UNIT5:

TAXATION OF BUSINESS INCOME

5.1 SCOPE OF LIABILITY

Section 17 of the Income Tax Act classifies income to include **gains or profits from any business**, emoluments, dividends, interest, royalties, etc. The charge of tax on income under section 14(1) of the Income Tax Act therefore extends to imposing a tax on income from a business. It is therefore necessary to look at what constitutes a "business" and "gains and profits" for purposes of the Income Tax Act.

5.2 MEANING OF BUSINESS

The starting point in determining whether an item of income is business income is to determine whether the activity giving rise to the income is properly characterized as a business.

In broad terms, a business is a commercial or industrial activity of an independent nature undertaken for profit. While the word business is commonly used in income tax laws, some countries use other expressions, such as "entrepreneurship", to identify independent economic activity. Some systems have distinguished a trade from a profession or vocation.

Section 2 of the Zambian Income Tax Act provides an inclusive definition of the term 'business.' Business is defined to include:

(a) any profession, vocation or trade;
(b) any adventure in the nature of trade whether singular or otherwise;
(c) manufacturing;
(d) farming;
(e) agro-processing; and
(f) hedging.

Whether a person is carrying on manufacturing, farming, agro-processing or hedging activities would normally be clear. However, the carrying on of a *profession, vocation or trade* or of *any adventure in the nature of a trade* may not always be clear. These terms are considered below to have a fuller understanding of the word business.

Profession

The term 'profession' is not defined under the Income Tax Act. However, 'profession' has been judicially described as 'involving the idea of an occupation requiring either purely intellectual skill or manual skill controlled by the intellectual skill of the operator.'[1] In its ordinary sense, the term profession means an ordinary handicraft depending on the personal skills of the practitioner, often, though not necessarily, requiring a qualification obtained by examination. A profession differs from a trade as it involves an element of continuity. The courts have expressed the view that the distinction between a profession and a trade is one of degree and therefore, of fact.

Vocation

[1] See Scrutton LJ in IRC V Maxse [1919] 12 TC 41

The term 'vocation' has been judicially defined by Denman J in *Partridge v Mallandaine*[2] as '…the way in which a man passes his life.' This definition is somewhat unhelpful as it would embrace a very wide variety of activities not all of which would be vocations. The term wide definition of the term can be used to bring within the scope of income tax any form of regular and continuous profit earning, which does not fall within the categories of trade, profession or employment.

Trade

'Trade' has equally not been defined in the Income Tax Act. However, there is ample case law which gives guidance as to the meaning of this word. Lord Atkin said in, *Fry v Burma Corporation Limited*[3] stated that:

> "Trade refers to the various activities of commerce – the wining and using the products of the earth, or multiplying the products of the earth and selling them or manufacturing them and selling them, the purchase and sale of commodities or the offering of services for a reward such as conveyance and the like".

In *Ransom v Higgs*,[4] Lord Wilberforce stated that:

> "Trade normally involves the exchange of goods or services for reward…there must be something which the trade offers to provide by way of business. Trade, moreover presupposes a customer.'

In *Smith Berry v Cordy*,[5] the appellant bought endowment policies taken out by other people on their own lives and maturing at various dates to provide himself with regular income. Scott LJ said:

> "the learned judge held that it was not an operation within meaning of "trade" because there was no "dealing" in the policies in sense of their being bought and sold again …. this interpretation of schedule D is now too narrow…"

He further pointed out that the word trade must be used in its ordinary dictionary sense and went on to note from the Oxford dictionary showing how very wide the meaning of the term is including "anything practised for a livelihood." He stated:

> 'We think Lord Wright had the Oxford dictionary in mind when in National Association of Local Government Officers v Bolton Corporation (19430 AC 166 at page 184 he was discussing the meaning of the "trade" in the Industrial Courts Act, 1919. He then had the occasion to consider its ordinary meaning in English language. After pointing out that in that statute the word was used as including "industry", he said indeed trade is not only in the etymological or dictionary sense but in legal … a term of the widest scope. It is connected originally with the word tread and indicates a way of life or an occupation. In ordinary usage it may mean the occupation of a small shopkeeper equally with that of a commercial magnate. It may also be a skilled craft. It is true that it is often used … with a profession. A professional worker would not ordinarily be called a tradesman, but the word "trade" is used in the widest application to the appellation trade unions."

It would follow from the foregoing that when construing the meaning of the word trade regard must be to its ordinary meaning in English language as well as the judicial meaning. Whether or not an activity is an adventure or concern in the nature of trade is mixed question of law and

[2] [1886] 18 QBD 276.
[3] 15 TC 144.
[4] [1974] 3 All ER 964.
[5] 28 TC 257.

fact. A person does not trade if he simply procures others to trade; he must be involved in the buying and selling or rendering of service – *Ransom v Higgs*. If there is a regular buying and selling or rendering of service it is clearly trading and the gains or profits therefore are taxable, but an isolated or casual transaction may be 'an adventure, or concern in the nature of trade" if it is of commercial nature. In *Erichsen v Last*,[6] The Master of the Rolls said,

> "there is not I think, any principle of law which lays down what carrying on a trade is. There are a multitude of things which together make up the carrying on of a trade: but I know no one distinguishing incident for it is a compound of fact made up of a variety of things."

Adventure in the nature of trade

A person may claim that he is not carrying on a trade, but he may nevertheless be carrying on *an adventure or concern in the nature of trade.* The meaning of the words "adventure or concern" in the nature of trade has also been subject of judicial interpretation. The courts have tended to support the view that the word 'adventure" is unqualified by the attributes of the nature of trade but it is clear from the context that the word cannot be dissociated from the notion of trading, as Lord McMillan said in *Leeming v Jones*[7]*:*

> "…adventure in this context must plainly be a "trading adventure".

Similarly, the words "in the nature of trade" are clearly meant to bring within the scope of the charge an activity which has some but not all of the characteristics of a trade.

In *Rutledge v IRC*,[8] the taxpayer was a businessman connected with the film industry. Whilst in Berlin he purchased 1 million toilet rolls for £1,000 that he resold in the UK at a profit of approximately £11,000. The Court of Session held that the taxpayer had engaged in an adventure in the nature of a trade so that the profits were assessable. The Court stressed that such a quantity of goods must have been intended for resale.

Similarly, in *Martin v Lowry*,[9] a sale and purchase of 44 million yards of government surplus linen at a profit of £1,600,000 amounted to a trade largely because of the nature of the subject matter and the commercial methods employed to sell it.

Is there a business being carried on?

From the above, it can be seen that a 'business,' excluding profession and vocation, is generally characterised by one primary activity – "something is sold". That which is sold may consist of goods or services or both.

However, it should be noted that a sale of goods or services does not, *ipso facto* amount to the carrying on of a business. This point can be illustrated by the hypothetical case of Mr. Bambo:

> Mr. Bambo is a civil servant. Ten years ago he bought a house in Lusaka and lived in it with his family up to the present time. He now sells it and buys another house in which he and his family are living. He sold the previous house for K100, 000 more than he paid for it. He has therefore made a profit on the transaction. He may have changed his residence for a variety of personal reasons. Does the purchase and sale of his residence amount to carrying on a business such as business of property dealing? The answer appears to be no, yet it should be noted that such a transaction has much in common with transactions which amount to the carrying on of a business. Buying and

[6] 4 TC 422.
[7] 15 TC 366.
[8] 14 TC 490 [1929].
[9] [1926] 1 KB 550.

selling is one of the characteristics of a business, seeking to make profit is another. We may assume that in our example, Mr Bambo would have tried to sell his house for as much as he could obtain it.

What exactly is the difference between him and a property dealer? What characteristics are to be found in the activities of a property dealer which are absent in the case of Mr. Bambo?

In seeking to answer to answer these and similar questions, it becomes necessary to consider what constitutes carrying on a business. This is because a sale of goods or services that does not constitute carrying on of a business does not give rise to business income. Only a sale of goods or services that is conducted while carrying on a business will give rise to business income.

