208/54

G.P.-S.018—1950-1—2,000. U.D.J. 219.

In the Supreme Court of South Africa
In die Hooggeregshof van Suid-Afrika

(APPELLATE Provincial Division).
(Provinsiale Afdeling).

Appeal in Civil Case.
Appèl in Siviele Saak. C.P.D.

COMMISSIONER FOR INLAND REVENUE *Appellant,*

versus

McGENN & Co. (PTY) LTD *Respondent.*

Appellant's Attorney / *Prokureur vir Appellant* Mauder VL

Respondent's Attorney / *Prokureur vir Respondent* Israel

Appellant's Advocate / *Advokaat vir Appellant* P. Rhoodie

Respondent's Advocate / *Advokaat vir Respondent* P. Schock

Set down for hearing on / *Op die rol geplaas vir verhoor op* MONDAY 28th MARCH 1955

~~Heard~~

3, 4, 5, 6 & 7.

9.45 – 12.50,
2.15 – 4.50. } C.A.V.

Judgment:

Schreiner, van Heerden, Hoexter, Hayman & Steyn, JJ.A. } Appeal dismissed with costs.

23 – 5 – 55.

H. Viccat
R.-S.

IN THE SUPREME COURT OF SOUTH AFRICA

(Appellate Division)

In the matter between :-

THE COMMISSIONER FOR INLAND REVENUE Appellant

and

M. GENN AND COMPANY (PTY) LTD. Respondent

Coram: Schreiner, van den Heever, Hoexter, Fagan et Steyn, JJ.A

Heard: 28th. March. 1955 Delivered: 13rd. May. 1955.

J U D G M E N T

SCHREINER, J.A. :- The respondent, which I shall call "the company", appealed to the Special Court for hearing Income Tax Appeals against the disallowance of certain deductions under assessments of taxable income and income subject to supertax in respect of the year ended 30th. June 1951. The Special Court allowed the company's appeal. The Commissioner appealed on a case stated to the Cape Provincial Division and failing there now brings a further appeal to this Court.

The stated case recites the following facts as having been admitted at the hearing before the Special Court:-

"(1) The appellant company is a private company in terms of the Act incorporated in the Union of South Africa with its registered office at Claremont, Cape, where it carried on the business of hardware and timber merchants.

(2) In its profit and loss account for the year ended 30th June, 1951, there appeared a debit item of £2330. 3. 5. described as 'Interest and Finance Charges on loans.'

(3)/....

(3) In this amount of £2330. 3. 5. was an amount of £384.1.9. expended by the appellant company and made up as follows:

Commission~~Commission~~ paid to General Trust and Investment Company (Proprietary) Limited.....	£290.	-.	-.
Bank Charges.....	£ 23	5.	1.
Interest to General Trust and Investment Company (Proprietary)Limited.....	£ 70.	16.	8.
TOTAL...	£384.	1.	9.

(4) The appellant company purchases some of its stock-in-trade locally and also imports stock-in-trade on a large scale.

(5) Prior to the year ended 30th June,1951, the imports of the appellant company were financed by shippers, for which service the shippers charged the appellant company, in addition to bank interest of 6% per annum on the amount involved, a further commission of 3% to 3¾% for every 90 days or 120 days for which the appellant company was being accommodated. The cost of financing on this basis worked out at up to 18% per annum.

(6) During the year ended 30th June, 1951, the method of financing purchases of stock-in-trade was changed and the method followed in that year has now become the normal way in which the appellant company finances its purchases.

(7) The method referred to in the preceding sub-paragraph was to obtain short term loans locally. The appellant company made it known to General Trust and Investment Company (Proprietary) Limited that it was prepared to pay 10% per annum for money to be borrowed by it including the raising fee. General Trust and Investment Company (Proprietary) Limited was to arrange for a client to make a loan to the appellant company for a stipulated period at a prescribed interest rate and General Trust and Investment Company (Proprietary) Limited was to get a raising fee equal to the difference between the prescribed interest rate payable by the appellant company and 10% per annum. In practice,

usually/.....

usually 8% per annum interest was paid by the appellant company to the lender for the use of the money and General Trust and Investment Company (Proprietary) Limited in such a case would receive from the appellant company a raising fee equivalent to 2% per annum on the amount of money borrowed.

(8) During the year ended 30th June, 1951, following the procedure outlined in sub-paragraph (7), the appellant company raised seven short term loans, viz:-

18/10/1950	£2,000	from	E.Gild.
24/10/1950	£3,000	from	P.Lurie.
24/10/1950	£5,000	from	M.Raphael.
17/ 2/1951	£3,000	from	M.Gross.
20/ 2/1951	£2,500	from	Sher.
22/ 3/1951	£1,000	from	P.Gild.
25/ 4/1951	£2,000	from	Lurie.

