case may be ; (b) any interim dividend shall be deemed to be the income of the previous year in which the amount of such dividend is unconditionally made available by the company to the member who is entitled to it.</td>
<td>(i) results in a reduction of contributed tax capital of the company; (ii) constitutes shares in the company; or (iii) constitutes an acquisition by the company of its own securities by way of a general repurchase of securities as contemplated in subparagraph (b) of paragraph 5.67(B) of section 5 of the JSE Limited Listings Requirements, where that acquisition complies with any applicable requirements prescribed by paragraphs 5.68 and 5.72 to 5.81 of section 5 of the JSE Limited Listings Requirements;</td>
</tr>
</tbody>
</table>
### Incomes not included in total income.

10. In computing the total income of a previous year of any person, any income falling within any of the following clauses shall not be included—

- (23F) any income by way of dividends or long-term capital gains of a venture capital fund or a venture capital company from investments made by way of equity shares in a venture capital undertaking:

(23FA) any income by way of dividends, other than dividends referred to in section 115-O, or long-term capital gains of a venture capital fund or a venture capital company from investments made by way of equity shares in a venture capital undertaking ...

(34) any income by way of dividends referred to in section 115-O; …

### 10. Exemptions

There shall be exempt from normal tax—

(1) tax—

...(k)

(i) dividends (other than dividends paid or declared by a headquarter company) received by or accrued to any person: Provided that this exemption shall not apply— …

### Expenditure incurred in relation to income not includible in total income.

14A. (1) For the purposes of computing the total income under this Chapter, no deduction shall be allowed in respect of expenditure incurred by the assessee in relation to income which does not form part of the total income under this Act. …

### Rule 8D

Method for determining amount of expenditure in relation to income not includible in total income.

23. Deductions not allowed in determination of taxable income

(1) No deductions shall in any case be made in respect of the following matters, namely—

...(f) any expenses incurred in respect of any amounts received or accrued which do not constitute income as defined in section one; …

<table>
<thead>
<tr>
<th>Expenditure incurred in relation to income not includible in total income.</th>
<th>23. Deductions not allowed in determination of taxable income</th>
</tr>
</thead>
</table>
| 14A. (1) For the purposes of computing the total income under this Chapter, no deduction shall be allowed in respect of expenditure incurred by the assessee in relation to income which does not form part of the total income under this Act. … | (1) No deductions shall in any case be made in respect of the following matters, namely—

...(f) any expenses incurred in respect of any amounts received or accrued which do not constitute income as defined in section one; … |
8D. (1) Where the AO, having regard to the accounts of the assessee of a previous year, is not satisfied with—

(a) the correctness of the claim of expenditure made by the assessee; or

(b) the claim made by the assessee that no expenditure has been incurred,

in relation to income which does not form part of the total income under the Act for such previous year, he shall determine the amount of expenditure in relation to such income in accordance with the provisions of sub-rule (2).

(2) The expenditure in relation to income which does not form part of the total income shall be the aggregate of following amounts, namely: —

(i) the amount of expenditure directly relating to income which does not form part of total income; and

(ii) an amount equal to one per cent of the annual average of the monthly average of the opening and closing balances of the value of investment, income from which does not or shall not form part of total income:

Provided that the amount referred to in clause (i) and clause (ii) shall not exceed the
<table>
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<tr>
<td>Dividends are included in total income in terms of s8(a) and (b) of the Indian Income Tax Act, 1961 (43 of 1961) (as amended by Finance Act, 2017) (hereafter “Indian Act”). The receipt of dividend income in India is excluded from total income chargeable to income tax in terms s10(23F) and s10(23FA) of the Indian Act. In South Africa, dividend income is included in gross income in terms of paragraph k of the definition of gross income as stated above. Furthermore, dividends are exempt from normal tax in terms of s10(1)(k)(i) of the Act subject to the certain exclusions. The Indian Act has similarities to the South African tax provisions insofar as it includes dividends as part of total income and excludes dividends in the computation of total income subject to tax.</td>
</tr>
</tbody>
</table>
Section 14A of the Indian Act bars the deduction of any expenditure incurred in relation to any income that is not subject to tax because it is not included in the total income by s10 of the Indian Act. Section 14A (1) of the Indian Act is similar to s23(f) of the Act insofar as it disallows a deduction of expenditure incurred to produce income not subject to tax.

