REPUBLIC OF SOUTH AFRICA

SOUTH GAUTENG HIGH COURT, JOHANNESBURG

CASE NO: A5033/10
TAX COURT CASE NO: 12401

(1) REPORTABLE: NO
(2) OF INTEREST TO OTHER JUDGES: NO
(3) REVISED.

1/7/11 .....
DATE SIGNATURE

In the matter between:

MOBILE TELEPHONE NETWORKS HOLDINGS (PTY) LIMITED — Appellant (Appellant in the court *a quo*)

and

THE COMMISSIONER FOR THE SOUTH AFRICAN REVENUE SERVICE — Respondent (Respondent in the court *a quo*)

JUDGMENT

VICTOR, J:

[1] This is an appeal from the Special Income Tax Court. The issues to be determined in this appeal are:

1.1. Whether the Commissioner was entitled to disallow appellant's expenditure incurred in respect of audit fees for the years 2001, 2002, 2003 and 2004 tax years; and

1.2. Whether the expenditure of R878 142 by the appellant in respect of professional fees charged by KPMG for the training of staff on a new accounting package was wholly deductible.

[2] The appellant initially appealed the Commissioner's finding to the Special Tax Court and succeeded partially on the first issue of the auditing fees by obtaining a deduction of 50% on the auditing fees for those tax years. It failed on the second issue of the deductibility of the cost of training of staff for the new Hyperion accounting package.

[3] The Special Tax Court referred the issue of the deductibility of audit fees back to the Commissioner to enable him to make new assessment for the years 2001, 2002, 2003 and 2004 tax years. The Special Tax Court also confirmed that the expenditure of R878 142 in respect of professional fees was of a capital nature was therefore not deductible.

[4] The respondent cross appealed in respect of the first issue and submitted that the deduction of 50% of the audit fee was incorrect. The Commissioner had a allowed a very small deduction for the audit expenses for the years in questions hence its main submission that no deduction should be allowed is puzzling and must fail. It is the respondent's alternative

argument that the 50% deduction ordered by the court a quo which must be considered in the cross appeal on the issue of the audit fees.

[4] The issues in the Special Tax Court related to the proper interpretation of the Income Tax Act No 58 of 1962 (the act) pertaining to the deduction of expenses incurred in the production of income. In terms of s 11(a) of the Income Tax Act 58 of 1962 expenditure and losses incurred in the production of income are deductible whilst in terms of s 23(f) and (g) expenses which do not constitute income or laid out for the purposes of trade are not deductible.

RELEVANT BACKGROUND FACTS

[5] The appellant is a wholly-owned subsidiary of the MTN Group Ltd and has five wholly-owned subsidiaries. The collective business of the MTN Group is the provision of mobile telecommunication networks and related services. It is common cause that the appellant carries on a trade. This aspect was agreed in a pre-trial meeting. The audit fees (which were partially disallowed) were incurred for the purposes of complying with its statutory obligations to have its accounts audited as well as for the purpose of trading. The professional fees relating to the second issue which were wholly disallowed were incurred when the services of KPMG were provided in order to train staff on the computer accounting system known as the Hyperion system.

AUDIT FEE

[6] It is common cause between the parties that the appellant traded during the years in question. Upon analysis the audit required the input and consideration of an auditor in respect of both the dividends and accruals in the form of interest. The appellant lent money to its subsidiaries and also earned dividends from investments made. The total dividend income represented the largest portion of its income of between 89% and 99% during the years in question.

[7] The applicable legal principles are clear but its application to the facts introduces the complexities. In order for the expenditure to be deducted it must be incurred in the bona fide performance of the operation[1], must have been incurred in the production of income and need not be causally related to the income[2] , and regard must be had to the purpose of the expenditure and to what it actually affects[3].

[8] The court a quo did not accept that the cost of statutory compliance necessarily means that such costs amount to expenditure incurred in the production of income.[4] In applying the principle in Joffe &Co Ltd v Commissioner for Inland Revenue [5] the court a quo found that the auditing fee was a function necessarily attached to the earning operation. Without the

[1] Port Elizabeth Tramway Co Ltd 1936 CPD 241
[2] CIR v Drakensberg Garden Hotel Pty Ltd 1960(2)SQA475(A)H-480A
[3] Commissioner for Inland Revenue v Genn &Co
[4] CSARS v Akharwary 68SATC 41
[5] 1946 AD 157

audit it could not comply with the JSE requirements to give comfort to creditors and access further loans.