The question of whether or not there is a business may arise in two sets of circumstances:

(a) where no business is admitted;

(b) where a business is admitted but the item in question cannot be included in computing the profits or gains of that business in which case it may be possible to show that it in itself constitutes a separate trade.

There is no single test for the determination of whether a business is carried on. However, certain objective tests ('badges of trade') have been suggested by case law as tests to be taken into account in dealing with this question. The problem has occurred most often in transactions of purchase and sale, though it can arise in providing a service. The following ten factors have been considered as helpful in determining whether or not a sale of goods or services is a business transaction:

(a) profit seeking motive;

(b) the way in which the asset is acquired;

(c) the nature of the asset;

(d) modification of the asset to make it saleable;

(e) the interval of time between purchase and sale;

(f) the existence of a sales organisation;

(g) the frequency of transactions;

(h) the existence of a trading interest in the same field;

(i) the existence of financing arrangements; and

(j) the destination of the sale proceeds.

- **Profit seeking motive.** If a transaction is done in order to realise a profit this is usually prima facie evidence of trading activity. Purchase with a view to resale at a profit however, is not necessarily sufficient evidence in itself but must be weighed along with other relevant factors in a given situation. Often, however, the subject matter involved will be decisive. In ***Wisdom v Chamberlain***[10] the taxpayer, a comedian, who bought £200,000 of silver bullion as a hedge against an expected devaluation of the sterling pound and three

[10] [1968] 1 All ER 332.

months later sold it realising a profit of £50,000 was held to be trading. His claim that he had made no profit, but rather that the pound had fallen in value, was rejected.

It should be noted that the absence of a profit motive does not necessarily prevent a commercial operation from amounting to a trade. Certain concerns may be regarded as trading even in the strict sense. The surplus made by a public utility board, for example may not be destined for the benefit of a group of individual shareholders in a company. Nevertheless, it is perhaps true to say that the profit-seeking motive still exists. These boards are expected to cover expenses and may be required to raise sufficient surplus by their activities to pay off loans. In order to cover their commitments, they may be said to aim at making profit.

It may be noted that a profit seeking motive as evidence of trade is more easily assigned to a company than to an individual, because the reasons for the company's existence is normally that it is a profit making concern. An individual, on the other hand, may buy and sell at a profit and particularly if the transaction is isolated, he may be regarded as merely realising the profit on a capital investment.

- **The way in which the asset is acquired.** If it is by gift or inheritance, it will be difficult if not impossible to show that a subsequent sale is by way of trade. If the asset is acquired by purchase the circumstances (e.g. the market in which it is bought or the correspondence leading up to the purchase), may tend to show either that it was being bought for resale or that it was wanted for the private use or as an investment.

  If an asset acquired as a capital asset, for example by gift or inheritance, is later sold at a profit you can only succeed in taxing that profit as a trade profit if you can show that, at some point before sale, the asset became trading stock of a trade. This is the concept of supervening trading. Megarry J expressed the concept most clearly in the case of ***Taylor v Good***[11] where a taxpayer purchased a house with the intention of using it as a family home. The taxpayer's partner did not approve the house and refused to move in, which forced the taxpayer to sell the house immediately. The purchaser genuinely had the intention of not buying the property for a profit motive. As the sale was a short period of time after purchase it was still not deemed to be a trade. Within the decision the judge stated:

  > 'Even if the house was purchased with no thought of trading, I do not see why an intention to trade could not be formed later. What is bought or otherwise acquired (for example, under a will) with no thought of trading cannot thereby acquire an immunity so that, however filled with the desire and intention of trading the owner may later become, it can never be said that any transaction by him with the property constitutes trading. For the taxpayer a non-trading inception may be a valuable asset: but it is no palladium. The proposition that an initial intention not to trade may be displaced by a subsequent intention, in the course of the ownership of the property in question, is, I think, sufficiently established…'

  An argument that there has been a change of intention, if it is to succeed, must be demonstrable.

- **The nature of the asset.** This may also be important. The commodity purchased may be something like whisky, which can be regarded as for personal use or for use as trading stock, but it may be fairly clear that if bought in large quantity it can only be used for purposes of trading. If by its nature it might have been acquired for personal enjoyment or use or to produce income whilst held, e.g. a painting or jewellery or shares, the difficulties in the way of showing that a trade was being carried on are formidable or if a trade is

[11] 49 TC 277; [1974] STC 148; [1974] 1 WLR 556; [1974] 1 All ER 1137

already carried on, it may have the appearance of a capital asset in that trade e.g. plant or machinery.

An important case in this area was ***Marson v Morton***.[12] This was where land was purchased with the intention to hold it as an investment. No income was generated by the land, however, it did have planning permission. The land was sold latter following an unsolicited offer. As the transaction was far removed from the taxpayer's normal activity (potato merchant) and was similar to an investment, it was not a trading profit. The transaction was not an adventure in the nature of a trade.

See also *Rutledge v IRC*, 14 TC 490 [1929]

- **Modification of the asset to make it saleable.** There may be modifications of the asset by way of processing or manufacture of some kind of adoption to secure that it is readily marketable. Thus the blending of brandy before sale or the refitting of a ship between purchase and sale could be a pointer to the conclusion that the whole activity was in the nature of trade.

- **The interval of time between purchase and sale.** A man who buys land and holds it for many years before selling it may be in stronger position to argue that he is realising an investment than if he sells very soon after he has bought it. This kind of evidence, however, cannot be regarded conclusively either way, and the reason for sale could rebut the presumption that a quick sale is more consistent with a business activity (see *Wisdom v Chamberlain* [1969] 1 All ER 332).

- **The existence of a sales organisation.** Any form of organised activity designed to promote a sale is evidence in favour of deciding that a trade is carried on, e.g. a sale by advertisement or the use of a selling agency or sales staff. In the case of ***Cape Brandy Syndicate v CIR***,[13] a syndicate of chartered accountants distilled brandy. They distilled more than they could actually drink themselves and sold the surplus. HMRC sought to tax them as trading income. They argued that they were simply selling what they could not physically drink themselves. However, as they had set up a special phone line and information desk and published brochures and adverts advertising their brandy, HMRC successfully argued that they had commenced a trade.

- **The frequency of transactions.** If any particular transaction is found to be one of a series, and there is evidence of methodical activity then the transaction tends to fall into the general pattern which in a whole constitutes a trade. The case is much stronger than if there is only one transaction to be judged on its merits. In ***Pickford v Quirke***[14] for example, the court held that although a single purchase and sale by a syndicate of four cotton mills did not amount to trading, the series viewed as a whole did. On the other hand, a line is to be drawn between a number of desultory (unstable) haphazard transactions perhaps spread over years, which it may be argued, do not constitute a series at all and transaction related to each other occurring at not too great intervals of one time, and presenting appearances of habitual and continuous activity.

- **Existence of a trading interest in the same field.** If the man has an admitted trade or connection between the transaction in question and that trade, it may indicate that it was entered into as a matter of trade. Such finding may affect the decision.

[12] Ch D 1986, 59 TC 381; [1986] STC 463; [1986] 1 WLR 1343
[13] 12 TC 358.
[14] 13 TC 251 [1927].

In ***Harvey v Caulcott***[15] a builder claimed that certain properties that he had built and then sold many years later were investments and not part of his trading stock. On the facts of his case he succeeded but the court commented at page 165:

> 'Such a case as the present is always coloured by the fact that the man is a builder. That no doubt puts a peculiar onus on him, to show that the profit from the sale of some property is profit from an investment, or profit from something which is not trading stock. That onus is not incapable of discharge.'

The courts in other cases have also considered possible connections with a person's main trade. In ***CIR v Fraser***[16] for example, the taxpayer was a woodcutter who bought a consignment of whisky in bond. He subsequently sold the whisky through an agent at a profit. Within the decision the judge stated:

> 'It is in general more easy to hold that a single transaction entered into by an individual in the line of his own trade (although not part and parcel of his ordinary business) is an adventure in the nature of trade than to hold that a transaction entered into by an individual outside the line of his own trade or occupation is an adventure in the nature of trade.'