Expenditure incurred by a taxpayer, which is not capital in nature and is wholly and exclusively laid out for business, is allowed as a deduction under s37(1) of the Indian Act in calculating the income chargeable to income tax. Section 37(1) of the Indian Act has similarities to s11(a) of the Act (as previously discussed in Chapter 2).

The following section discusses various Indian tax court cases dealing with the applicability of s14A of the Indian Act, where the taxpayer trades in shares and dividend income is earned on the shares held as trading stock.

4.3 Analysis of Indian tax cases dealing with deductibility of expenditure incurred in earning exempt dividend income

Firstly, in sub-section 4.3.1 below tax cases are discussed dealing with the deductibility of expenditure incurred by taxpayers who are involved in various activities such as holding of shares as investments (capital asset) or selling of shares as part of their business operations (trading stock). Secondly, sub-section 4.3.2 outlines the courts’ treatment of expenditure incurred by traders in shares where they also earn non-taxable dividends on unsold shares. Finally, sub-section 4.3.3 deals with tax cases where the taxpayer holds shares purely as an investment. This sub-section is included to demonstrate the different conclusion reached by the courts depending on the purpose for which the shares were held.

4.3.1 The courts’ treatment of expenditure incurred by taxpayers holding shares as an investment and trading stock

Kolkata DCIT v S.G. Investments and Industries
In Kolkata DCIT v S.G. Investments and Industries (2004), the taxpayer held a controlling interest in a group of companies as an investment. The other shares were held as trading stock for the purpose of selling at a profit as part of its share-dealing business. The taxpayer had loan funding in its accounts. Due to holding trading
shares beyond the cut-off date, the taxpayer earned dividend income. The taxpayer claimed against income a deduction of interest expense on inter-corporate deposits and loans. The taxpayer received dividends on long-term investments and claimed an exemption under s10(33) (now s10(34)) of the Indian Act.

The AO disallowed expenditure incurred by the taxpayer on the basis that it related to income not subject to tax and applied the provisions of s14A of the Indian Act. The AO disallowed interest paid, finance charges, administrative and other expenditure on a proportionate basis. The AO apportioned the interest paid on the borrowings as relating to the earning of dividend income. The AO was of the view that dividends received by the taxpayer in the past were from shares held as investments.

The taxpayer indicated that no costs could be apportioned for earning dividend income. The taxpayer further submitted that the interest expense was incurred in relation to its indivisible business activities, consisting of dealing in papers, securities and shares. The earning of dividend income could not be identified as an independent business activity. The taxpayer stated that the receipt of dividends could not be regarded as the sole purpose of the business expenditure, therefore, the provisions of s14A of the Indian Act could not apply.

The CIT(A) reversed the disallowance of interest raised by the Commissioner. This was based on reference to various cases wherein it was held that borrowed funds utilised for the purchase of shares and dealing in shares was one of the business activities of the taxpayer. The interest expenditure incurred on money borrowed for the purpose of purchasing of shares is deductible under s36(1)(iii) of the Indian Act. The interest expenditure incurred on borrowed funds cannot be apportioned as relating to dividend income. The CIT(A) further stated that interest expenditure incurred in relation to indivisible business activity comprising of dealings in various activities cannot be identified as relating to any independent business activity.

In reversing the decision of the CIT(A), the court held that the proportionate interest on borrowed capital relating to the acquisition of shares held as investment should be considered against dividend income earned from non-trading shares. Therefore, interest paid should not be allowed as a deduction against income as it related to shares held for investment and not for trading.
It is clear from the decision reached by the court that where stockbroking entities hold shares as an investment, the expenditure that can be linked with the generation of the dividends will not be allowed as a deduction against assessable income. In such a case, an apportionment is required to restrict expenses linked to the investment-holding activities.

**ACIT, Circle 3(1), New Delhi v M/s Cheminvest Ltd**

In ACIT, Circle 3(1), New Delhi v M/s Cheminvest Ltd (2007), the taxpayer traded a portfolio of investment on capital account as well as on trading account. The investment held on capital account was financed partly by borrowed funds for which interest was paid by the taxpayer. For investment held on capital account, a capital gain was subjected to tax and expenditure was disallowed with regard thereto. For trading activities, proceeds from the sale of shares were declared as business income and interest and other expenditure was claimed as a deduction against the income. The taxpayer did not receive any exempt dividends during the year under consideration on shares held as trading stock nor on shares held as investment.