[9] The court a quo found that the expenditure was for a dual purpose and in the circumstances was thus entiled to apportion the expenditure between two purposes[6] and considered various formulae for the apportionment and arrived at the 50% apportionment. The court a quo found it inappropriate to apply an arithmetical basis and relied on Tuck v CIR [7] where the relative importance of each element was weighed against the other. The apportionment was done on the basis of value of the income and not the amount of work done.

[10] In my view the acceptance that it was common cause that the appellant was a trading entity constituted an essential element in determining the issue. In addition the undisputed contention of the appellant that on average only 6% of the entries in its books of account such as the cash book, and ledger related to dividends was an important consideration.

[11] The respondent contends that audit expenditure is of an ex post facto nature in that it verifies expenditure the year after it was incurred. These services do not advance the trade of the company and the production of its revenue. Its main submission being that all audit fees should be disallowed, however, based on the fact that the Commissioner himself had allowed a small deduction the respondent was driven to submit that the 50% ordered by

[6] CIR v Nemojenm,1983(4) SA 935(A)
[7] 1988(3) SA 819 (A)

the court a quo was overly generous and that such deductions as the Commissioner had allowed were appropriate.

[12] In developing its main submission the respondent contended that the audit fee was of a statutory nature and relied on an Australian authority where the expenditure was disallowed for undertaking a statutory task e.g. expenditure incurred in assessing the fairness of a takeover [8]. The similarity in thinking emerges in the writing of Professor J L Pretorius [9] which the court a quo referred to with approval. Emphasis was placed on the primary role of an auditor in company law as not being related to the generation of income but as being a in the vanguard of protecting the interests of investors, potential investor and creditors. Whilst the evolution of the statutory role of an auditor in auditing a company may involve non-income producing aspects, in this case the evidence which the appellant led was not undermined on the necessity of the auditor's role in its income generating activities. The application of this evolving jurisprudence has no application in this case since the factual matrix is clear.

[13] The parties accepted that the appellants business constituted trading and therefore fell within the purview of s 1 of the act which defines "trade". Trade is given a wide definition and "is intended to embrace every profitable activity"[10] . The appellant's evidence that it embraced "every profitable activity" was not undermined.

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[8] FCT v the Swan Brewery co Ltd (19191) 22ATR 295
[9] 1986 Modern Business law 82 at 90
[10] ITC 770 (1954) 19 SATC 216 at 217.

[14] It was common cause that the amount of work by the auditors extended beyond the verification of interest income and the receipt of dividends. But these additional tasks did not detract from the appellant's main submission that the costs related to the income earning activities.

[15] Upon a proper application of the law pertaining to the apportionment of expenses, the facts are clear. Only 6% of time was spent on the dividend section of the audit.

[16] I am of the view that the appellant's evidence cannot be rejected. The facts as proven i.e. the amount of work done must remain the yardstick or benchmark and not the value of the dividend payments. The testimony of Messrs Steyn and Van Doorene on behalf of the appellant was clear. Only 5% or 6% of the auditor's time was spent on the dividends, the rest was in relation to the interest which was its income-producing activity. The expenditure was incurred to directly facilitate the carrying on of its trade not only in a legally compliant manner but to generate income.

[17] The appellant does not have to show a direct causal link or connection but a closeness of connection between the expenditure and the income e.g. cost price of expenditure incurred for a product which is later sold by appellant for profit. Such direct causal link is not the only link required in terms of section 11(a) of the Act. There are instances where expenditure does not causally produce the income but is still deductible in terms of section 11(1) of the Act.

[18] In determining the causal connection between the expenditure regard must be had to the purpose of the expenditure and what it actually affects[11]. The court a quo placed importance on the role of the auditor in company law statutory requirements as suggested by Professor Pretorius. The facts in this case are not probative of the learned Professor's work and the court a quo's finding cannot be upheld.

[19] The only fair basis would be on the evidence as established and that is 94% in favour of the appellant.

[20] In *ITC 1589* 57 SATC 153 (Z) the court accepted that expenses relating to the portion of the accountancy work relating to dividend income should be disallowed and the remainder of the accountancy work relating to income producing activities should be allowed. This was the only fair and reasonable approach having regard to all circumstances.