More recently in ***Marson v Morton and Others***[17] the court posed the question, at page 391G:

> 'Is the transaction in question in some way related to the trade which the taxpayer otherwise carries on? For example, a one-off purchase of silver cutlery by a general dealer is much more likely to be a trade transaction than such a purchase by a retired colonel.'

- **Financing arrangements.** If the purchaser especially borrows money in such circumstances it would be clear from the first that he would have to sell to repay the loan. He may undertake the purchase in the expectation that he will pay for it out of the proceeds of a trade which he is already carrying on. All these situations would on the whole favour the conclusion that he was trading. On the other hand, the evidence may be that the money for purchase is merely changing investments. See ***Wisdom v Chamberlain*** [1969] 1 All ER 332.

- **The destination of the proceeds**. If the proceeds of the sale of the asset are retained for the use in a similar transaction when the opportunity arises, this may indicate that the sale transaction was entered into as a matter of trade as opposed to when the proceeds of the sale are invested or used for a different purpose.

5.3 GAINS AND PROFITS

We have seen from the above discussion that the broad effect of the statutory provisions regarding the scope of tax liability in relation income from a business may be stated as follows:

(a) a 'business' is the subject matter of assessment; and

(b) only *profits* or *gains* of the business can be taxed.

[15] [1952] 33 TC 159
[16] [1942] 24 TC 498
[17] [1986] 59TC381

In a particular situation, therefore it is necessary to consider not only whether a business is carried on, but also whether that which is brought to be taxed represents 'profits' or 'gains' of that business.

The expression "gains or profits" is frequently encountered in the Income Tax Act but it is nowhere defined. The words must accordingly be construed in their ordinary dictionary meaning.

In its ordinary dictionary meaning, the word profit means the surplus remaining after total costs are deducted from total revenue. Taxation on business income is therefore only effected on the surplus after certain costs of the business are deducted from the total revenue of the business.

5.4 ALLOWABLE DEDUCTIONS

In computing gains or profit of a business for income tax purposes, the Income Tax Act in section 29(1)(a) allows for the deduction of "losses and expenditure, *other than of a capital nature*, wholly and exclusively incurred for the purposes of the business".

- **Deductible expenditure** – in terms of section 29 of the Income Tax Act, expenditure of a business will be deductible in arriving at the gains or profits of the business only if:

  (a) it is a revenue and not capital expenditure; and

  (b) it is incurred wholly and exclusively for business purposes.

  A distinction is drawn between expenses incurred in earning the profits (which are deductible) and expenses incurred after the profits have been earned, which are not deductible. For example, the payment of income tax is an application of profit which has been earned and is, therefore, not deductible.[18]

  Expenditure must be revenue not capital expenditure

  Expenditure is only deductible if it is revenue and not capital expenditure. It is therefore necessary to understand what constitutes capital expenditure.

  Capital expenditure is not defined in the statute and there is no single test to be applied in distinguishing capital from revenue expenditure. There are various tests for whether expenditure is of a capital nature, and the determination must depend upon the facts of the particular case. No single test applies in making that determination. Lord Denning in *Heather v P E Consulting Group Ltd*[19] made the following still very pertinent observations at page 321A:

  > "The question - revenue expenditure or capital expenditure - is a question which is being repeatedly asked by men of business, by accountants and by lawyers. In many cases the answer is easy: but in others it is difficult. The difficulty arises because of the nature of the question. It assumes that all expenditure can be put correctly into one category or the other: but this is simply not possible. Some cases lie on the border between the two: and this border is not a line clearly marked out; it is a blurred and undefined area in which anyone can get lost. Different minds may come to different conclusions with equal propriety. It is like the border between day and night, or between red and orange. Everyone can tell the difference except in marginal cases; and then everyone is

[18] See Ashton Gas Co. v A-G [1906] AC 10.
[19] [1972] 48 TC 293.

> in doubt. Each can come down either way. When these marginal cases arise, then the practitioners - be they accountants or lawyers - must of necessity put them in one category or another. And then, by custom or by law, by practice or by precept, the border is staked out with more certainty. In this area at least, where no decision can be said to be right or wrong, the only safe rule is to go by precedent. So the thing to do is to search through the cases and see whether the instant problem has come up before. If so, go by it. If not, go by the nearest you can find."

And in the case of *B.P. Australia Ltd. v. Commissioner of Taxation of the Commonwealth of Australia,*[20] Lord Pearce in referring to the matter of determining whether expenditure was of a capital or an income nature said:

> "The solution to the problem is not to be found by any rigid test or description. It has to be derived from many aspects of the whole set of circumstances some of which may point in one direction, some in the other. One consideration may point so clearly that it dominates other and vaguer indications in the contrary direction. It is a common sense appreciation of all the guiding features which must provide the ultimate answer."

In *Strick v Regent Oil Co Ltd*,**[21]** Lord Reid described the difficulties in making sense of the large number of decisions on this topic:

> "It may be possible to reconcile all the decisions, but it is certainly not possible to reconcile all the reasons given for them. I think that much of the difficulty has arisen from taking too literally general statements made in earlier cases and seeking to apply them to a different kind of case which their authors almost certainly did not have in mind - in seeking to treat expressions of judicial opinion as if they were words in an Act of Parliament.'

In the case *Vodafone Cellular Limited and others v Shaw (Inspector of Taxes)*[22] the Court of Appeal, citing a number of leading cases on the issue of capital / revenue expenditure, stated that the distinction is a question of law and that a number of factors may be taken into account in making the distinction, with some factors being particularly relevant when the question arises on an acquisition and others being of particular relevance when the question arises on a disposal, as was with the case at hand. The Court found that among the factors to be considered include:

(a) the nature of the payment, i.e., whether the payment is a lump sum or not; and

(b) the nature of the advantage obtained by the payment.

In *Vodafone Cellular Limited* the Court was of the view that where a lump sum payment is made for the purpose of commuting or extinguishing a contractual obligation to make recurring revenue payments then the payment is *prima facie* a revenue payment. If, however, the lump sum payment is made to secure the modification or disposal of an identifiable capital asset then the payment is a capital payment. Millett LJ stated as follows at p. 433:

[20] [1966] A.C. 224, [1965] 3 All E.R. 209
[21] [1965] 43 TC 1 at 29
[22] [1997] 69 TC 376.

> "But the principle that a payment made in order to commute or discharge a liability to make recurring revenue payments is itself a revenue payment is subject to an important qualification. If the liability to make recurring revenue payments is reduced or brought to an end by the modification or disposal of an identifiable capital asset, then any payment made for the modification or disposal is itself a capital payment."

The tests that have been applied by the courts in classifying expenditure as revenue or capital include the following:

- the object of the expenditure;
- whether the expenditure was made from fixed or circulating capital;
- whether the expenditure is recurring or once-off;
- whether the expenditure produces, improves or disposes of an asset; and
- how the expenditure would be treated on ordinary principles of commercial accounting.

(a) The object of the expenditure

This test, set out in the case of *Atherton v British Insulation Helsby Cables Limited*,[23] arguably looks to the purpose or motive of expenditure ('...with a view to...') - expenditure is of a capital nature if it is made *for the purpose of bringing into existence an asset for the enduring advantage of the business*. In *Atherton*, Viscount Cave said at p. 192:

> "Where an expenditure is made with a view to bringing into existence an advantage for the enduring benefit of a trade, I think there is very good reason (in the absence of special circumstances leading to opposite conclusion) for treating such an expenditure as properly attributable not to revenue but to capital"

The modern authorities, however, reject that approach. Instead, they argue that you should seek to identify on what the expenditure was incurred or what was obtained for it (or would have been obtained if the expenditure had not proved to be abortive). Thus, in *Tucker v Granada Motorway Services Ltd*[24] expenditure for the purpose of reducing a revenue outgoing (rentals due over a period of years under a lease of land) was nevertheless capital because it was incurred on a capital asset (the lease of land).

See also *Lawson v Johnson Matthey Plc* [1992] 65TC39.