The AO submitted that s14A of the Indian Act applied irrespective of whether income exempt from total income was received or not. Furthermore, the AO argued that the receipt of income in a year of assessment was not material for the disallowance of expenditure. The AO argued that s14A of the Indian Act did not refer to income for the year. Income referred to in s14A of the Indian Act may be earned in future years, but expenditure will have to limited in the current year.

The taxpayer argued that interest cannot be disallowed as an expense in terms of s14A of the Indian Act, where dividend income has not been received in a year of assessment. Furthermore, income must be received or receivable not forming part of the total income for s14A of the Indian Act to apply. The taxpayer submitted that interest was allowable under s36(1)(iii) of the Act, therefore, the disallowance in terms of s14A of the Indian Act was not justified. In support of its argument, the taxpayer relied on the decision in Income Tax Office v Daga Capital Management P. Ltd (2003), where it was held that what is pertinent is to identify the expenditure relating to the exempt income and not to examine whether the expenditure incurred by the taxpayer had resulted in exempt income or assessable income. The taxpayer further referred to the decision in CIT v Maharashtra Sugar Mills Ltd (1971) where it
was held that in allowing the expenditure, the fact that the income was exempt was not a relevant circumstance. The taxpayer also referred to the decision of the Supreme Court in the case of Rajasthan State Warehousing Corporation v CIT (2000) which dealt with non-divisible business and held that if there was a claim of one and indivisible business, the amount of expenditure would be allowable in terms of s 14A of the Indian Act.

In ACIT, Circle 3(1), New Delhi v M/s Cheminvest Ltd (2007) the court did not agree with the contention of the taxpayer. The court held that where expenditure is incurred in relation to income which does not form part of total income, it must be disallowed irrespective of whether any income was earned by the taxpayer or not (ibid). The court held that the actual earning or receipt of income would not be a condition for the disallowance of interest in terms of s14A of the Indian Act. The court held that s14A of the Indian Act has an overriding effect and expenditure deductible under s36(1)(iii) of the Act must satisfy the requirements of s14A of the Indian Act (ibid).

It is clear from the above case that where stockbroking entities incur expenditure that is directly linked with the earning of dividend income from capital investments in shares, such expenditure cannot be deducted against assessable income. The disallowance of such expenditure is not conditional on the receipt of the dividends. As long as the expenditure can be linked with the earning of exempt income from holding shares as investments, that expenditure will be disallowed irrespective of whether the income will be received in future years.

CCI Ltd v the JCIT
The taxpayer in CCI Ltd v the JCIT (2011) was a distributor of state lotteries and a dealer in shares and securities. The taxpayer acquired 24 000 fully paid up shares from MS Kurden Ltd and further converted its partly paid up shares into fully paid up shares. In funding the conversion cost, the taxpayer received an interest-free loan from M/s Kitchen Appliances Pvt. Ltd. The loan was facilitated by a third party for which a brokerage fee was paid by the taxpayer. The shares purchased by the taxpayer were part of its trading stock. The taxpayer received dividend income from the shares of certain companies and 93% from the shares of MS Kurden Ltd.
The AO held that the brokerage fees paid by the taxpayer were not deductible expenditure in terms of s14A of the Indian Act as the fees were linked to the earning of dividends. The AO argued that in terms of s14A of the Indian Act, where shares retained yielded dividends and the dividend was exempt from tax, the costs incurred in attaining that dividend should be excluded proportionately from deductible expenditure.

The taxpayer contended that expenditure was incurred for purchasing shares, of which 63% was sold and the revenue earned was included as part of taxable income. The unsold 37% of the shares yielded dividend income. Therefore, no specific expenditure was incurred to earn dividend income. Consequently, no expenditure could be linked to earning incidental dividend income and the expenses could not be disallowed.