Raising fees in respect of these loans of £60, £30, £50, £60, £50, £20 and £20 respectively were paid by the appellant company to General Trust and Investment Company (Proprietary) Limited. A total of £290, which is the amount of £290 referred to in sub-paragraph (3) above.

(9) The loans referred to in the preceding sub-paragraph were all raised by the appellant company for purposes of financing its purchases of stock-in-trade and were in fact so used. By paying for stock-in-trade supplied by certain local suppliers within 7 days of date of purchase the appellant company received discounts of 2½% and 5%. Some of the money borrowed by the appellant company was used to pay cash for local purchases, thus gaining the benefit of the discounts. The balance of the borrowed money was used for the purpose of financing the purchase of stock-in-trade imported by the appellant company. "

Before this Court it was ~~argued~~ agreed by counsel that three of the seven loans were for a period of

six/.....

six months and that the remaining four were for one year. In its judgment the Special Court pointed out that the amount of the commission was in each case directly proportionate to the duration of the loan.

The decision of the question whether the sum of £290, being the total amount of the commissions paid by the company during the year in question, was deductible from its income depends on the effect of the following provisions of the Act. So much of the definition of "Gross Income" as is relevant reads, "the total amount whether in "cash or otherwise received by or accrued to or in favour of "any person, excluding such receipts or accruals of a capital "nature" as are not referred to in certain paragraphs which need not be particularised. "Income", being what remains of "gross income" after exemptions under section 10 have been taken away, is subject to deductions under section 11, in order to arrive at "taxable income". The directly relevant provision is section 11(2)(a), which reads,

"(2) The deductions allowed shall be

(a) expenditure and losses actually incurred in the Union in the production of the income, provided such expenditure and losses are not of a capital nature."

Section 12 provides that no deduction shall in any case be made in respect of certain matters, including

"(f) any expenses incurred in respect of any amounts received or accrued which are not included in the ~~item~~ term 'income' as defined in this Chapter;

"(g) any moneys, claimed as a deduction from income

derived/.....

derived from trade, which are not wholly or exclusively laid out or expended for the purposes of trade."

Before the Special Court and the Cape Provincial Division the enquiry appears to have followed the usual lines of investigation based on the language of section 11(2)(a) and section 12 (g), but before this Court counsel for the Commissioner for the first time advanced an argument based on section 12 (f). That argument was that the commissions were expenses in respect of loans received and that loans are receipts or accruals which are not included in the term "income" as defined in Chapter II of the Act; consequently, it was contended, the deduction of the commissions is expressly prohibited.

I shall return to section 12(f) later but it will be convenient first to consider the deductibility of the amount of the commissions apart from that provision. It should I think be observed at the outset that, whatever might be the position on other facts, it is not possible in the present case to justify a difference in treatment between the interest on the loans and the commissions; the circumstances mentioned above show that in each case the commission together with the interest formed in effect one consideration which the company had to pay for the use of the money for the period of the loan. Although, therefore, the Commissioner allowed the deduction of the interest, as distinguished from the commission, the principles to be followed are on the present facts equally

applicable/.....

applicable to both.

Our Income Tax legislation in relation to "deductions", although it has been altered in detail, has not undergone any change that is important for present purposes since Act 41 of 1917 substituted the definition of "gross income" for the definition of income based on "gains and profits", which had appeared in Act 28 of 1914. In the case of Port Elizabeth Electric Tramway Co. v. Commissioner for Inland Revenue (1936 C.P.D.241) WATERMEYER A.J.P. analysed the provisions of Act 40 of 1925 which corresponds to the present sections 11(2) (a) and 12(g), holding that they provided a positive and negative test of whether the expenditure in question is deductible as having been incurred in the production of the income. The relationship of the two provisions was also referred to by CENTLIVRES C.J. in Sub-Nigel Ltd. v. Commissioner for Inland Revenue (1948(4) S.A. 580 at page 588). For present purposes the chief importance of the Port Elizabeth Tramways case lies in its reference to the factor of the closeness of the link which must exist between the expenditure and the production of the income in order to make the expenditure deductible. At page 246 the learned judge said that "all expenses attached to the performance of a business "operation bona fide performed for the purpose of earning income are deductible whether such expenses are necessary for its performance or attached to it by chance or are bona fide incurred for the more efficient performance of such operation provided they are so closely connected with it

that/.....