(b) Whether expenditure was from fixed or circulating capital

In his classic definition, Adam Smith distinguished between capital and revenue expenditure by reference to fixed and circulating capital. According to this test, *expenditure will be revenue expenditure if made out of circulating capital and capital expenditure if made out of fixed capital of the business.* In income tax law the distinction has been recognised repeatedly, and in discussing it the courts have had recourse to the economists (Adam Smith, Marshall, Mill etc.) and to company law.[25] A defect with this test is that the

[23] [1925] 10 TC 155
[24] [1979] 53 TC 92
[25] See Viscount Haldane's judgment in **John Smith and Son v Moore [**1921] 12 TC 266

classification of the asset as fixed or circulating depends upon the particular business.

The question that follows is what is 'fixed' and 'circulating' capital?

In his 'Wealth of Nations', Adam Smith described 'fixed capital' as "what the owner turns to profit by keeping it in his own possession", and 'circulating capital' as "what he makes profit of by parting with it and letting it change masters."

The courts have not always found this often quoted definition to be helpful.

In *Van den Berghs Ltd v Clark*[26] the distinction between fixed and circulating capital played some part in the Court of Appeal finding for the Revenue. In the circumstances and for the reasons he gives at page 432 Lord Macmillan did not find the Adam Smith definition helpful:

> "…I confess that I have not found it very helpful. Circulating capital is capital which is turned over and in the process of being turned over yields profit or loss. Fixed capital is not involved directly in that process, and remains unaffected by it. If this is to be the test, I fail to see how the appellants could be said to have been engaged in turning over the asset which the agreements in question constituted. The agreements formed the fixed framework within which their circulating capital operated; they were not incidental to the working of their profit-making machine but were essential parts of the mechanism itself. They provided the means of making profits, but they themselves did not yield profits. The profits of the Appellants arose from manufacturing and dealing in margarine."

Lord Macmillan's strictures are but one of many examples where judges have warned against taking a particular method of identifying the capital/revenue divide and applying it to all and sundry cases.

In the case of *J & R O'Kane and Co. v Commissioner of Inland Revenue*[27] Roland L.J. quotes from 'Buckley on Companies' at p. 336 as follows:

> "The author would define fixed capital as property acquired and intended for retention employment with a view to profit, as distinguished from circulating capital, meaning property acquired or produced with a view to resale or sale at a profit".

A definition of difference is suggested again by Rowlatt J., in *Rees Roturbo Development Syndicate Ltd v Ducker & CIR*[28] at p.379:

> "In one sense the words "capital assets" are not words of art because you do not have one set of assets representing income. Of course, but what is meant by the phrase "capital assets" is that this is an asset which represents fixed capital as opposed to circulating capital, that is to say that this is an article which is possessed by an individual in question, not that he may turn it over and make a profit by the sale of it to his advantage, but that he may keep it and use it and make a profit by its

[26] [1935] 19 TC 390
[27] [1922] *12 TC 303*
[28] [1928] *13 TC 366*

> use. Then if an article of that sort is sold at a profit, that profit is not a profit of trade."

Very briefly, 'Carter's Advanced Accounts' defines fixed and floating capital as follows:

- Fixed capital comprises all the fixed assets
- Circulating (or floating) capital consists of the floating or circulating assets.

These terms mark a distinction which constantly occurs in commercial practice. There appears to be little difference between circulating and floating capital, except that the word circulating emphasises the liquidity of the capital and the case of converting it into cash. Sometimes the fixed capital is referred to as capital assets of the concern.

Thus premises, plant, leases and goodwill are fixed capital retained and used in the business; while stock, book debts and cash are circulating capital, turned over in order to make a profit.

The courts, however, are naturally concerned with arguable items and have repeatedly affirmed that the distinction is not easy to apply in the borderline example. There are two reasons why this should be so, first, the same kind of asset may either be fixed or circulating according to the nature of the business. Thus "investments" would be circulating to a stockbroker but fixed capital to an ordinary trader. Similarly, plant would be fixed capital to an ordinary manufacturer but circulating capital to a company which manufactures or deals in plant. Secondly, the existence of arguable items in a particular case shows that although the distinction can be said to be real one there is no hard and fast line to be drawn. The one kind of capital shades off into another. The point made is by Lord Hanworth, MR in *The European Investment Trust Co. Ltd v Jackson 18 TC* at page 13 –

> "The question whether or not a sum is fixed capital is one of degree; and he goes on to say, therefore, a question of fact."

Sometimes the question arises in regard to something that does not appear as an asset in the balance sheet at all e.g. the right secured by a contract may be very valuable and consideration often entering into or cancelling the contract may be capital expenditure or a capital receipt.

The distinction being clear in principle between fixed and circulating capital it follows from what has been so far discussed, its application in practice to a disputed item requires a close examination of various factors including:

(i) the nature of the trade;
(ii) the relation of the asset to ordinary trading operations;
(iii) the purpose for which the asset was acquired;
(iv) the circumstances in which it was acquired and sold.

It is only when the full facts are known that a decision can be taken whether the particular receipt is to be included in computing the gains or profits of the business. It may be noted incidentally that it is difficult to show that fixed capital has changed its nature into circulating capital. One or two judges in

obiter dicta have suggested that such a change is possible but so far has been decided on the basis of a change having taken place.

(c) Whether expenditure is recurring or once-off

A once and for all expenditure, even though it brings no enduring asset into existence, is more likely to be of a capital nature than a recurring expense. In *Watney Combe Reid & Co. Ltd v Pike,*[29] for example, ex gratia payments made by Watneys (the brewers) to tenants of tied houses to compensate them for the termination of their tenancies were held to be capital, because their purpose was to tender capital assets (the premises) more valuable.

Expenditure which is not once-off (i.e. recurring expenditure) may nevertheless be capital. Expenditure of a recurring nature on the acquisition of assets which are clearly fixed rather than circulating capital (for example a fleet of vehicles used by a concern's sales representatives), for example, remains capital expenditure. Moreover, an outgoing does not cease to be of a capital nature merely because it is payable by instalments.[30] But there can sometimes be a fine line between the payment of a capital sum by instalments and revenue payments for the use of an asset, particularly finance lease rental payments. But a 'once and for all' payment may not necessarily be capital (for example, paying off an unsatisfactory employee).

(d) Whether the expenditure produces, improves or disposes of an asset

One of the tests in determining whether expenditure is of a capital nature is whether the expenditure produces an asset or at least an advantage to the permanent and enduring benefit of a trade. If so, the expenditure is a capital expenditure - *Sampson v The Commissioner of Taxes.*[31]

Expenditure will also be capital if it spent for the improvement[32] or disposal[33] of a capital asset. It is not sufficient that it was paid in connection with (or on the occasion of) the acquisition, improvement or disposal of the asset. For example, the goodwill of customers may be a valuable capital asset. But that is not enough to make expenditure such as the pay of staff (who, by serving customers well, may have helped create the goodwill) a capital outgoing. See also *Lawson v Johnson Matthey Plc* [1992] 65TC39.

There is no simple yardstick of the length of time for which an asset or advantage must endure before it may be regarded as capital. There are other important considerations such as: how the asset or advantage functions in the context of that particular trade; how it benefits the business, and whether it is obtained by a lump sum or by periodical payments.

It is necessary to identify a specific capital asset for which the expenditure is incurred. See *Tucker v Granada Motorway Services Ltd.*[34] The asset may be tangible or intangible.

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[29] [1982] 57 TC 372
[30] See CIR v Adam [1928] 14 TC 34
[31] [1966] Z.R. 51 See also Rolfe v Wimpey Waste Management Ltd [1989] 62 TC 399
[32] See Tucker v Granada Motorway Services Ltd [1979] 53 TC 92
[33] See Mallet v The Staveley Coal & Iron Co Ltd [1928] 13 TC 772
[34] [1979] 53TC92

Where the asset is tangible the question will usually be straightforward - either the asset is held as a current (revenue) asset such as trading stock (or otherwise for resale at a profit) or it is held as a fixed (capital) asset. (See below for intangible assets.)