The court held that no notional expenditure (estimated expenditure that cannot be directly linked with the earning of dividends) could be prohibited from being deducted from the taxpayer's income. Additionally, it was held that the taxpayer did not retain the shares to benefit from a dividend yield; dividend income was incidental to the taxpayer's business of selling shares. Therefore, expenditure incurred in buying the shares could not be apportioned and could not be disallowed as a deduction.

It is evident from the above case that the expenditure of stockbroking entities cannot be disallowed where they cannot be directly linked with the dividends earned. Additionally, where stockbroking entities do not hold shares with the intent of harvesting the dividends, the expenditure cannot be disallowed.

**Kolkata DCIT Circle-6 v M/s. Kredent Brokerage Services Ltd**

In Kolkata DCIT Circle-6 v M/s. Kredent Brokerage Services Ltd (2012), the taxpayer was a trader in shares and held shares as part of its trading stock. The taxpayer also held unquoted shares in mutual funds as investments. The taxpayer earned dividends on unsold shares held as trading stock. The dividends received for the year amounted to 10% of turnover. Additionally, the taxpayer did not receive dividends on investments held as capital assets. In the tax returns, the taxpayer did not claim expenditure relating to the exempt dividends that would accrue from shares held as investments.
The AO’s view was that the cost of shares incurred by the taxpayer related to the earning of dividend revenue, thereby not allowing the deduction claimed against assessable income. The trading stock was disallowed by the AO in terms of s14A of the Indian Act. The taxpayer appealed against the assessment to the CIT(A) which concluded that the shares held as trading stock should be excluded from the application of s14A of the Indian Act as the taxpayer was a dealer in shares and trading securities was one of its principal business. The CIT(A) observed that the turnover from the sale of securities was higher than dividends received, the dividends income being a mere 10% of turnover. The Commissioner of Taxes appealed against the decision of the CIT(A) to the tribunal.

In reaching its judgement, the tribunal placed reliance on the decision in CCI Ltd v the JCIT (2011), where it is held that:

"Where the taxpayer has not incurred expenditure that can be directly linked with the earning of dividends there cannot be a disallowance of unreal expenditure against income. It was also stated that where dividends earned on unsold shares held as trading stock are incidental to the business of selling shares, expenditure incurred in buying such shares cannot be disallowed as a deduction against the income of the taxpayer."

The tribunal held that, where shares are not retained with the intent of receiving the dividend income and the dividends are secondary to the business of selling shares, disallowance under s14A of the Indian Act was not applicable (Kolkata DCIT Circle-6 v M/s.Kredent Brokerage Services Ltd, 2012). The tribunal further confirmed the decision of the CITA, that the disallowance under s14A of the Indian Act does not apply where the shares are held on a trading account (ibid).

The decision of the tribunal supports the view that stockbroking entities’ purpose of holding shares as trading stock is to earn profits on sale of such shares. Dividends received by stockbroking entities are incidental to the business of share dealing therefore expenditure incurred are linked with the earning of total income. Stockbroking expenditure incurred in the course of trading shares for profit making by stockbroking entities should be allowed as a deduction in full without apportioning.
4.3.2 The courts’ treatment of expenditure incurred by a taxpayer that only trades in shares

Ambit Securities Broking P. Ltd v The ACIT

In Ambit Securities Broking P. Ltd v The ACIT (2013), the taxpayer was a trader in shares and held shares as trading stock that yielded dividends. The Commissioner disallowed the expenditure incurred by the taxpayer on the basis that they earned dividend revenue, notwithstanding the fact that the taxpayer was a share trader. The taxpayer demonstrated to the Commissioner that no ownership of investment in shares existed other than shares held as trading stock.

The court found that as far as the legal principle was concerned, the provisions of s14A of the Indian Act are not applicable to the dividend income earned on the shares held as trading stock (*ibid*). Furthermore, the taxpayer had not retained shares with the intention of earning dividend income; it arose from shares that remained unsold, as held in the case of CCI Ltd v the JCIT (2011). The taxpayer was not engaged in investment holding of shares and the purchase of the shares was for the taxpayer to sell the stock in his trade (Ambit Securities Broking P. Ltd v The ACIT, 2013).

The above case clearly reflects that the limitations imposed by s14A of the Indian Act should not apply to stockbroking entities. Stockbroking entities do not hold shares to earn dividends; therefore, their expenditure cannot be directly linked with earning dividends.

