Preamble

References to sections are to sections of the Act, unless otherwise stated.

1. Purpose

This Note provides clarity on the deductions that may be claimed by employees and office holders.

This update incorporates the changes made in terms of section 18(1)(g) and section 37(1)(c) of the Revenue Laws Amendment Act No. 60 of 2008, which introduced sections 11(nA) and (nB) into the Act and amended section 23(m).

2. Background

Section 23(m) was introduced to limit the deductions that may be claimed by employees and office holders against their employment income. The limitation excludes agents and representatives whose remuneration is normally derived mainly in the form of commission based on sales or turnover attributable to that agents or representatives.

Section 23(m) has been periodically updated to expand the deductions that employees and office holders may claim. The most recent amendment provides that, if certain amounts were received by or accrued to an employee and were included in the employees' taxable income, where any portion of that amount is refunded by the employee to the employer, the refunded amount will be allowed as a deduction against the employee’s taxable income. The same principle applies to restraint of trade payments that were previously included in taxable income, and were subsequently refunded by the employee.

To the extent that the employee’s taxable income is insufficient in any particular year of assessment, the deduction for the repaid benefit may create an assessed loss, which may be carried forward to the following tax year.
3. **The law**

Section 23\((m)\) of the Act reads as follows:

“23. **Deductions not allowed in determination of taxable income.**—No deductions shall in any case be made in respect of the following matters, namely—

\((m)\) subject to paragraph \((k)\), any expenditure, loss or allowance, contemplated in section 11, which relates to any employment of, or office held by, any person (other than an agent or representative whose remuneration is normally derived mainly in the form of commissions based on his or her sales or the turnover attributable to him or her) in respect of which he or she derives any remuneration, as defined in paragraph 1 of the Fourth Schedule, other than—

(i) any contributions to a pension or retirement annuity fund as may be deducted from the income of that person in terms of sections 11\((k)\) or \((n)\);

(ii) any allowance or expense which may be deducted from the income of that person in terms of section 11\((c)\), \((e)\), \((i)\) or \((j)\);

(iiA) any deduction which is allowable under section 11\((nA)\) or \((nB)\)

(iii) any deduction which is allowable under section 11\((a)\) in respect of any premium paid by that person in terms of an insurance policy, to the extent that—

\((aa)\) it covers that person against the loss of income as a result of illness, injury, disability or unemployment; and

\((bb)\) the amounts payable in terms of that policy as contemplated in item \((aa)\) constitutes or will constitute income as defined; and

(iv) any deduction which is allowed under section 11\((a)\) or \((d)\) in respect of any rent of, cost of repairs of or expenses in connection with any dwelling house or domestic premises, to the extent that the deduction is not prohibited under paragraph \((b)\);”

4. **Application of the law**

The wording of section 23\((m)\) is analysed and interpreted below:

<table>
<thead>
<tr>
<th>Wording</th>
<th>Interpretation</th>
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<tr>
<td>No deductions shall in any case be made in respect of the following matters, namely—</td>
<td>Section 23 contains a number of prohibitions on deductions. Paragraph ((m)) of section 23 is one of them.</td>
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<td>subject to paragraph ((k))</td>
<td>Paragraph ((k)) of section 23 prohibits certain deductions for labour brokers without an exemption certificate and personal service providers. The application of paragraph ((m)) is subject to the application of paragraph ((k)), which means that a personal service provider or a labour broker that falls under the restrictions imposed by paragraph ((k)) will remain restricted under that paragraph despite the provisions of section 23((m)).</td>
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<td>any expenditure, loss or allowance, contemplated in section 11</td>
<td>Before the introduction of section 23((m)) an employee or holder of an office could under certain (in practice very limited) circumstances have been entitled to claim a deduction under section 11. With effect from 1 March 2002 this is, with a few exceptions, no longer possible. [See examples A and B of Annexure A]</td>
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The prohibition on the deduction of expenditure, losses and allowances only applies to expenditure, losses and allowances that would otherwise have been deductible under section 11. Deductions for medical expenditure under section 18 and donations to approved public benefit organisations under section 18A remain available. Subsistence and travelling expenses under section 8(1)(b) or (c), or the expenditure listed under section 8(1)(d) in respect of holders of a public office, are not expenditure, losses or allowances claimed under section 11, but are amounts taken into account in the determination of the amount to be included in taxable income, and are thus not affected by the limitation imposed by section 23(m). [See Example B of Annexure A]

