Case No 392/92

IN THE SUPREME COURT OF SOUTH AFRICA

APPELLATE DIVISION

In the matter between:

COMMISSIONER FOR INLAND REVENUE Appellant

and

GIUSEPPE BROLLO PROPERTIES

(PROPRIETARY) LIMITED Respondent

CORAM: CORBETT, CJ, HEFER, NIENABER, JJA, NICHOLAS et

HARMS, AJJA HEARD:

11 November 1993 DELIVERED:1

Desember 1993

J U D G M E N T

NICHOLAS, AJA

This is an appeal by the Commissioner for Inland Revenue ("the Commissioner") against a decision of the Transvaal Income Tax Special Court upholding the appeal of Giuseppe Brollo Properties (Pty) Ltd ("the taxpayer") against the disallowance of its objections to assessments issued in respect of the 1984, 1985 and 1986 years of assessment.

The taxpayer is a property company in the Barlow Rand group. It owns a single property which it leases to Brollo Africa (Pty) Ltd, which is also a member of the Barlow Rand group. The taxpayer was one of the companies affected by a scheme of arrangement under s. 311 of the Companies Act 1973 which was duly confirmed by the Witwatersrand Local Division in September 1963. The scheme provided for the merging of the industrial interests of Metal Box South Africa Limited with those of Robor Industrial Holdings Ltd ("RIH"), which was at the time a wholly-owned subsidiary of Barlow Rand Limited ("Barlow Rand"). The scheme was a complex one but it will suffice to refer to one only of its facets.

In connection with the scheme an agreement dated 15 September 1983 was concluded between Barlow Rand and RIH ("the sale agreement"), in terms of which RIH acquired seven property companies of which the taxpayer was one. The agreement provided for the sale by Barlow Rand to RIH of "the sale shares" (meaning shares representing the entire issued share capitals of the respective property companies) and "the sale claims" (meaning all claims against the property companies of companies in the Barlow Rand group). The purchase price in respect of each property company was its net asset value. In the case of the taxpayer, the sale shares comprised all the issued shares, namely, 100 shares of R2 each, which were at that time held by Hume Ltd., also a subsidiary of Barlow Rand; and the sale claims comprised Hume Ltd's loan account.

For the purposes of the scheme of arrangement independent valuators had revalued the land and buildings owned by each of the seven property companies. In the case

of the taxpayer its land and the buildings thereon were revalued upwards by R 4 779 260. This surplus was transferred by the directors to Non-distributable Reserves which, with this increment, aggregated R 6 160 586, and this sum was then transferred to Distributable Reserves, the total of which was thereby brought up to R 6 289 144, which sum was then available for distribution as dividends.

Barlow Rand duly procured the transfer of the shares and the cession of the loan account by Hume Ltd to RIH. Stamp duty was payable under the Stamp Duties Act 77 of 1968 upon the transfer of the shares at the rate prescribed under item No. 15(1) of Schedule 1 to the Act ("Tariff of Stamp Duties"). In this connection the taxpayer adopted a device which had the effect of reducing the value of the shares in the hands of Hume Ltd from more than R 10 million to R 200, the nominal value of the issued shares. (In 1983 this was a lawful way of reducing the incidence of stamp duty on the transfer of shares.) On 4 November 1983

and 28 February 1984 respectively the directors of the taxpayer resolved that dividends of R 1 509 884 and R 4 779 260 be declared payable to shareholders registered in the books of the company on 1 October 1983. As a result dividends totalling R 6 289 144 ("the dividend debt") became payable to Hume Ltd.

The taxpayer did not have liquid resources with which to pay the amounts of the dividends. Its only assets of any significance were the land and buildings. Consequently, the dividend debt was simply credited to the interest-bearing loan account of Hume Ltd with the taxpayer, presumably with the consent, express or tacit, of Hume Ltd. The result was that the dividend debt which was due and payable, and which in terms of the company's articles of association did not bear interest, was converted into an interest-bearing indebtedness on loan account which was in the nature of a long term investment in the taxpayer company. In consequence Hume Ltd's loan account increased from

R 4 428 336 as at 1 October 1983 to R 10 717 480 as at 30 September 1984.

Barlow Rand (which was the controlling shareholder of RIH) had a group policy, in terms of which every operating subsidiary of RIH had to operate as a self-sufficient profit centre and to this end "the companies were structured on a one-to-one debt/equity ratio". The loan indebtedness value of each company was split as to 50% "equity loan" (which was treated as an interest free loan) and 50% as an interest bearing loan.

This policy was also applied to the taxpayer from the 1984 financial year, as appears from the Annual Financial Statements for the year ending 30 September 1984. In the balance sheet under "Capital Employed" is an item:

	Notes	1984	1983
HOLDING COMPANY	6	10 717 480	4 428 336

Note 6 to the Financial Statements reads:

	1984	1983

6. HOLDING COMPANY

6.1 Equity loan 5 358 740

The loan is unse
cured, interest free
and no repayment terms have been
arranged.