Where the expenditure is on an intangible benefit or advantage (for example, trading agreements, licences or other intangibles) it will be necessary to ask whether the identifiable asset is of a sufficiently substantial and enduring nature to count as capital. See for example:

Heather v P E Consulting Group Ltd [1972] 48 TC 293

Anglo-Persian Oil Company Ltd v Dale [1931] 16 TC 253

CIR v Carron Company [1968] 45 TC 18

In *Walker v Joint Credit Card Co. Ltd*[35] for example, a payment by a credit card company to preserve its goodwill was held to be a capital expenditure.

(e) How payment would be treated under ordinary accounting principles

For determining profits for accounting purposes, the important issue is whether expenditure is 'consumed' (i.e. used up) and therefore must be charged to the profit and loss account; or whether it the expenditure brings into existence an asset or advantage for the enduring benefit of the trade, in which case the expenditure is capital expenditure and must be added to the asset account.[36] Capital expenditure is commonly found on the cash flow statement under "investment in plant, property, and equipment" or a similar section.

For tax purposes, capital expenditure is a cost which cannot be deducted in the year in which it is paid or incurred and must be capitalized. The general rule is that if the acquired property's useful life is longer than the taxable year, then the cost must be capitalized. The capital expenditure costs are then depreciated over the life of the asset in question.

Expenditure must be 'wholly and exclusively' incurred for business purposes

A taxpayer must justify any given deduction so as to show that it relates to an expenditure incurred wholly and exclusively for the purposes of its trade or in the production of its income, otherwise the deduction will be disallowed.

Read: *Commissioner of Taxes v Basil Stores Limited (1973) Z.R. 107*, where the High Court upheld the disallowance of excessive amounts indicated as directors' fees which the Respondent claimed as deductible amounts from its income on the basis of "expenditure incurred wholly and exclusively for the purposes of its trade or for the production of its income". The court held that the services rendered by the directors in question were largely nominal and the remuneration paid to them could not be regarded as expenditure incurred wholly and exclusively for the purpose of its trade or in the production of its income.

In *Mallalieu v Drummond 1983 STC 665* the taxpayer was a practicing lady barrister who bought black clothing for her court appearances in conformity

[35] [1982] 55 TC 617
[36] See: *Atherton v British Insulation Helsby Cables Limited*.

with the Bar Council's guidance notes on dress. She claimed the cost of replacing and laundering her court clothes. The Court held that the taxpayer's object was both to serve the purpose of her profession and also to serve her personal purposes.

Part IV of the Income Tax Act sets out other specific allowable deductions and these include:

- **Foreign currency exchange gains and losses** – section 29A - any foreign currency exchange losses, other than those of a capital nature, shall be deductible in the charge year in which such losses are realised, that is, in the charge year in which the person or partnership concerned is required to pay the additional kwacha or is allowed a rebate or a reduction in settlement of a foreign of a foreign debt or liability.

  While foreign exchange losses of a capital nature are generally not deductible, foreign exchange losses of a capital nature incurred *on borrowing used for the building and construction of an industrial or commercial building i*s deductible.

  The deduction of foreign currency exchange losses does not apply to banks.

- **Losses** – section 30 - Any loss incurred in a charge year by a person from:

  (a) a source other than a mining operation, shall be deducted from that person's income from the same source on which the loss was incurred; and

  (b) a mining operation, shall be deducted from 50 percent of the income of the person from the mining operation.

  Where a loss in respect of operations other than a mining operation exceeds the income of a person for a charge year, the excess shall, as far as possible, be deducted from that person's income from the same source on which the loss was incurred in the following charge year.

  Where a loss in respect of mining operations exceeds 50 percent of the income from mining operations for a charge year, the excess shall, as far as possible, be deducted from 50 percent of that person's income from the mining operation in the following charge year.

  The carry-over of losses to the subsequent charge year is subject to the following limitations:

  (a) a loss incurred by a person carrying on mining operations or hydro and thermo power generation shall not be carried forward beyond 10 subsequent charge years after the charge year in which the loss was incurred; and

  (b) in any other case, the loss incurred shall not be carried forward beyond 5 subsequent charge years after the charge year in which the loss is incurred.

- **Capital allowances** – section 33 - Capital allowances are deductible in ascertaining the gains or profits of a business and the emoluments of any employment or office for each charge year-

  (a) for buildings, implements, machinery and plant, and premiums, according to the provisions of Parts I to V of the Fifth Schedule;

  (b) for capital expenditure in relation to mining operations, according to the provisions of Parts I to VI inclusive of the Fifth Schedule; and

(c) for farm improvements and works, according to the provisions of the Sixth Schedule.

Capital allowances for buildings, implements, machinery and plant, and premiums

Under the Fifth Schedule of the Income Tax Act, the following are the capital allowances permitted:

(i) initial allowance for industrial buildings;
(ii) wear and tear allowance;
(iii) balancing allowance;
(iv) premium allowance; and
(v) improvement allowance.

Initial allowance for industrial buildings

Under paragraph 3 of the Fifth Schedule, a deduction known as an initial allowance is allowed in respect of capital expenditure incurred on the construction of a building intended to be used as an industrial building, or on an addition to or an alteration of an industrial building.

An 'industrial building' is defined in paragraph 1 of the Fifth Schedule as:

(a) a building or structure in use for the purposes of any electricity, gas, water, inland navigation, transport, hydraulic power, bridge or tunnel undertaking, or any like undertaking of public utility, or is in use for the purposes of any trade which: (i) is carried on in a mill, factory or like premises; (ii) consists of the manufacture of goods or materials, or their subjection to any process; (iii) consists of the storage of goods or materials to be used in the manufacture or processing of other goods; (iv) consists of the storage of goods on import or for export; or (v) consists in the working of a mine or well for the extraction of natural deposits;

(b) any building constructed as a hotel which the Minister of Tourism has certified as such;

(c) any building constructed or acquired to provide housing for the purposes of that person's business; and

(d) any building in use for the welfare of employees engaged in the undertakings and trades referred to in paragraph (a) above e.g. a cafeteria, recreational facility, health centre etc.

The allowance is calculated as a percentage of the expenditure incurred – currently **10 percent** – and is deductible only once in the charge year in which the said building, addition to or alteration is brought into use as an industrial building.

The initial allowance is deductible from the cost of the building in determining its written-down value.

The initial allowance is also available to a person who acquires the industrial building from another person who constructed it in the course of his trade and is the first user of that building. In such case the capital expenditure is the cost of acquisition.

Wear and tear allowance for buildings

Under paragraph 4 of the Fifth Schedule, a wear and tear allowance (also known as 'writing down allowance') is allowed as a deduction in ascertaining the business profits of any person in a charge year. The wear and tear allowance is available to a person who uses for the purposes of his business an industrial or commercial building which he acquired, constructed, added to or altered.

A 'commercial building' is defined in paragraph 2 of the Fifth Schedule as 'a building or structure, or part thereof, which is not an industrial building as defined in paragraph 1, or farm improvement or farm works as defined in the Sixth Schedule, and which is in use for the purposes of any business.'

The wear and tear allowance is also calculated as a percentage of the original cost of the building to such person, provided that in no case shall the total of all the deductions allowed to such person exceed the cost to such person of such acquisition, construction, addition or alteration, as the case may be.

Currently, wear and tear allowance for industrial buildings is **10 percent** in the case of low cost housing that qualifies as industrial buildings, and **5 percent** for other industrial buildings. Wear and tear allowance for commercial buildings is **2 percent**.

Where a building is used by a person as an industrial building for part of a charge year and as a commercial building for another part of the same charge year, that building shall be regarded as used by that person solely as an industrial building for that charge year.

No wear and tear allowance shall be deductible for any charge year in respect of any building if at any time during the said charge year that building *is used as his usual dwelling place* by-

(a) any individual who uses such building for the purposes of the business, or by any individual partner in such business;

(b) any individual who, by reason of his shareholdings, or of his control of shareholdings, in any company or by reason of any partnership interest, is in a position to exercise control, directly or indirectly, over the person or persons using the building for the purposes of the business;

(c) a director of a company using the building for the purposes of its business, who is not a whole time service director thereof.