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<th>which relates to any employment of, or office held by, any person</th>
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<td>The prohibition on deductions applies to expenditure, loss or allowances which relate to the employment of any person or to an office held by any person.</td>
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<td>The term “employment”, in this context, should be afforded its narrower meaning of an employer-employee (master-servant) relationship. An independent contractor is therefore not affected by the prohibition on deductions. [See Example B of Annexure A]</td>
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<td>The holding of an office generally flows from an appointment (such as the President of South Africa, Ministers in the Cabinet, and Judges, as well as directors of companies) whereas the holding of employment flows from a contract and is something in the nature of a post.</td>
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<tr>
<th>(other than an agent or representative whose remuneration is normally derived mainly in the form of commissions based on his or her sales or the turnover attributable to him or her)</th>
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<tr>
<td>An agent or representative whose remuneration is normally derived mainly in the form of commission based on sales or turnover that is attributable to that agent or representative is excluded from the provisions of section 23(m). The term “remuneration” in this context is not necessarily as defined in the Fourth Schedule, that is, it is a general reference to a reward or pay received in return for services rendered or work done. The term “mainly” is interpreted to mean more than 50% of the taxpayer’s gross remuneration. This means that the total income of the taxpayer (including 100% of all allowances) must be compared to his or her commission income. Furthermore, where the commission is more than 50% of the gross remuneration, the agent or representative who is in this position may continue to be granted permissible deductions under section 11. [See examples C, D, E and F of Annexure A]</td>
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<tr>
<td>In the event that an agent or representative did not derive more than 50% commission income for the year of assessment, but it can nevertheless be shown that his or her income normally consists of more than 50% commission, the limitation of section 23(m) will not be applicable. The test for “normally” is a subjective test and each case must be evaluated on its own merits, with due regard to the taxpayer’s previous and future years of assessment.</td>
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<td>For purposes of section 23(m) the terms “agent”, “representative” and “commission” should be interpreted as follows:</td>
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<td>• “Agent” – a person authorised or delegated to transact business for another.</td>
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<td>• “Representative” – one who represents another or others.</td>
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<td>• “Commission” – a percentage of sales or turnover of the person on behalf of whom the agent or representative is acting.</td>
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<td>in respect of which he or she derives any remuneration, as defined in paragraph 1 of the Fourth Schedule,</td>
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<td>The prohibition applies to expenditure, losses and allowances that relate to “remuneration” as defined in the Fourth Schedule to the Act. Expenditure, losses and allowances that relate to income other than “remuneration” may therefore still be considered for deduction. An employee or office holder in receipt of two or more streams of income may thus be in a situation where the deduction of expenditure, losses or allowances relating to a “remuneration” stream of income is prohibited, while expenditure, losses or allowances relating to another trade remain deductible. [See Example B of Annexure A]</td>
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<tr>
<th>other than—</th>
<th>These expenses and allowances are still deductible by an office holder or an employee:</th>
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<tbody>
<tr>
<td>any contributions to a pension or retirement annuity fund as may be deducted from the income of that person in terms of sections 11(k) or (n);</td>
<td>Contributions to a pension or retirement fund subject to the limits imposed by sections 11(k) and (n).</td>
</tr>
</tbody>
</table>
| any allowance or expense which may be deducted from the income of that person in terms of section 11(c), (e), (i) or (j); | • Qualifying legal expenses [section 11(c)].  
• Wear-and-tear allowances on items used for purposes of trade, such as computers or books [section 11(e)].  
• Bad debts, for example, income which was not paid to the employee as a result of the insolvency of the employer [section 11(i)].  
• Doubtful debts [section 11(j)]. |
| any deduction which is allowable under section 11(nA) or (nB) | Any amount, including a restraint of trade payment, received by or accrued to an employee or office holder that was included in that taxpayer’s taxable income, and was refunded by that taxpayer. Only amounts actually refunded may be claimed as a deduction. [See Example H of Annexure A] |
| any deduction which is allowable under section 11(a) in respect of any premium paid by that person in terms of an insurance policy, to the extent that— | It is crucial to ensure that the premium is deductible under section 11(a) as premiums that do not qualify for a deduction under section 11(a) are in any event not permitted. |
| it covers that person against the loss of income as a result of illness, injury, disability or unemployment; and | The policy must provide cover against the loss of income as a result of one of the following:  
• illness;  
• injury;  
• disability; or  
• unemployment.  
Many policies purport to cover loss of income but pay in the event of illness, injury or disability. Some calculate the benefit with reference to days in hospital or sickness, or the severity of the disability, but do not test against actual loss of income. Premiums on these policies do not qualify for deduction. |
| the amounts payable in terms of that policy as contemplated in item (aa) constitutes or will constitute income as defined; and | The benefit payable under the policy must also constitute “income” as defined. Premiums to policies that pay out amounts of a capital nature, and which are not included in the special inclusions in “gross income”, are thus prohibited. |
any deduction which is allowed under section 11(a) or (d) in respect of any rent of, cost of repairs of or expenses in connection with any dwelling house or domestic premises, to the extent that the deduction is not prohibited under paragraph (b).

Home office expenses that relate to rental, repairs and expenses incurred in relation to a dwelling house or domestic premises can also be permitted as a deduction. [See Example G of Annexure A]

5. Effective date

Section 23(m) of the Act is effective from 1 March 2002; and subparagraph (iiA) is effective from the commencement of any year of assessment ending on or after 1 January 2009.