4.3.3 The courts’ treatment of expenditure incurred by a taxpayer that holds shares as an investment

Prakash Heat Treatment and Industries P Ltd v Income Tax Appellate Tribunal

The taxpayer, in Prakash Heat Treatment and Industries P Ltd v ITAT-Mumbai (2007), was involved in the business of trading iron and steel parts. The company purchased several shares in M/s. Spectra Industries Ltd, which was a related party. The company borrowed substantial amounts of money to finance the share purchase. The taxpayer paid interest on the borrowed funds which it claimed as a deduction against assessable income. Furthermore, the company earned dividends on the shares purchased. Dividends earned by the taxpayer were exempt from tax under s10(33) of the Indian Act.
In applying the provisions of s14A of the Indian Act, the AO disallowed as a deduction the interest paid that related to funds utilised in acquiring the shares in the associated company. In deliberating its decision, the court indicated that it was hard to accept the idea that dividends can be earned without incurring any expenses, including management or administrative expenses. Furthermore, it was stated by the court that dividends cannot be earned without the existence of a company and management. The view held by the courts was that investment decisions are intricate and demand market research, day-to-day analysis of market trends and decisions with respect to buying, holding and selling shares at the appropriate time. Additionally, investment decisions are largely made by the board of directors, which incurs administrative expenses. It is therefore not accurate to say that dividends are earned without incurring any expenditure. The court referred to the following cases in reaching its decision.

In Southern Petro Chemical Industries v DCIT (2005), it was held that senior executives are involved in strategic decisions of a business which includes making investment decisions. Therefore, a portion of management expenses is required to be disallowed when computing expenses relating to earning exempt dividend income. In Harish Krishnakant Bhatt v Income Tax Officer (2004) the tribunal held that interest on capital lent for the procurement of shares earning exempt dividends cannot be allowed as a deduction in terms of s14A of the Indian Act.

The court in Prakash Heat Treatment and Industries P Ltd v ITAT-Mumbai (2007) held that all the expenditure associated with the exempt dividends must be disallowed under s14A of the Indian Act irrespective of whether the costs are direct or indirect, fixed or variable, managerial or financial.

It can be construed from the above case that the limitations imposed by s14A of the Indian Act would apply in full where a taxpayer is not a stockbroking entity and invests in shares to earn dividends exempt from tax and for the capital appreciation of the investment. Expenditure that is directly or indirectly linked to earning dividend income will not be allowable as a deduction. It is also clear that the cost of funds used in acquiring the shares will not be allowed as a deduction.
4.4 Conclusion

This chapter discussed what principles the Indian legislation and tax courts viewed as pertinent for expenditure incurred by stockbroking entities to be allowed as a deduction. The cases discussed highlighted that there is a difference between a taxpayer that holds shares or securities as an investment and a taxpayer that holds securities as part of its trading stock. Stockbroking entities hold shares as part of their trading stock with the intention of selling them profitably while an investor in shares is looking to earn dividends from the investment and realise capital appreciation on the shares held as an investment.

The chapter further concluded that expenditure incurred by an investor in shares is not allowed as a deduction in terms of s14A of the Indian Act. On the other hand, the expenditure of a trader in shares should be allowed as a deduction in full even though dividends may have been received on shares held as trading stock. It was stated that for stockbroking expenditure to be disallowed, there must be a close connection between expenditure and dividends received.

The chapter also deliberated on the apportionment of expenditure where the share dealer has investment in shares and trades in shares. It was stated that only expenditure relating to the dividends that arises from investment in shares is not deductible. Therefore, there will be no disallowance of expenditure where the taxpayer trades in shares and receives a dividend. It was also concluded that there must be actual expenditure incurred in earning non-taxable income and that notional expenditure cannot be disallowed.

It was stated in this chapter that it is pertinent to identify the expenditure linked to the exempt income and not to examine whether the expenditure incurred by the taxpayer resulted in exempt income.

The final chapter will provide the summary of the findings of the study and make necessary recommendations.
CHAPTER 5

CONCLUSION

5.1 Introduction

Stockbroking entities are engaged in buying and selling shares at a profit which are held as trading stock by the entities. Prior to the sale of shares, the entities may earn incidental dividends on unsold shares. The research question was whether the stockbroking expenditure should be subjected to an apportionment in terms of s 23(f) of the Act where incidental dividends are received on shares held as trading stock.

