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COLLEGE OF  
ACCOUNTING

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TAXATION | BASIC/INTERMEDIATE

# Video Transcription: In the Production of Income



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Hi, I'm Shaun Parsons. This is the second video in which we are going to focus on an important requirement of the section 11(a) general deduction definition. In this video we are going to look at the requirement that expenditure must be incurred in the production of income, to be deductible under section 11(a). Remember, in our "Capital and Revenue" video we discussed how section 11(a) only permits the deduction of expenditure that is not capital in nature.

Let's start with an example. Assume an individual owns a T-shirt shop. She buys T-shirts from her suppliers for R150, and sells them to customers for R200. Each time she buys and then sells a T-shirt, the net increase in the cash in her bank account is R50, being R200 less R150. The R200 she receives will be included in her taxable income, but if her income tax is calculated on her sales value it would clearly be too high. If she was in the top tax bracket of 41% that would come to R82 but the net increase in her cash was only R50.

This simple example shows that taxpayers' taxable income cannot be calculated purely on their income, they must be allowed to deduct the expenditure that they incurred in producing that income. A taxpayer might incur a wide variety of expenditure in producing income, such as the cost of trading stock, salaries and wages, rent, and advertising. All of these costs would generally be deductible, because they are incurred in the production of income. In contrast, expenditure that is not incurred in the production of income is not deductible, because it does not give rise to any income that will be subject to tax.

So for example, the rent that she pays for the home where she lives, or the cost of her meals, is not deductible, because neither gives rise to income that will be subject to tax. So, expenditure is only deductible under section 11(a) if it is not capital in nature, and if it is incurred in the production of income. We must remember that income, when spoken about in tax, has a specific meaning. Income means amounts that will be included in gross income and will not be exempt from tax in terms of section 10.

So how do we determine whether expenditure is incurred in the production of income? In most cases this is fairly easy to do, the trading stock we buy is what we sell. The employees whose salaries we pay provide services to our customers. There is a clear causal link between the expenditure that we incur and the income that we earn.

Firstly, the courts have decided that expenditure does not need to have been necessarily incurred in the production of income, only that it needs to have been actually incurred in the production of income. This means that the taxpayer does not need to justify why he chose a particular course of action, or to prove that it was the most efficient course to take. He only needs to show that he actually incurred the expenditure and that this was to produce income.

For example, if our T-shirt shopkeeper employs two assistants to help in her shop, she can deduct the wages paid to both assistants, even if she could have managed with only one assistant, as long as both are actively engaged in the business.



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The second issue, the courts have been asked to consider, is how one should determine whether or not expenditure has been incurred in the production of income. In particular, does it need to have actually resulted in income accruing to the taxpayer? And does that income need to have been received or accrued in the same year of assessment? The courts have decided that the real test is whether expenditure has been incurred for the purpose of earning income.

This is more important than whether the taxpayer was successful in producing income or not. Expenditure is therefore deductible when it is incurred for the purpose of earning income, even if that income is only received or accrued in a later year of assessment, or even if no income is ever received or accrued as a direct result of that expenditure.

For example, if our shopkeeper decides to keep her shop open on a Saturday afternoon to increase her business, she can deduct the wages paid to her assistants for the afternoon even if no customers come to her shop. This is because she incurred the cost for the purpose of producing income, even though she was unsuccessful in doing so. The last issue to consider is how closely the expenditure has to be linked to the taxpayer's income-earning activities, to be deductible.

Most times the link between the taxpayer's expenditure and how they earn income is fairly obvious. The shopkeeper needed to buy the T-shirt in order to sell it, to pay the assistant to serve the customers, and even to pay her accountant to record the month's transactions so that she has the information she needs to make financial decisions that will keep her in business.

But, what about other types of expenditure; what happens if a customer gets injured because one of the assistants forgets to take the pins out of a T-shirt, and our shopkeeper has to pay compensation to that customer? Is that compensation in the production of income? How is paying this going to produce any more income? Through a series of court cases the court arrived at the test for such circumstances. The court decided that an amount is incurred in the production of income if the risk of incurring that expenditure is inherent in the taxpayer's business.

The term frequently used here is "inevitable concomitant". Inevitable is another way of saying certain or definite, and concomitant means "comes together with". It is not the expenditure itself that must be inevitable, but the risk. In other words, if you are going to sell T-shirts, is the risk of someone being hurt by a pin always there, or could that risk not reasonably be said to be part of the T-shirt business? While you can do certain things to reduce the chances of the risk occurring, like double-checking the T-shirts before putting them on display, it would seem that the risk of leaving a pin behind is always there. After all, if it wasn't, why would you double-check the T-shirts? So the compensation to the customer would be considered to be expenditure that is deductible.



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The difficulty arises in that there is no list of what types of expenditure are considered to be an inevitable concomitant of various types of businesses. Each situation you face as a tax consultant, or in tests and exams, will have to be decided, based on the facts presented.

Lets do a quick recap of the three points to consider, in determining whether expenditure is incurred in the production of income:

1. Expenditure has to be actually incurred, not necessarily incurred.
2. Expenditure doesn't have to actually produce income, as long as it was incurred for the purpose of producing income.
3. Expenditure incurred must be an inevitable concomitant of the business operations in order to be in the production of income.

Thanks for watching.