Legal and Policy Division
SOUTH AFRICAN REVENUE SERVICE
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Annexure A – Examples

Example A

Facts:
An employee received pensionable salary of R130 000. The employee contributed R9 750 to an approved pension fund and incurred –

- entertainment expenses of R1 000;
- cell phone airtime expenditure of R1 500; and
- text book costs of R750 that are required for and relate directly to her profession.

Result:
The restrictions of section 23(m) apply to the remuneration of R130 000. In terms of these restrictions the entertainment, cell phone and textbook expenditure are not permissible deductions. Section 23(m) continues, however, to permit a wear-and-tear allowance under section 11(e) for the textbook expenditure. The pension fund contribution remains deductible.

Example B

Facts:
Ms X received salary of R100 000 and fees of R198 000 from a professional practice in which she trades as an independent contractor. She incurred expenses of R88 000 in relation to the professional practice. In relation to the salary income she incurred –

- medical expenses of R3 000;
- entertainment expenses of R1 000;
- cell phone airtime expenditure of R1 500; and
- bad debt of R8 333 for salary due but not paid by the liquidated employer.

Result:
The expenses relating to the professional practice are deductible for tax purposes as they relate to income other than “remuneration”. The restrictions of section 23(m) apply to the salary of R100 000. In terms of these restrictions the entertainment and cell phone costs are not permissible deductions. The bad debt of R8 333 may be considered for purposes of section 11(i) or (j) as it relates to remuneration. The medical expenses can be considered for deduction under section 18.

Example C

Facts:
An employee received a pensionable salary of R40 000 and commission income of R130 000 on sales. The employee contributed R3 000 to an approved pension fund and incurred commission-related business expenses of R70 000.
Result:
Since more than 50% of the employee's remuneration consists of commission, the restrictions of section 23(m) do not apply. The R70 000 commission expenses may therefore be considered for deduction against the commission income of R130 000 under section 11. The pension fund contribution is unaffected by the introduction of section 23(m) and remains deductible.

Example D

Facts:
An employee received a pensionable salary of R60 000 and commission of R60 000 on sales. The employee contributed R4 500 to a pension fund and incurred commission-related business expenditure of R10 000, consisting of telephone and stationery costs.

Result:
Since not more than 50% of the employee's remuneration consists of commission, the restrictions of section 23(m) apply. The commission-related business expenditure of R10 000 can therefore not be considered under section 11 for deduction. The pension fund contribution remains deductible.

Example E

Facts:
For the period 1 March 2002 to 31 August 2002 an employee received a salary of R300 000 from employer A, in respect of which cell phone airtime expenses of R3 000 were incurred. For the period 1 September 2002 to 28 February 2003 the employee received commission income of R250 000 on sales from employer B (which is not connected to employer A) and incurred commission-related business expenses consisting of telephone and stationery of R30 000.

Result:
For purposes of section 23(m), each contractual arrangement arising from unconnected sources has to be considered on its own. This means that section 23(m) prohibits the deduction of the expenses incurred in relation to remuneration received from employer A, but that section 23(m) does not prohibit the deduction of expenses incurred in relation to remuneration received from employer B.

Example F

Facts:
An employee receives a pensionable salary of R80 000 a year, commission income of R100 000 and is in receipt of a travel allowance of R40 000 for the year. The employee contributes R4 000 towards a retirement annuity. He was involved in a legal dispute with his employer and incurred legal costs of R5 000. In addition he incurred commission-related expenses of R35 000.
Result:
Since the employee’s commission income is less than 50% of his total income, that is, salary and total allowances (R80 000 + R40 000), the restrictions of section 23(m) will apply. The commission-related expenditure of R35 000 will therefore not be considered under section 11 for a deduction. The retirement annuity of R4 000 will remain deductible. The employee may be able to deduct the travel allowance if it is proved that he incurred business mileage and travel-related expenses. The legal costs of R5 000 may be considered for a deduction under section 11(c).

Example G

Facts:
Mr. Z received a pensionable salary of R100 000 and contributed R6 000 to a pension fund. Mr. Z stays in a 100 square metre rented house and he uses a 15 square metre room exclusively as his home office. He pays a monthly rental of R2 000 and the total amount of rates and taxes for the year is R3 600.

Result:
Since Mr. Z does not have any other source of income, the restrictions of section 23(m) will apply. However, the following expenses will be deductible:
- Pension fund contributions of R6 000.
- Rental cost of R3 600 (15% of R2 000 x 12).
- Rates and taxes of R540 (15% of R3 600).

Example H

Facts:
An employee received a salary of R185 000. His employer paid him an additional amount of R50 000 as a retention bonus on 1 April 2009. Employees’ tax was deducted by the employer. In terms of the contract between the employer and employee, the employee was required to remain in the firm’s employment until he had served one full year. On 31 October 2008 (six months later) the employee resigned. In terms of the retention contract, the employee repaid the bonus.

Result:
For purposes of section 23(m), the employee will be permitted to claim the amount of the bonus actually repaid (in this case, the amount of R50 000) against his or her taxable income on assessment for normal tax in the 2009 year of assessment.