The objectives of the study were firstly, to investigate whether the disallowance of stockbroking expenditure in terms of s23(f) of the Act is appropriate where the core business of stockbroking entities is the buying and selling of shares at a profit. Secondly, the study investigated the treatment in India of stockbroking expenditure incurred when entities hold shares as trading stock. It was also ascertained whether any principles originating from Indian tax courts judgements could be implemented in South Africa.

5.2 Summary of findings

5.2.1. Requirements of the general deduction formula

The study outlined that stockbroking entities, during their trade, incur stockbroking expenditure that meets the requirements of the general deduction formula. The elements of this formula that the entities fulfil are the carrying on of any trade; expenditure and losses; actually incurred; during the year of assessment; in the production of income; not of a capital nature and to the extent not laid out for the purposes of trade. The key elements of the general deduction formula for this study are:

Firstly, whether the buying and selling of shares by the stockbroking entities constitutes the carrying on of trade?

- The definition of trade includes a business; the activities of buying and selling of shares by stockbroking entities is a business. Stockbroking entities do not
seek to earn passive income; shares held are sold with a profit motive, therefore they meet the carrying on of trade requirement.

Secondly, whether stockbroking expenditure is incurred in the production of income?

- Stockbroking entities’ trade is the buying and selling of shares at a profit. Stockbroking entities’ expenditure originates from selling shares at a profit. As a result, it is closely linked to the performance of the stockbroker’s trade. Therefore, stockbroking expenditure is incurred in the production of income which arises from the sale of shares held as trading stock.

Thirdly, whether the stockbroking expenditure is laid out for purposes of trade?

- Stockbroking expenditure is essential for the activities of stockbroking entities and is genuinely incurred for buying and selling shares. Therefore, stockbroking expenditure is incurred for the purpose of trade which is the buying and selling of shares to clients.

The other elements of the general deduction formula are not issues of contention for the study and are therefore not discussed further. Expenditure incurred by stockbroking entities meet the requirements of s11(a) and s23(g) of the Act.

5.2.2. The application of s23(f) of the Act to stockbroking entities

Section 23(f) of the Act requires that expenditure incurred in earning amounts not constituting income as defined be disallowed as a deduction. Chapter 3 outlined that the general test that is applied in reviewing the provisions of the general deduction formula applies equally to s23(f) of the Act. Therefore, the closeness of connection between the expenditure, exempt income received, and the purpose of the stockbroking expenditure must be assessed. Furthermore, if the expenditure incurred by the stockbroking entities is not closely connected with the production of dividend income, the cost incurred in buying shares held as trading stock should be deducted.

It was held in CIR v Nemojim (Pty) Ltd (1983) that, where the taxpayer did not trade in shares, the expenditure could not be deducted in full. Furthermore, the court stated that there were vital differences between the company buying all the shares in
a dormant company with a view to dividend stripping, and the company buying shares in companies to make a profit on their resale and incidentally also receiving whatever dividends that may be declared on the shares while it holds them. Stockbroking entities do not incur expenditure directly linked to the dividends earned on unsold trading stock.

The judgements presented in this study show that an argument exists that stockbroking expenditure incurred by stockbroking entities holding shares as part of their trading stock might not be subjected to an apportionment in terms of s 23(f) of the Act. It has been established in the study that where shares are held as trading stock by stockbroking entities for their core business of selling those shares to clients at a profit, stockbroking expenditure incurred is closely associated with income-producing activities. Therefore, consideration should be given to deducting stockbroking expenditure in full against income.

Based on the view expressed by the courts, the author believes s23(f) of the Act should not be applied to stockbroking entities holding shares as trading stock.

5.2.3. The difference between a share dealer and an investor in shares

The study outlined the difference between a trader that buys shares to sell on for a profit and an investor who holds shares as an investment with the intention of earning dividends. In the De Beers Holdings (Pty) Ltd v CIR (1986) is was held that where shares are bought to on-sell, then a trade is carried on. Additionally, the court recognised that a stockbroker does not hold shares as capital assets and indicated that dividends earned on shares held as trading stock are part of the return of the business.