[21] The principles in *ITC 1589* supra apply. In this case the bulk of the auditor's fee should be apportioned to the operating and income producing section of the appellant's business.

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[11] CIR v Genn supra

CROSS APPEAL

[22] The cross appeal was based on whether the court a quo erred in finding that the test in Joffe supra was satisfied on the apportionment. The commissioner had already permitted certain deductions. In Joffe supra the test considers the expenditure which is linked to the performance of income – earning operations. It is the respondent's case that audit fees do not attach to those operations as there is no statutory obligation to have audited financial statements. Where there is trading through a company then the trader must accept it must accept that there are additional expenses for audit fees and the legal obligation is unrelated to the earning of income. The commissioner however is not seeking to disallow the expenses in totality but allowed only 11%, (2001), 6% (2002), 2% (2003) and 1% (2004). This ambivalence in approach by the respondent resulted in fortifying its alternative argument where it did assume in favour of the tax payer that expenses were incurred in the production of revenue. Once that is so then the respondent must accept that audit expenses are not related to an election made to trade through a company (which requires audited accounts as opposed to an individual which does not). Such an approach would provide enormous obstacles to the world of commerce and trade.

[23] The respondent then went on to analyse the nature of the business as regards the generation of income and submitted that the appellant comprised the holding of shares in its subsidiaries from which dividends were earned as

well as interest from lending of money to its subsidiaries some of which were interest free. Interest free loans were not productive of income. Only lending money at interest was. Again the respondent relies on value as being the benchmark and not the amount of work involved in the audit process. No heed was paid to the amount of work involved.

[24] Clearly the facts in this case are distinguishable form Swan supra. I accepted the evidence of the appellant's witnesses despite the fact that the person involved in the negotiating of the audit fee for 2001 to 2004 was not available to testify, instead a Mr Steyn testified on the apportionment of the work. The basis for this that the testimony of Mr Steyn on behalf of the appellant was not undermined. Mr Steyn was a partner at the firm Sizwe Ntsaluba VSP from 2003 to 2007. The firm was responsible for the audit of the appellant during the relevant years except for 2001. Mr Steyn attended the 2006 audit and was familiar with the business activities of the appellant in that year as well as the previous years. His evidence was that the amount of audit work done on the income producing side was similar.

[25] It was the opinion of Messrs Van Doorene and Steyn that as a generalisation there is no precise correlation between the number of journal entries of a taxpayer and the time that an auditor would take. In this matter, however, they testified that there was such a correlation.

[26] The grounds relied upon by the respondent for income apportionment method is factually and legally incorrect. Similarly the finding of the 50% apportionment by the court a quo must fail since it is unchallenged that the audit functions and its concomitant cost related to the interest-producing operations and not the dividend-producing operations.

THE COST OF TRAINING ON HYPERION COMPUTER MANAGEMENT SYSTEM

[27] The system was introduced in the 2004 tax year in order to capture record and index certain aspects related to the appellant's financial affairs. The system assists in the conduct of its business in particular it assists in the consolidation of financial results and the reporting of its results to others.

[28] The professional fee was incurred with its auditors in relation to them rendering services about the implementation, adjustment, fine tuning and user operation of the system.

[29] Mr C H Gericke testified on behalf of the appellant. He testified that the Hyperion system assists the appellant in the consolidation of its financial results. It assists the underlying companies and the superior ones. Auditors assisted in facilitating the consolidation of its results based on the new system. Mr Gericke also testified and was adamant that expenditure was part

and parcel of the appellants normal day to day operation or day to day trading expenses

[29] The majority of transactions in the appellant's financial records relate to interest income and therefore they must necessarily use the Hyperion system. It is not used in relation to the dividend income.

[30] It was neither owned nor located in the appellant's information technology main frame. It was made available to use by another company in the appellant's group. Before the appellant used the Hyperion system the system already implemented and ready for use but this was done by a different company MTN International. It was when the appellant used the system that costs were incurred to operate the system. It had to be customised for the appellant and the cost to the appellant was to get someone to explain the running of the system and teach the appellant's staff how it worked. Mr Gericke was adamant that the fees were for the purposes of the appellant operating the system. It had to be programmed to use a particular IT language. The employees of KPMG who performed the services were not specialist IT people they were auditors who had knowledge of accounting system services.