Wear and tear allowance for implements, machinery and plant

Under paragraph 10 of the Fifth Schedule, a wear and tear allowance is allowed as a deduction in ascertaining the business profits of the business for each charge year of any person who has used any implements, machinery or plant belonging to him for the purposes of his business.

Where a person holds any implements, machinery or plant under a hire-purchase agreement as defined in the Hire-Purchase Act, then the implement, machinery or plant shall be deemed to belong to that person for the purposes of this paragraph.

The wear and tear allowance for any charge year is also calculated as a percentage of the original cost of the implement, machinery or plant; provided that in the charge year in which the business ceases the allowance shall be the amount of the residue of the original cost.

The wear and tear allowance for implements, machinery and plant is calculated on a straight line basis of the original cost of the implements, machinery and plant. *However, in the case of any implements, machinery or plant which were acquired by a person other than for the purpose of a business, the original cost shall be the current market value of such implements, machinery or plant as determined by the Commissioner-General in the charge year that they are first used for the purpose of a business.*

Currently, wear and tear allowance for implements, machinery and plant (including commercial vehicles) is **25 percent,** while the wear and tear allowance for non-commercial vehicles is **20 percent**.

The wear and tear allowance on any implement, machinery or plant which is proved to the satisfaction of the Commissioner-General to be exclusively and directly used in *farming, mineral processing, manufacturing, tourism or leased out under an operating lease* for any charge year, is calculated on a straight line basis at the rate of **50 percent** of the cost.

The wear and tear allowance on the cost of any new plant or machinery acquired and used by any soft drinks manufacturer in respect of such business carried on by him in a rural area, shall, in any charge year, be calculated on a straight-line basis at the rate of **20 percent** of the cost of such plant and machinery.

Balancing allowance

This is provided for under paragraph 5 of the Fifth Schedule. It is available where any building in respect of which an initial or wear and tear allowance has been or could have been deducted ceases to belong to a person or permanently ceases to be used by him for the purposes of any business. It is the difference between the written down value and disposal price or market value of the building. If the amount realised on disposal is less than the written down value of the building, the difference is granted as a balancing allowance and is deductible from the income of the business in respect of which the said building was last used in order to arrive at the taxable profits of that business for the charge year of such cessation.

Example

The balancing allowance on the disposal of a commercial building developed at a cost of K2,000,000 with total wear and tear allowances of K200,000 over 5 years and disposed of at a price of K1,500,000 can be calculated as follows:

Cost of building:	K2,000,000
Less wear and tear allowances:	K 200,000
Written down value:	K1,800,000
Less amount realised on disposal:	K1,500,000
Balancing allowance:	K 300,000

The amount of K300,000 can be deducted from the income of the business in arriving at the taxable profits of the business in that charge year.

If, however, the amount realised on disposal of the building is greater than the written down value of the building, the difference becomes capital recovery which constitutes taxable income. Thus, in the above example, if the amount realised on disposal was K1,900,000, the K100,000 difference would be added to the profits of the business in arriving at taxable income.

Where wear and tear allowance has been deducted for part only of the entire period of ownership or possession of the building, the allowance deductible shall be determined by multiplying the balancing allowance as above calculated by the number of years in respect of which wear and tear allowance has been deducted and dividing the result by the number of years of the said ownership or possession.

Thus, if in the above example, the building was owned for a period of 5 years but wear and tear allowance in the amount of K120,000 was only deducted for a period of 3 years. The deductible balancing allowance would be calculated as follows:

Cost of building:	K2,000,000
Less wear and tear allowances:	K 120,000
Written down value:	K1,880,000
Less amount realised on disposal:	K1,500,000
	K 380,000

K380,000 x 3 years = K1,140,000

K1,140,000 ÷ 5 years = K228,000

Therefore, the deductible balancing allowance will be K228,000.

Premium allowance

Under paragraph 14 of the Fifth Schedule, a deduction is allowed (called a premium allowance) in ascertaining the profits of a person's business equal to the amount of any premium or like consideration paid by him for the right of use of machinery or plant, or for the use of any patent, design, trade mark or copyright, or for the use of other property which the Commissioner-General determines is of a like nature, where such right is used by that person for the purposes of his business.

The amount of any premium allowance allowed as a deduction for any charge year shall not exceed the amount of the premium or like consideration divided by the number of years for which the right of use is granted. In other words, the allowance is pro-rated over the period of years for which the right of use the particular item has been granted.

For example, if a company pays K10,000 for the right to use a patent for 5 years, the premium allowance is:

K10,0000 / 5 years = K2,000 per year

Where a person acquires any interest in the ownership of property for payment of a premium or like consideration for the right of use of which he has been allowed a deduction, he ceases to be allowed that deduction as from the date of such acquisition.

Improvement Allowance

Under paragraph 4A of the Fifth Schedule, a person operating in a priority sector or in respect of a priority product and operating in multi-facility economic zone or industrial park designated as such under the Zambia Development Agency Act, 2006 who in that year uses for business, an industrial or commercial building which that person has constructed, or altered, a deduction shall be allowed (called improvement allowance) for that charge year.

The improvement allowance is calculated as a percentage of the original cost of such industrial or commercial building to such person, currently at 100 percent.

Capital allowances for farm improvements and works

Under the Sixth Schedule of the Income Tax Act, the following are the capital allowances permitted:

(i) a farm improvement allowance; and

(ii) a farm works allowance.

Farm improvement allowance

Under paragraph 2 of the Sixth Schedule, an allowance (known as a farm improvement allowance) is allowed in determining the profits of a farming business for any expenditure incurred in a charge year on farm improvements.

A "farm improvement" is defined under paragraph 1 of the Sixth Schedule as 'any permanent work, including a farm dwelling and fencing appropriate to farming and any building constructed for and used for the welfare of, employees, and in relation to farming land owned or occupied by the farmer…'.

Read: *Enviro-Flor Limited v Zambia Revenue Authority* 2001/RAT/36

A farm improvement allowance is calculated at **100 percent** of the expense incurred on the farm improvement.

Where the expenditure on farm improvements is partly in respect of a farm improvement, and partly in respect of some other purposes, only such proportion of that expenditure as the Commissioner-General may determine will be taken into account for the purposes of the allowance.

Farm works allowance

Under paragraph 5, a deduction (called the farm works allowance) is allowed to a farmer in respect of expenditure on farming land in his ownership or occupation and for the purposes of farming, on stumping and clearing, works for the prevention of soil erosion, boreholes, wells, aerial and geophysical surveys, and water conservation (collectively referred to as "farm works").

The expenditure incurred in respect of any farm works is allowed as a deduction in ascertaining the profits of his farming business for that year, provided that where the person incurs the expenditure in a charge year prior to the charge year in which he commences farming operations the expenditure shall be allowed as a deduction in the charge year in which he commences farming operations.

A farm works allowance is calculated at **100 percent** of the expense incurred on the farm improvement.

In terms of paragraph 8 of the Sixth Schedule, the amount of any capital expenditure incurred in respect of farm improvement or in respect of farm works will be reduced by the amount of any subsidy or grant received by the farmer from public funds towards or in aid or in recognition of such expenditure.

- **Investment allowance –** section 34 - Where a person incurs capital expenditure on the construction of, addition to, or alteration of any industrial building, as defined in paragraph 1 of the Fifth Schedule, to be used by him for the purposes of his business *as a manufacturer*, an investment allowance of 10 percent of such expenditure shall be

deducted in ascertaining the gains or profits of that business for the year in which the said building, addition or alteration is first used for the said purposes. *However, unlike the initial allowance, the investment allowance is not deductible from the cost of the building to arrive at its written down value.*

- **Development allowance** – section 34A - Where a person incurs expenditure on the growing of rose flowers, tea, coffee, or banana plant or citrus fruit trees, or other similar plants or trees, a development allowance of 10 percent of such expenditure is deductible in ascertaining the gains or profits of that business for the charge year. In the case of a person growing for the first time the aforementioned plants or trees, the development allowance may be carried forward to the following charge years up to the first year of production, but in no case shall the development allowance in respect of more than three consecutive years be carried forward.