"that they may be regarded as part of the cost of performing "it." If I am right in understanding the words "they may "be regarded" as connoting that it would be proper, natural or reasonable to regard the expenses as part of the cost of performing the operation this passage seems to state the approach to such questions correctly. Whether the closeness of the connection would properly, naturally or reasonably lead to such treatment of the expenses must remain dependent on the Court's view of the circumstances of the case before it.

In giving the judgment of this Court in New State Areas Ltd. v. Commissioner for Inland Revenue (1946 A.D. 610), the same learned judge, then Chief Justice, referred at page 620 to the distinction between floating and fixed capital and said, " When the capital "employed in a business is frequently changing its form from "money to goods and vice versa (e.g. the purchase and sale "of stock by a merchant or the purchase of raw material by "a manufacturer for the purpose of conversion to a manufac- "tured article), and this is done for the purpose of making "a profit, then the capital so employed is floating capital. "The expenditure of a capital nature, the deduction of which "is prohibited under section 11(2), is expenditure of a fixed "capital nature not expenditure of a floating capital nature, "because expenditure which constitutes the use of floating "capital for the purpose of earning a profit, such as the "purchase price of stock-in-trade, must necessarily be de- "ducted from the proceeds of the sale of the stock-in-trade "in order to arrive at the taxable income derived by the

"taxpayer/.....

"taxpayer from that trade. The problem which arises when "deductions are claimed is, therefore, usually whether the "expenditure in question should properly be regarded as part "of the cost of performing the income earning operations or "as part of the cost of establishing or adding to the income "earning plant or machinery." In deciding how the expenditure should properly be regarded the court clearly has to assess the closeness of the connection between the expenditure and the income earning operations, having regard both to the purpose of the expenditure and to what it actually effects.

Before these general considerations are applied to the facts of this case reference should be made to such mention of interest as appears in the present Act and its predecessors. In the 1914 Act, when the tax was levied on "gains or profits", section 14 (1) provided that there should be deducted from the gross amount of the taxpayer's income "(a) losses, outgoings, including interest "and expenses actually incurred.....in the production of "his taxable income....." In terms of section 15(2) no deduction might be made in respect of "(c) interest "which might have been made on any capital employed in the "trade." This provision reappears in each of the three succeeding Acts; it forbids deduction of a notional return on capital by way of interest but does not mention interest actually expended by the taxpayer, such interest, if actually incurred in the production of the income, being expressly made deductible by section 14(1) of the 1914

Act/.....

Act but not by the later Acts. Section 17 (1)(a) of Act 47 of 1917 is in exactly the same form as section 11(2)(a) of the 1925 and the 1941 Acts, save that "losses and out-"goings" is the expression used instead of "expenditure and "losses." The 1917 and the 1925 Acts prohibited the deduction of debenture interest but the prohibition was repealed by section 4 of Act 18ø of 1928 and there is no similar prohibition in the 1941 Act. The provisions point to Parliament's having in general recognised interest on money borrowed for the purpose of making an income as an expenditure or outgoing, not of a capital nature, incurred in the production of income. In the case of debenture interest, which is more closely associated with the permanent capital structure of the company than with its trading operations, Parliament when it has considered that such interest should not be deductible has specially so provided.

Interest paid on money borrowed and used for the purposes of a business would appear to be expenditure actually incurred in the production of the income of the business, whether the loan was for the acquisition of fixed or floating capital. There might of course be the further question whether or not, because of its association with the fixed capital into which the loan is

turned,/.....

turned, interest on such a loan may not properly be said to be expenditure of a capital nature. It is, however, unnecessary to pursue that question since in the present case the facts found by the Special Court show that the expenditure by way of interest or its equivalent was to meet a continuous demand for the means of acquiring the company's stock-in-trade, that it was not aimed at augmenting the fixed capital or maintaining an enduring asset of the company, but that on the contrary it was directed towards and achieved a relatively rapid turnover of the company's floating capital, with the object and effect of gaining a profit. It follows that apart from the argument based on section 12 (f) the amount of the commissions would be deductible under section 11(2) (a).

In the examination of the argument based on section 12 (f), to which I now return, it should be noted in the first place that the provision first made its appearance as section 21 (1)(f) of the 1917 Act, and that the very next provision, section 21 (2) (a), introduced the prohibition against the deduction of debenture interest. The negative inference here seems to be decidedly strong; it is very unlikely that Parliament would by section 21 (1) (f) exclude the deduction of

interest/.....

interest on every kind of borrowing by taxpayers generally, including companies, and go on immediately to exclude deduction of debenture interest. The material for inference seems so strong that it might even suffice, by itself, to lead to the conclusion that, whatever the cases might be which section 12 (f), the successor of section 21(1)(f) of the 1917 Act, is intended to cover, at least it does not exclude from deductibility all interest and similar charges on the taxpayer's borrowings.