[31] The system enabled the appellant to consolidate its financial statements and took care of 90% of the accounting work that would otherwise have had to be performed manually. It could not perform its accounting consolidation requirements without such a tool. The Hyperion system was

used purely for the benefit of the appellant as its subsidiaries would not have "*bothered if there was Hyperion or not, they would still be able to produce the trial balance that they ultimately had to submit to the appellant*". The subsidiaries did not derive any benefit of significance from the system.

[32] The system was used on a daily basis in the appellant's operations. It assisted with the preparation of budgets, forecasts, monthly reports and complex calculations. Ms Sibiya was quite clear that the services were rendered to teach the staff how to operate the system and in this regard they were not vague. Ms Sibiya had direct knowledge of the system.

[33] Mr Steyn testified and he was certain about the activities of the appellant. He was adamant that without the Hyperion system the appellant would have missed its deadlines for producing consolidated accounts. This would have resulted in loans becoming immediately repayable. The audited financial statements produced by the system were required for the appellant to carry on its trade. Failure to do so would result in a breach of the relevant legislation. The appellant installed the Hyperion system and the concomitant professional fees were expenditure incurred in order to achieve the results mentioned above.

[34] The professional fees are closely connected to the earning of the interest income and should properly be regarded as a cost incurred in order to generate the income. In my view the Hyperion system was directly related to its trading activities

[35] The other companies in the group derived a benefit from the Hyperion system because of its interconnected structure in which the companies within the group trade. I find that the ancillary benefit does not undermine the primary purpose of the Hyperion system. The fact of trading more effectively does not convert expenditure into a capital item. The fact that the Hyperion system aids in assisting the appellant to report its trading results is not a justifiable reason to disallow the expenditure.

[36] The respondent disallowed the professional fee because the Hyperion system aids in the presentation and reporting of results of the appellant and the consolidated results in the group. In so doing it has disregarded the factors referred to above.

[37] The appellant is obliged in terms of its business arrangements to report its results to other companies with the MTN group and such a function is in the ordinary course of business and related to its trading activities. This function necessarily relates to the ongoing production of its income in a manner consistent with its obligations to other companies in the group.

[38] The criticism by the respondent that the appellant has not provided sufficient information so to cause it to deal with the deductions is to be assessed must fail. I find that appellant has discharged the onus by providing all the relevant information in relation to the Hyperion System. It is the

respondent who failed to consider the relevant information before disallowing the auditors' training fee.

[39] The Hyperion system constitutes a tool in the appellant's business as a trader. The appellant's trade is based on the fact that the appellant's activities are that of a money-lender. The scale of the investment by the appellant in the shares of its subsidiary companies is such as to amount to the carrying on of trade. It is the appellant's contention that if one of the activities amount to trade then it is entitled to a deduction in respect of that expense.

[40] In Joffe supra expenditure has to be a necessary concomitant of the income-earning operation and once it is a necessary concomitant then the cost is deductible. A necessary concomitant is defined as "*all expenditure ... necessarily attached to the performance of operations which constitute the carrying on of the income-earning trade which would be deductible*".

[41] The appellant's contention that the audit opinion and the production of audited financial statements and the consolidation thereof where there is a group of companies must be regarded as expenditure necessarily attached to the carrying on of a trade where the trading vehicle is a company must succeed.

[42] In CIR v Hickson[12] a physically disabled appellant required someone to accompany him overseas on business trips and this was held to be a necessary expenditure connected with travel.

[43] In this case the expenditure on the Hyperion System was necessary for the appellant to conduct its income-earning business (interest) and is deductible irrespective of whether or not there is also in a non-income-earning advantage for the appellant.

[44] The appellant's appeal on the issue on the deductibility of the expenses incurred on the Hyperion System is upheld.

[45] The appellant has been substantially successful and the costs must follow the result.

The order that I would make is the following:

1. The issue of the deductibility of the audit fees is remitted to the Commissioner to enable him to make new assessments for the years 2001, 2002, 2003 and 2004 in accordance with the apportionment 94% being deductible in respect of the audit fee.

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[12] 1960 (1) SA 746 (A).

2. The Commissioner is ordered to allow the deduction of the expenditure relating to the fees of KPMG for the training on the Hyperion System.

3 The cross appeal is dismissed with costs including the costs of two counsel.

4 The respondent is ordered to pay the costs of the appeal including the costs of two counsel.

VICTOR J

HORN J I concur

HORN J

WEPENER J I concur

WEPENER J