- **Preliminary business expenses**: section 35 – expenses incurred within 18 months before the commencement of a business are regarded as deductible preliminary business expenses so long as they are of non-capital nature i.e. they should not be expenses on capital assets. This deduction is allowed in the first year of business.

- **Post-cessation expenses** – section 36 – expenses incurred by any person after the cessation of his business which, if incurred prior to the cessation, would have been deductible in computing his gains or profits from the business, are deductible from his income for the charge year to the extent to which the said expenses have not already been deducted in computing the gains or profits of the ceased business. The deduction is only allowed in the charge year in which the expenses are incurred or, if he has no income in that charge year, from his income for the charge year in which the business ceased.

- **Payments to approved funds** – section 37 - A deduction is allowed in ascertaining the gains or profits of a business in a charge year, any amount paid by the business by way of contribution to an approved fund, such as the National Pension Scheme Authority, established for the benefit of the employees of the business.

  However, no deduction is allowed under section 37 in respect of any contribution other than a contribution-

  (a) which is not a contribution in arrear; or

  (b) which is a special lump sum contribution allowed to be deducted under and in accordance with section 37(2).

  The deduction to be allowed for a charge year in respect of current contributions to an approved fund shall not exceed 20 percent of the emoluments liable to tax received from the employer in that charge year by each employee in respect of whom the contributions are paid.

- **Deduction for share option scheme** – section 37A - A deduction is allowed in ascertaining the gains or profits of an employer for a charge year of any amount incurred by the employer in the establishment or in the administration of an approved share option scheme for that year.

- **Technical education** - section 38 - A deduction is allowed in ascertaining the gains or profits of a business for any payment made for the purposes of technical education relating to that business or for the purposes of obtaining further experience, training or

qualifications, relating to that business; provided that no deduction will be allowed under section 38 in respect of any payment made-

(a) on behalf of an individual who is related by blood or marriage to the person making the payment, or to a person who is able to control directly or indirectly the person making the payment;

(b) in pursuance of an agreement or undertaking to the effect that the person making the payment will receive any reciprocal benefit for such payment where made on behalf of an individual who is related by blood or marriage to any other party to that agreement or undertaking.

- **Subscriptions** – section 39 - A deduction is allowed in ascertaining the gains or profits of a business for any subscription paid by a person in respect of his membership of a trade, technical or professional association which is related to his business, employment or office. For example, a payment made by a legal practitioner to the Law Association of Zambia as membership fee for the issuance of a practicing certificate will be deductible from the business income of such legal practitioner.

- **Donations to public benefit organisations** – section 41 - Any amount paid by a person during a charge year to a public benefit organisation shall be deducted from the income of that person for that charge year if-

  (a) the payments are in money or money's worth;

  (b) the payments are made for no consideration;

  (c) the public benefit organisation to which the payment is made is one approved by the Minister of Finance; or the payment is made to a public benefit organisation that is owned by the Government.

  A deduction under section 41 may not exceed 50 percent of the assessable income of the person for that charge year.

- **Deductions for research** – section 43 - A deduction is allowed in ascertaining the gains or profits of a business of any expenditure, not being expenditure of a capital nature, incurred by the business during a charge year on experiments or research relating to the business.

  A deduction is also allowed for any contribution to a scientific or educational society or institution or other like body of a public character approved by the Commissioner-General where a condition of the contribution is that it must be utilised by the society, institution or body, as the case may be, solely for the purposes of industrial research or scientific experimental work connected with the business.

- **Deduction for bad and doubtful debts** - section 43A - A deduction is allowed in ascertaining the gains or profits of a business for debts *to the extent that the debts have been included in the income of that business and to the extent that they are proved to the satisfaction of the Commissioner-General to be bad or likely to become bad* i.e. not likely to be paid. Where there is no income from that business for the charge year for which such deduction is due that deduction will be deemed to be a loss under section 30.

Section 43A does not stipulate what means should be used to satisfy the Commissioner General that debts have become bad or are likely to become bad. The determination of whether satisfactory proof has been given by the taxpayer is therefore the discretion of the Commissioner-General. You will note in section 114 of the Income Tax Act that when it is provided in the Income Tax Act that a particular matter is subject or according to the Commissioner-General's discretion, an exercise of such discretion shall not be questioned in any proceedings.

Read: *Lusaka Water and Sewerage Company v Zambia Revenue Authority - 1999/RAT/36*

Where a deduction has been allowed for a bad or doubtful debts and in the subsequent charge year part or all the debt is recovered, the amount of the recovery or, where less, the total deductions allowed in one or more charge years in respect of that debt, shall be assessable in the charge year in which the recovery is received (section 43A (2)). Where recoveries are effected in more than one charge year, the total amount assessable in each charge year after the first such charge year shall not exceed the amount of the recovery in that later year or, where less, the total of the deductions previously allowed less any recoveries assessable in previous charge years.

- **Deduction of mineral royalty** – section 43B. - A deduction shall be allowed in ascertaining gains or profits of a business of any mineral royalty payable and paid for a charge year in pursuance of the provisions of the Mines and Minerals Development Act 2008.

- **Deduction for employing handicapped person** - section 43D - A deduction shall be allowed in ascertaining the gains or profits of a business in respect of each person with disability who has been employed full-time by such business for the whole or substantial part of the charge year for which the deduction is claimed. The amount of the deduction allowed under section 43D is K2,000.

5.5 NON-PERMITTED DEDUCTIONS

Section 44 enumerates certain items of expenditure that may not be deducted. No deduction is made in respect of any of the following matters:

(a) the cost incurred by an individual in the maintenance of himself, his family or establishment, or which is a domestic or personal expense;

(b) any loss or expense which is recoverable under any insurance contract or indemnity;

(c) capital expenditure or loss of capital, other than loss of stock in trade, unless specifically permitted under the Income Tax Act (See *Zamcell Limited v Zambia Revenue Authority*, 1999/RAT/36);

(d) any payment to a pension or superannuation fund or scheme or premium payable under an annuity contract, except such payments as are allowed under section 37;

(e) any tax or penalty chargeable under the Income Tax Act;

(f) any amount which would be deductible in ascertaining the income from a source or from income which the Commissioner-General is prohibited from including in any assessment under the provisos to section 63(1);

(g) any expenditure incurred or capital asset employed, whether directly or indirectly, in the provision of entertainment, hospitality or gifts of any kind, provided that this paragraph shall not apply to-

(i) any expenditure incurred or capital asset employed in the provision of anything which it is the purpose of a person's business to provide and which is provided in the ordinary course of that business for payment or for the purpose of advertising to the public generally without payment;

(iii) any expenditure incurred in the provision of a gift to any person consisting of an article incorporating a conspicuous advertisement for the donor the cost of which to the donor, taken together with the cost to him of any other such articles given by him to that person in the same charge year, does not exceed K100;

(h) any amount incurred by the employer in the establishment or administration of a share option scheme, except such amounts as are allowed under section 37A;

(i) the cost of any benefit or advantage not capable of being turned into money or money's worth that is provided to employees, subject to such directions as shall be issued by the Commissioner-General; see *Chempro (Zambia) Limited v Zambia Revenue Authority, 2000/RAT/57*.

(j) any copper price participation payment or cobalt price participation payment; and

(k) incidental costs of obtaining finance such as commitment and guarantee fees, commissions and any other incidental cost of a similar nature.

5.6 TURNOVER TAX

Turnover tax is a tax that is charged on gross sales/turnover (i.e. earnings, income, revenue, takings, yield and proceeds) of certain businesses and persons.