5.2.4. Indian tax treatment of expenditure incurred by stockbroking entities

Section 14A of the Indian Act bars the deduction of any expenditure incurred in relation to any income that is not subject tax because it is not included in the total income by s10 of the Indian Act. The Indian courts indicated that s14A of the Indian Act cannot find application where the taxpayer trades in shares and holds unsold shares on which incidental dividends are earned. The study outlined that the Indian courts have allowed stockbroking expenditure to be deducted in full where the
shares are held as trading stock even though dividends are received on unsold shares by the entities.

Where the taxpayer has not kept shares with the goal of attaining dividend income and dividend income is incidental to its business of selling shares, it cannot be said that the expenditure incurred in buying the shares must be apportioned to the extent of dividend income.

Additionally, the courts have indicated that where no expenditure has been incurred in earning dividend income, no notional expenditure can be prohibited from being deducted from income. The study points out that expenditure that is not directly related to the earning of dividend income cannot be disallowed as a deduction.

Chapter 4 showed that there must be a close association between the expenditure and the income which does not form part of the total income. Once such a proximate relationship exists, the disallowance can then be effected. Furthermore, it is pertinent to identify the outlay that relates to exempt income and not to examine whether the expenditure incurred resulted in exempt income or taxable income. Expenditure incurred by stockbroking entities is not closely connected with the earning of dividends; therefore, it should be fully allowed as a deduction.

The Indian courts have disallowed expenditure on a proportionate basis where the entities hold shares as trading stock and as an investment to earn dividends as well as to benefit from the capital appreciation of the shares. However, the courts have established that the expenditure that should be disallowed should be actual expenditure linked with the earning of dividends. Stockbroking expenditure disallowed cannot be estimated costs.

5.3 Recommendations

The study has answered the question posed in Chapter 1. The study has found that the disallowance of stockbroking expenditure in terms of s23(f) of the Act might not be appropriate where the core business of stockbroking entities is the buying and selling of shares to make a profit. Additionally, it was established that the Indian tax courts allow expenditure incurred by stockbroking entities to be deducted in full where dividends are received on shares held as trading stock. There are a number
of principles emanating from Indian tax courts judgements that South Africa might consider adopting when dealing with the deductibility of stockbroking expenditure.

Stockbroking expenditure incurred by stockbroking entities is closely associated with income-producing activities, namely, earning taxable income. The earning of dividends is incidental to stockbroking entities as their main business is selling shares held as trading stock for a profit. The courts have held that the business strategy of stockbroking entities should be considered in determining the deductibility of expenditure incurred given that dividend income is incidental to their business. The apportionment of stockbroking expenditure incurred by the stockbroking entities in terms of s23(f) of the Act should be reconsidered. Stockbroking expenditure is not linked with earning exempt income, it might be deducted in full. Furthermore, the study suggests that the disallowance of stockbroking expenditure in terms of s23(f) of the Act might not be appropriate where the core business of stockbroking entities is the buying and selling of shares at a profit.

It is recommended that the limitation imposed by s23(f) of the Act should be reviewed. SARS and National Treasury should be lobbied by SAIS to recommend that a proviso be added, stating that s23(f) of the Act should not apply where the taxpayer is a stockbroker registered with SAIS and holds shares as trading stock for the purpose of selling to clients. The proviso should further state that the exclusion will apply where the shares are held as unsold for a period not exceeding 12 months. The 12-month limitation should be inserted to ensure stockbroking entities do not hold shares for periods exceeding 12 months in order to abuse the proposed amendment by earning exempt income on shares held longer and claiming deductions of stockbroking expenditure in full.

Alternatively, if the legislation cannot be amended, the author further supports the idea of SAIS applying for a binding class ruling at SARS on behalf of stockbroking entities that are licenced to trade in shares. The binding class ruling application should state that stockbroking expenditure incurred by the entities in the production of income should be allowed in full as a deduction without limitations, where the shares are held as trading stock and dividends are incidental to the business of stockbroking for a period not exceeding 12 months.
The study focused mainly on legislation and tax court cases in Indian and South African therefore it is recommended that other jurisdictions with legislation similar to s23(f) of the Act be investigated as an area for future research to determine how the tax courts have dealt with the deductibility of stockbroking expenditure where shares sold are held as trading stock.
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