6.2 Long term loan 5 358 740 4 428 336

The loan is unsecured,
bears interest at 14% (1983 - 12%)
per annum and no repayment terms
have been arranged._____

Total Holding company 10 717 480 4 428 336

Similar items appear in the Financial Statements for the 1985 and 1986 years, except that the rates of interest levied in those years increased to 15.3% and 17% respectively. The idea behind this policy was that the property companies should pay market-related interest rates and receive market-related rentals. They would pay interest at a rate below prime so that the rate could be sustained and would not fluctuate as violently as prime. The long term goal was that the rental earned would eventually exceed the interest paid so as to ensure ever-increasing net income. The effect of this policy was to establish a direct correlation between the

receipt of rental at market-related rates and the payment of interest to fund the owning of the property.

In each of its returns of income for the 1984, 1985 and 1986 years of assessment the taxpayer claimed as a deduction the interest which it paid to RIH calculated in terms of the Barlow Rand policy. These deductions were allowed in the original income tax assessments issued in respect of those years, but in a letter dated 25 May 1987 the Receiver of Revenue advised the taxpayer as follows:

> "The following adjustments have been made in the calculation of your taxable income/assessed loss and/or the determination of your rebates. An assessment will be issued to you in due course.
>
> It is clear that the company increased its loan from the holding company to finance the dividend paid in 1984.
>
> Total increase in loan R6 289 144
> Interest free portion R5 358 740
> Interest bearing portion R 930 404
>
> 1984: R930 404 x 14% R 130 256
>
> 1985: R930 404 x 15.3% R 142 351
>
> 1986: R930 404 x 17% R 158 168"

As foreshadowed in this letter revised tax assessment for the respective years of assessment were issued in August 1987.

The objections to these assessments made by the taxpayer were disallowed by the Commissioner. The taxpayer thereupon noted an appeal which was upheld by the special court. The judgment (per Melamet J, the president) has been reported as Income Tax Case No. 1500 (1991) 53 SATC 272. It was held that "the Commissioner for Inland Revenue was wrong in not allowing a deduction, in the 1984, 1985 and 1986 years of assessment in toto of the interest payable on the loan of the appellant to its parent company RIH" (at 283).

The Commissioner thereupon noted an appeal against the decision to this court on the ground inter alia that

> "3. The Court should have found that the interest paid was on loan account created for the purpose to enable the Appellant to distribute its profits through the declaration of a dividend and that accordingly the interest expenditure was not incurred in the production of income nor was it wholly or exclusively expended for the purposes of trade."

The only witness at the special court proceedings

was Mr. Desmond Claude Arnold, who was the financial director of the division of Barlow Rand group which included RIH and its subsidiaries. He gave evidence on the Barlow Rand group policy the effect of which is summarized above. He said that in implementing the policy he did not apply his mind to the origins of the loan account. He was following a standard policy of restructuring the property companies on a financially sound basis.

The general deduction formula laid down in s. 11(a) of the Income Tax Act 58 of 1962, permits the deduction from the taxpayer's income of

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

It is well settled that "generally, in order to determine in a particular case whether moneys outlaid by the taxpayer constitute 'expenditure incurred in the production of the income', important, sometimes overriding, factors are the purpose of the expenditure and what the expenditure actually

effects". (per Corbett JA in Commissioner for Inland Revenue v Standard Bank of SA Ltd 1985(4) SA 485 (A) at 498 F-G.) In a case concerning the deductibility or otherwise of interest payable on money borrowed, the enquiry relates primarily to the purpose for which the money was borrowed. That is often the "dominant" or "vital" enquiry, although the ultimate user of the borrowed money may sometimes be a relevant factor. Where a taxpayer's purpose in borrowing money upon which it pays interest is to obtain the means of earning income, the interest paid on the money so borrowed is prima facie an . expenditure incurred in the production of income. See Commissioner for Inland Revenue v Allied Building Society 1963(4) SA 1 (A) at 13 C-G. In this judgment approving reference was made to what was said in Farmer v Scottish North America Trust Ltd 1912 AC 118 at 127 in relation to a company which had borrowed money for use in its investment business:

> "The interest is, in truth, money paid for the use or hire of an instrument of their trade, as much as is the rent paid for their office or the hire paid

> for a typewriting machine. It is an outgoing by means of which the company procures the use of the thing by which it makes a profit, and, like any similar outgoing, should be deducted from the receipts to ascertain the taxable profits and gains which the company earns."

If on the other hand the purpose of the borrowing was for some other purpose than obtaining the means of earning income (e.g. to pay a dividend), the interest is not deductible. The following passage from an unreported judgment was quoted with approval in Income Tax Case No 678 (1949) 16 SATC 348 at 349:

> "Now what was the purpose of the expenditure in the present case, what did it do here? It enabled the appellant company to distribute its dividend. The distribution of a dividend is the distribution of its profits or of its accumulated profits. So this expenditure cannot be said to have produced the income of the company - that had already been previously earned. It simply enabled the company to distribute its profits, and that is the purpose of this expenditure."