Turnover tax for businesses is provided for under section 64A(2) of the Income Tax Act.[37] This section states as follows:

> "The Commissioner-General may make a standard assessment requiring any person carrying on any business, other than the business referred to in subsection (1), with an annual turnover of eight hundred thousand kwacha or less to pay tax on turnover at the rate set out in Part II of the Ninth Schedule;
>
> Provided that the provisions of this subsection shall not apply to income earned from the provision of consultancy services or from mining operations or to income earned from a business that qualifies for voluntary registration under the Value Added Tax Act and is issued with a value added tax registration certificate…

According to section 64A(2), therefore, turnover tax is applicable to any person carrying on any business, other than a business referred to in section 64A (1), with an annual turnover of K800,000 or less. The business referred to in section 64A (1) is the business of operating a public service vehicle for the carriage of persons.

Inapplicability of turnover tax

[37] It will be noted that section 64A(3A), which came into effect on 1 January 2022, also imposes a turnover tax on persons and partnerships that let out real property.

According to section 64A(2), turnover tax does not apply to the following businesses even if they are within the prescribed turnover threshold:

(a) any individual or partnership carrying on business of public service vehicle for the carriage of persons (i.e. bus operators);

(b) any person providing consultancy services;

(c) any person carrying on a business who has voluntarily registered for VAT under the Value Added Tax Act, Cap 331 of the Laws of Zambia; and

(d) any person who is involved in mining operations as provided under the Mines and Minerals Development Act.

Rate of Tax

For businesses covered under section 64A(2), turnover tax is calculated as a percentage of the turnover (gross sales) of the business, at rates prescribed in Part II of the Ninth Schedule of the Income Tax Act. The current rate of tax is 4 percent of monthly turnover.

Change in Annual Turnover

Where a business whose turnover is below the threshold discovers that his annual turnover will exceed K800,000 during the course of the year, he must notify the Commissioner General immediately. However, he shall continue to pay turnover tax till the end of that particular charge year and shall be assessed under the income tax system thereafter.

When a taxpayer who has been paying Provisional Income Tax discovers that his annual turnover will not exceed K800,000 during the year, he must notify the Commissioner General immediately. However, he shall continue to pay provisional income tax till the end of that particular charge year and shall be assessed under the income tax system. At the end of the year, the taxpayer will be required to submit a turnover tax return and a set of accounts with supporting documents covering the whole year.

Any change from turnover tax to income tax and vice versa shall take effect only at the beginning of a charge year. No change will be effected during the course of the charge year

Turnover tax returns and payments

For businesses covered under section 64A(2), turnover tax returns must be submitted as follows:

(a) in the case of manual returns, by the 5th of the month following the month in which sales occurred;

(b) in the case of electronic returns, by the 14th of the month following the month in which sales occurred.

Failure to submit returns by the due date attracts a penalty of two hundred and fifty penalty units (K75.00) per month or part thereof.

No Provisional tax returns are required for turnover tax.

Remittance for turnover tax is due by the 14th of the month following the month in which the sales occurred.

5.7 TAXABLE BUSINESS ENTITIES

The law relating to the taxation of business income differs according to whether a business is incorporated or unincorporated. While employment is an activity exclusively engaged in by individuals, business activities may be engaged in by individuals or legal persons. Consequently, the rules for taxing income from business cut across the taxation of individuals and legal persons. Most jurisdictions recognize, first, the individual, second, corporations, and third, certain fiduciaries as income-generating entities that can be taxed in respect of income from business. These entities constitute the major form of business organization and the tax treatment differs depending on the type of business entity.

The Individual as a Business Entity

At individual level, a business can be organised in two forms:

(a) as a sole proprietorship; or

(b) as a partnership.

Sole Proprietorship

A sole proprietorship is where there is a single owner of the business who is personally liable for anything done by the business. For tax purposes the sole proprietor has no standing as an entity. The law looks at the individual who owns the business - it looks at the income earned by the individual and takes into account any allowable deductions to which the individual is entitled to arrive at taxable income.

A sole proprietor is taxed at the tax rates that apply to individuals as set out in paragraphs 2(1)(c) – (f) of the Charging Schedule of the Income Tax Act. These rates are currently as follows:

First K54,000	@	0%
Next K3,600	@	25%
Next K25,200	@	30%
Balance	@	37.5%

Example:

Sungani, a sole trader, runs a hardware business located at Twin Palms Mall in Lusaka. During the year 2022 he made gross sales of K2 million. He also incurred total expenses of K1.4 million, of which only K1.1 million are deductible for tax purposes. Sungani's tax liability will be calculated as follows:

(a) Calculation of taxable profit:

Gross Income:	K 2,000,000
Less deductible expenses:	K 1,100,000
Taxable profit:	K 900,000

(b) Calculation of tax using the tax rates:

			Rate of Tax	**Tax (K)**
Taxable income:	K 900,000			
	- 54,000	@	0%	0.00
	846,000			
	- 3,600	@	25%	900.00

	842,400			
	- 25,200	@	30%	7,560.00
	817,200	@	37.5%	306,450.00
Tax Due will be				**314,910.00**

Partnership

Tax laws also ignore the existence of a partnership as a taxable entity because a partnership is not a legal person. In a partnership there are two or more individuals who are the owners of the business and are personally liable for everything done by the partnership firm.

When the firm makes a profit, the profit is shared among the partners depending on the ratio of each one's share in the firm. Section 26 of the Income Tax Act provides that:

> "Where a business is carried on by two or more persons in partnership, the income of any partner from the partnership for any period is the share to which he was entitled in that period, such income being ascertained in accordance with the provisions of this Act and that share shall be assessed and charged on him accordingly."

Each partner will then be taxed on the profits due to him using the individual income tax rates set out in paragraphs 2(1)(c) – (f) of the Charging Schedule of the Income Tax Act.

However, partners in a partnership do not file individual tax returns, but are required to file a joint return. Section 61 of the Income Tax Act states that:

> "Persons carrying on any business in partnership shall furnish a joint return of the income of the partnership for a charge year declaring therein the names and addresses of all the partners and the amount of the share of the income to which each partner is entitled for that year, together with such other particulars as the Commissioner-General may, in writing, require."

A partnership is therefore not treated as a taxpayer but as a reporting unit whose income, gains, losses, deductions etc are allocated to the individual partners.

Example:

Musonda, Sitali and Temwani are in a partnership sharing profits in the percentages of 50% (Musonda), 30% (Sitali) and 20% (Temwani). In the year ended 31 December 2022 the business's taxable profits (after deducting expenses) were K1,200,000. This profit will be divided between the partners in accordance with their profit-sharing arrangements as follows:

Musonda	50% of K1,200,000	=	K600,000
Sitali	30% of K1,200,000	=	K360,000
Temwani	20% of K1,200,000	=	K240,000

The tax liability of each partner can then be computed in the same manner as the computation for a sole trader above.

For instance, Musonda's tax liability will be:

			Rate of Tax	**Tax (K)**
Taxable income:	K 600,000			
	- 54,000	@	0%	0.00

	546,000			
	- 3,600	@	25%	900.00
	542,400			
	- 25,200	@	30%	7,560.00
	517,200	@	37.5%	193,950.00
Tax Due will be				**202,410.00**

Corporations

A company or corporation is an entity regarded in laws as having legal personality of its own, separate from the individuals who own it. A corporation can own property, contract in its own name, and sue and be sued. For this reason, a corporation is recognised and treated as a taxpayer and therefore differs from a partnership.

The principle underlying corporate tax is that corporate status conveys a number of privileges and companies should pay for those privileges. For instance, the corporate form makes possible the assembly of capital for investors and large-scale activities. Further, the shareholders of a company are not liable for the debts of the company, their only liability being the amount unpaid on the shares in the company issued to them.

Corporate tax is assessed on the profits of the company, currently at a standard rate of 30 percent.

Individuals may use the incorporated form of a business to vary their tax liability. For example, if corporate tax rates are lower than those applicable to individuals, a sole proprietor could incorporate his business and pay lower taxes on his business income. Furthermore, because of the separate entity concept, the owner can be treated as an employee of his business, and the salary that the corporation pays the owner can be deducted from the gross income of the corporation as a business expense. Therefore, both the individual and the corporation are able to reduce their tax liability significantly.