But further consideration leads to the same result. The argument under consideration presupposes that amounts borrowed are received by or accrue to the taxpayer within the meaning of section 12 (f), which would otherwise have no application at all. If they are receipts or accruals for the purpose of section 12 (f) they would also presumably be receipts and accruals within the definition of "gross income"; but, so the argument runs, they are not included in "gross income" or "income" because all loans are essentially and necessarily of a capital nature. Accordingly, it is contended, any expenditure incurred in connection with loans - even, for instance, the interest payable on a fluctuating business overdraft - is incurred in respect of amounts which are not included in the term "income" as

defined, and is therefore not deductible.

I have grave doubts whether this argument does not fail at the outset on the ground that borrowed money is not received nor does it accrue within the meaning of either of the definition of "gross income" or of section 12 (f). It is difficult to see how money obtained on loan can, even for the purposes of the wide definition of "gross income", be part of the income of the borrower, any more than the value of the tractor which a farmer borrows is to be regarded as being income received otherwise than in cash. Though a borrowing for use differs from a borrowing for consumption in that the borrower in the former case does not become the owner of the thing borrowed and must return it in specie, while in the latter case he does become the owner and is only obliged to return what is similar, for present purposes there would seem to be no difference between the two cases. Nor would it seem to make any difference whether or not hire is paid for the use of the tractor or interest for the use of the money. Neither in the case of the borrowed or hired tractor nor in the case of the borrowed or "hired" money does it seem to accord with ordinary usage to treat what is borrowed or hired as a receipt within the meaning of the definition of "gross income", or to treat

what/.....

what is paid as rent or interest as paid in respect of something received within the meaning of section 12 (f). It certainly is not every obtaining of physical control over money or money's worth that constitutes a receipt for the purposes of these provisions. If, for instance, money is obtained and banked by someone as agent for trustee for another, the former has not received it as his income. At the same moment that the borrower is given possession he falls under an obligation to repay. What is borrowed does not become his, except in the sense, irrelevant for present purposes, that if what is borrowed is consumable there is in law a change of ownership in the actual things borrowed.

It may be accepted, on the authority of the majority judgments in Ochberg v. Commissioner for Inland Revenue (1931 A.D. 215 at pages 225 to 229), that the presence or absence of a benefit to the taxpayer from something that passes into his possession does not provide a proper test in applying the definition of "gross income". But the Court was there dealing with a case where the shares issued to the taxpayer became his own in full ownership, without any accompanying obligation to return them. The transaction was of a type in which benefit was notionally

possible/.....

possible, to the extent at least that what before the transaction did not belong to him became, as a result of it, his property absolutely. The question whether anything is "received" by a taxpayer, although it is only on loan, was not in issue or considered, and the case is not authority for the view that, in deciding that question, no regard should be paid to the fact that a borrowing, by its very nature, involves a correspondence between what is obtained and the obligation to repay or redeliver.

But however that may be, section 12 (f) only prohibits the deduction of expenses in respect of amounts"which are not included in the term 'income' as defined "in this Chapter." The apostrophes about the word"income" and the express mention of the definition of "income", which features were present in the corresponding provisions of the 1917 and the 1925 Acts, show that it is to this definition itself and not to any possibly wider notion like "gross income" that reference is being made. The point gains emphasis if one contrasts the use of the word income,<u>simpliciter</u>, in section 11(2)(a). When one turns to the definition of "income" in section 7 one finds that it means, "the amount remaining "of the gross income.....after deducting therefrom any

"amounts/.....

"amounts exempt from normal tax under this Chapter"; in other words "income" is "gross income" less the exemptions mentioned in section 10. If one asks oneself why the legislature in 1917, 1925 and 1941 stressed the definition of "income" in enacting section 12 (f) and its predecessors, the only satisfactory answer seems to be that reference was only being made to expenses incurred in respect of such parts or forms of "gross income" as fall within the exemptions in section 10. (cf. Income Tax Case No. 174, 5 S.A.T.C. 177). That being so it follows that section 12 (f) does not assist the Commissioner.

The amount of the commissions was correctly held to be deductible and the appeal is accordingly dismissed with costs.

Van den Heever, J.A.
Hoexter, J.A.
Fagan, J.A.
Steyn, J.A.
} Concur

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