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PROTECTING YOUR REPUTATION: DEDUCTIBILITY OF LEGAL EXPENSES

The question of deductibility of legal expenses incurred to protect one's reputation or the goodwill of a business seems to be a recent hot topic of conversation, especially when following the news. Interestingly, two international cases relating to the deductibility of legal expenses, both related to reducing reputational risk and challenging alleged unfounded allegations against the taxpayer, have recently been handed down in Australia and England, respectively.

In the Australian matter of *Taxpayer and the Commissioner of Taxation* 2013 AATA 783, the taxpayer applied for a private ruling from the Commissioner of Taxation regarding the deductibility of legal expenses incurred in challenging a banning order made against the latter by the Australian Securities and Investments Commission. The banning resulted in the taxpayer not being permitted to provide financial services for a period of five years. The court reiterated that legal expenses, like any other expenditure, are deductible to the extent that they are incurred 'in gaining or producing' assessable income. Legal expenses are not, however, deductible to the extent that they are capital or private in nature. The court found that the incurral of the legal expenses in question was aimed at enabling the taxpayer to re-enter the financial services industry and as such related to his income-earning structure. It follows that the expenditure was capital in nature and not deductible.

In the English case of *Duckmanton v Revenue and Customs Commissioners* [2013] UKUT 305 (TCC), the taxpayer lodged an appeal to the Upper Tribunal, against the decision of the First-Tier Tribunal (FTT), regarding the deductibility of legal expenses incurred in defending criminal proceedings instituted against the taxpayer.

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By way of general background, the taxpayer was the owner of an unincorporated transport business. As a result of a fatal accident involving one of the taxpayer's vehicles, the taxpayer incurred substantial legal costs in defending the criminal proceedings instituted against him. In computing his profits for the relevant year of assessment, the taxpayer claimed a deduction for sums paid in preparation of his defence against the criminal proceedings. The taxpayer based his argument on the fact that the expenditure had been principally incurred not to protect his liberty, but to protect his operator's license and business reputation, both of which were an integral part of his trading operation.

The FTT rejected the taxpayer's argument and found that the main reason for incurring the expenditure was to support the taxpayer's defence in the criminal proceedings and to prevent a civil claim for damages against the taxpayer.

The taxpayer subsequently appealed to the Upper Tribunal who confirmed the decision of the FTT by reiterating that the preservation of the taxpayer's business and more specifically his reputation was not his only object when the taxpayer incurred expenditure on legal fees. The reasons behind the incurred expenditure were that they minimised the risk of imprisonment and prevented a substantial civil claim for damages. Accordingly, the expenditure was not wholly and exclusively incurred for purposes of the taxpayer's trade and the taxpayer was therefore not entitled to deduct the legal expenditure so incurred.

Based on the latter judgement it is clear that, in England at least, it is a specific requirement that legal expenditure must be 'wholly and exclusively' incurred for the purpose of producing income, in order for it to be deductible.

Before 1993, the Income Tax Act, No 58 of 1962 (Act), contained a similar requirement in that expenditure had to be 'wholly and exclusively' laid out for purposes of trade to be deductible. This requirement was of great concern in circumstances where expenditure was incurred with a dual motive. This provision has, fortunately, been amended. The Act contains a general deduction formula which provides that, in determining the taxable income derived by a person from the carrying on of any trade, there shall be allowed as a deduction expenditure and losses actually incurred in the production of income, provided that such expenditure and losses are not of a capital nature. However, the deduction formula is further qualified by s 23(g) of the Act, which prohibits the deduction of any moneys claimed as a deduction from income derived from trade, to the extent that they are not laid out or expended for the purposes of trade. This provision enables the disallowance of expenditure which has been incurred in carrying on a trade, but has not been expended exclusively for the purposes of that trade.

In light of the above it is important to note that in the South African context, courts will apportion legal expenditure where the expenditure has been incurred for a dual purpose, ie where the expenditure has been incurred to preserve the taxpayer's business and to prevent a civil claim for damages, and it is therefore not a requirement that the expenditure be incurred 'wholly and exclusively' for the purposes of trade in order for it to be deductible. This principle relating to the deductibility of expenditure incurred for a dual purpose was applied in the case of *CIR v Nemojim (Pty) Limited* 45 SATC.

However, as illustrated by the Australian case cited above, expenditure that is capital in nature, and that relates to the income-earning structure of a taxpayer, will be disallowed.

Nicole Paulsen and Danielle Botha

ON-CHARGES AND SUPPLIES SUBJECT TO VAT

For a transaction in South Africa to attract Value-added Tax (VAT), there should be a supply of goods or services by a vendor in the course or furtherance of an enterprise.

Consider the following scenario:

A and B, both vendors for VAT purposes, have a business arrangement whereby, for example, B provides consulting and management services to A. It transpires, in the course of their business arrangement, that A requires the use of a rented vehicle. B agrees to arrange the vehicle. B enters into a rental agreement with C, also a VAT vendor, and the vehicle is made available for the benefit of A. C subsequently invoices B for R100 plus VAT of R14 and B pays C the R114. Naturally, B seeks to recover the cost from A. B does not wish to recover anything in excess of the cost from A because A is a good client. How should B deal with the recovery of the cost from a VAT perspective?

B is faced with two possibilities:

- Firstly, B could issue an invoice to A for R100 plus VAT of R14. B could claim the R14 input VAT in respect of the payment made to C, but would also have to account to the South African Revenue Service (SARS) for the R14 VAT charged to A. Since A would be in possession of a VAT invoice, it could claim the R14 VAT paid to B from SARS.

- Secondly, B could consider simply presenting the invoice from C to A for payment in order to recover his cost.

The first possibility is an administratively intense process but appears to carefully follow the so-called 'VAT chain'. However, a fundamental question that needs to be asked is whether B actually made a supply to A (and if so, what the nature and value of that supply is), or whether it was C who made a supply to A. The matter is complicated by the fact that one is probably dealing with a contract (between B and C) for the benefit of a third (A).

In the case of *CSARS v British Airways PLC*, it was held that VAT will only be levied on actual supplies made and that the receipt of money is not a supply subject to VAT. In this case, the issue that needed to be determined was whether British Airways was required to charge VAT on that part of its ticket price constituting a 'passenger service charge'. The passenger service charge is levied by Airports Company Limited on aircraft operators such as British Airways. However, British Airways would recover this 'passenger service charge' from its passengers as a direct on-charge on its tickets (account for separately). SARS sought to recover output VAT from British Airways, however the court held that the charge was in respect of a service supplied by the Airports Company Limited and not by British Airways. Accordingly, British Airways was not required to charge VAT on the recovery of the passenger service charge. British Airways was simply recovering it directly from its passengers. Effectively, the court held that Airports Company Limited was liable to account for the output VAT as it was making the supply.

In light of this judgment, the first possibility might not necessarily be the correct approach. C made a supply to B for the benefit of A, but did B make a supply to A? B certainly did not on-rent the vehicle to A. If anything, B supplied a procurement service to A. In this regard B could, for example, charge a R1 fee to A (plus VAT of R0.14) in respect of the procurement service.

The second possibility is administratively very simple. B would raise a tax invoice to A in respect of the usual consulting and management services supplied to A, but would simply present the invoice from C to A for payment. B could, of course, consider charging a procurement fee to A, on which B would have to account for output VAT.

Should B decide to handle the transaction in terms of the second possibility, A could potentially find itself in a position where it would not be able to claim any input VAT in respect of the supply of the rental vehicle. This is so because A will not be in possession of a tax invoice reflecting its details, the invoice from C having been made out to B.

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