See also Commissioner of Taxes v Avenue Buildings (Pty) Ltd 1963(4) SA 954 (SR); and Income Tax Case No 678 (supra).

The present case is not one in which money was

borrowed to be used by the taxpayer for the production of income. The taxpayer's capacity to produce income was not increased by the transaction. On the contrary, the only result of the transaction was to burden the taxpayer with a liability to pay interest with a consequent reduction in its net income.

It was submitted on behalf of the taxpayer that the original purpose of borrowing money does not for ever govern the deductibility, at the instance of the borrower, of the interest paid by him to the lender on the loan debt. Regard must be had to the purpose of the actual expenditure, as and when it is incurred, month by month; and if the interest on a loan debt is paid in the course of the normal income-earning operations of the borrower and for the purpose of earning his income, it is deductible, whatever the original purpose of the borrowing may have been. The following cases were cited in support of this submission: Producer v Commissioner of Taxes 1948(4) SA 230 (SR); Financier v

Commissioner of Taxes 1950(3) SA 293 (SR); Income Tax Case No. 953 (1961) 24 SATC 552 at 554; Income Tax Case No. 1171 (1972) 34 SATC 80 at 81-82. The question in those cases related to the diversion of money borrowed for one purpose (income producing operations) to another. They are not relevant to the present case, in which the taxpayer did not receive any money as a result of the transaction in issue, but incurred an indebtedness with a liability for interest attached to it.

It appears that in the view of the special court a new factor was introduced by the implementation of the Barlow Rand policy (see the reported judgment at 282). There was, it was said, no longer any identification between the determination of the amount of interest expenditure and the original dividend debt. The taxpayer's obligation to pay interest did not relate to any original purpose for which any original borrowing or indebtedness was made or from which it arose. The taxpayer incurred the obligation to pay interest

in terms of a policy adopted by the group which linked the obligation to pay interest to the right to receive income. Accordingly, so the special court concluded, any link between the obligation to pay interest and the pre-existing dividend debts and loans was severed.

I respectfully disagree with this view which, it seems to me, results from a misconception of the nature and effect of the Barlow Rand policy.

That policy did not create any obligation to pay interest. It created a mechanism for computing the amounts of interest payable by, and the rentals payable to, property companies in the division concerned. Arnold agreed that the policy was "an administrative device for computing a proper profit for the property-owning company". It was no more than that, and it was not immutable, but was liable to change at the will of of Barlow Rand. Thus during the 1987 year of assessment a change was made which was reflected in item 4 of the Notes to the taxpayer's financial statements for that

year:

"4. HOLDING COMPANY 1987 1986

4.1 Equity loan 6 317 480 5 358 740 The loan is unsecured, interest free and no repayment terms have been arranged.

4.2 Long-term loan 4 400 000 5 358 740
The loan is unsecured, bears interest at 14,5% (1986 - 17%) per annum and no repayment terms have been arranged _____ _____

Total holding company loan 10 717 480 10 717 480

Asked to explain this change, Arnold said:

"My Lord, the answer is very simple. It was at the time that the Commissioner ... disallowed the interest that we had been claimed in prior years and we were not certain of what the outcome would be and it did not make commercial sense to leave the loan as it was structured before, so we restructured it in order to fall within the ambit of what the Commissioner was saying was allowable."

The implementation of the policy did not alter the

fact that the loan account liability was incurred with the

purpose of discharging the dividend debt and it is that

purpose which continued to be overriding. In my opinion therefore the appeal should be upheld.

Counsel for the taxpayer submitted that in the event of the appeal being allowed there should be a special order as to costs.

The submission related to the fact that shortly before the hearing of the appeal there was served on the taxpayer supplementary heads of argument in which the Commissioner sought to contend, for the first time in this court or the court a quo, that by crediting the amount of the dividends to the loan account of Hume Ltd the taxpayer contravened s. 38 of the Companies Act 1975 by providing "financial assistance" in relation to the purchase by RIH of the shares in the taxpayer. Supplementary heads of argument were filed in reply on behalf of the taxpayer which persuaded the Commissioner to abandon the point. It is now submitted on behalf of the taxpayer that the Commissioner should be ordered to pay the costs incurred by the raising of the new

point.

I do not think that a special order for costs should be made. If the point had been raised in the original heads of argument filed in support of the appeal, and then abandoned, I do not think that the court would have made a special order. The fact that the point was taken at a late stage should not, I think, produce a different result.

The following order is made:

The appeal is allowed with costs including the costs of two counsel. The order of the special court is set aside and there is substituted therefor: "The appeal is dismissed. The revised assessments are confirmed."

H C NICHOLAS, AJA

CORBETT, CJ) HEFER,
JA) NIENABER, JA) concur
HARMS, AJA)