IN THE SUPREME COURT OF SOUTH AFRICA
(APPELLATE DIVISION)

In the appeal of:

THE COMMISSIONER FOR INLAND REVENUE Appellant

versus

D. & N. PROMOTIONS (PTY) LTD Respondent

CORAM: CORBETT CJ, HEFER, VIVIER, NIENABER et
HOWIE JJA

DATE OF HEARING: 8 November 1994

DATE OF JUDGMENT: 29-November 1994

J U D G M E N T

/ CORBETT CJ: ....

CORBETT CJ:

This is an income tax appeal. The respondent is a private company with its registered office in Pietermaritzburg, Natal. It derives its income mainly from farming operations. These operations consist principally in the growing and marketing of sugar cane. Other subsidiary operations include livestock trading, the production and marketing of dairy products and livestock feed and timber growing. The matters which give rise to this appeal relate to respondent's sugar farming operations.

During the tax year ended 30 April 1985 the respondent received two items of interest, viz a sum of R12 035 and a sum of R71 025. It is common cause that these receipts constituted income in respondent's hands. The dispute between the parties concerns the question whether or not in each case the receipt constituted income derived from farming operations. The appellant (the Commissioner for Inland Revenue) contends that they did not: respondent contends that they did.

Before dealing with the facts it is convenient

to sketch the legal background to the dispute and to explain briefly why it is to the advantage of the fiscus that the interest receipts in question be classified as income not derived from farming operations and to the advantage of the taxpayer that they be regarded as income derived from farming operations.

Sec 26(1) of the Income Tax Act 58 of 1962 ("the Act") provides that the income of any person carrying on "pastoral, agricultural or other farming operations" (for convenience I shall refer merely to "farming operations") shall, in so far as it is derived from such operations, be determined in accordance with the provisions of the Act, but subject to the provisions of the First Schedule. The First Schedule deals in detail with how taxable income derived from farming operations is to be computed.

Par 12(1) of the First Schedule then provided that, subject to the provisions of subparas (2) to (6) inclusive (of which only (3) is relevant in this case), there shall be allowed, as deductions in the determination of the taxable income derived by any

farmer, expenditure incurred by him during the year of assessment in respect of certain defined items, listed (a) to (j). Several of these items relate to what would otherwise constitute non-deductible capital expenditure, such as expenditure on dipping tanks, dams, boreholes, fences, the erection of or extensions, additions or improvements to farm buildings, the building of roads and bridges, the acquisition of machinery used for farming purposes and so on. In this respect farmers are, as a class, placed in a favourable position and for this reason the courts have, in dubio, tended to reject a construction of such a statutory provision which implied the extension of such a class privilege and to interpret the provision strictly (see Ernst v Commissioner for Inland Revenue 1954 (1) SA 318 (A), at 323 C-F; Buglers Post (Pty) Ltd v Secretary for Inland Revenue 1974 (3) SA 28 (A), at 34 B-E).

A limitation is in effect placed upon the total amount which may be allowed by way of deduction in terms of most of the subparas of par 12(1) by par 12(3), which reads as follows:

> "(3) The amount by which the total expenditure incurred by any farmer during any year of assessment in respect of the matters referred to in items (c) to (j), inclusive, of subparagraph (1) exceeds the taxable income (as calculated before allowing the deduction of such expenditure and before the inclusion as hereinafter provided of the said amount in the farmer's income) derived by him from farming operations during that year of assessment shall be included in his income from such operations for that year and be carried forward and be deemed for the purposes of subparagraph (1) to be expenditure which has been incurred by him during the next succeeding year of assessment in respect of the matters referred to in the said items."

In terms of this somewhat convoluted provision, where the deductions allowable under subparas (c) to (j) of par 12(1) in a tax year exceed the farmer's taxable income derived from farming operations (before the deduction of such expenditure), then such excess is treated as income for that year and is also carried forward as deductible expenditure in the next ensuing tax year. The effect of treating this excess as income in the immediate tax year is to wipe out any loss and to produce a nil income from farming operations in that tax year; and this means that

the farmer is in effect prevented from deducting excess expenditure on the items listed in par 12(1) (c) - (j) from income derived from non-farming sources. The amount of the excess is then carried forward from year to year as deductible expenditure until it has been fully deducted.

It is normally to the advantage of a farmer that income earned by him be classified as derived from farming operations because he can then deduct therefrom the type of expenditure referred to above; whereas such expenditure cannot be deducted from income not derived from farming operations. Conversely it is to the advantage of the fiscus that such income be classified as income not derived from farming operations.

In assessing respondent to income tax in the 1985 tax year the appellant, in a revised assessment, treated the two receipts referred to above as income not derived from farming operations. Respondent objected to this and certain other items in the assessment (no longer in issue) and, the objection having been disallowed, appealed to the Natal Income Tax Special Court. The

Special Court allowed the appeal in respect of the receipt of R12 035 and dismissed the appeal in so far as it related to the receipt of R71 025. (The judgment of the Court has been reported - see Income Tax Case No 1505 53 SATC 406.) The appellant appealed to the Natal Provincial Division in respect of the decision concerning the R12 035 and respondent cross-appealed against the decision concerning the R71 025. The full bench of the Natal Provincial Division (consisting of Thirion, Levinsohn and Van der Reyden JJ) dismissed both the appeal and the cross-appeal. (See Commissioner for Inland Revenue v D & N Promotions (Pty) Ltd 1993 (3) SA 33 (N).)

There is no definition of "farming operations" in the Act and whether or not a person's economic activity constitutes farming operations is essentially a question of fact (see Income Tax Case No 1319 42 SATC 263, at 264) . In the Court a guo Levinsohn J, who delivered the judgment of the Court, considered the question as to what was meant by the phrase "derived from farming operations" in the context of sec 26(1) of the

Act and the various provisions of the First Schedule which require income to be derived from farming operations. He concluded (at 38F) that for income to so qualify -

> ". . . the income and the source from which the income arises, namely farming operations, which of course embraces numerous agricultural activities, must be directly connected. An indirect connection or a remote one will not suffice."

I agree. (See also the judgment of Melamet J in the Special Court, at 414-15.)

I turn now to the facts. In terms of sec 4 of the Sugar Act 9 of 1978 the Minister of Economic Affairs is empowered, after consultation with the South African Sugar Association, to determine and publish the terms of an agreement to be known as the Sugar Industry Agreement. This agreement may provide for, inter alia, the regulation and control of the production, marketing and exportation of sugar industry products. On 27 April 1979, acting in pursuance of this power, the Minister published such an agreement in the Government Gazette.

(I shall refer to this as "the Sugar Agreement".)

Growers of sugar market their product by selling and delivering the cane to sugar millers. Clause 42 of the Sugar Agreement deals with the determination of the price to be paid for cane delivered by a grower to a miller; and clause 46 prescribes the basis for payment of the price by millers to growers. Clause 46 has been quoted in its entirety in the judgment of the full bench (see reported judgment at 36 G to 37 E) and it is not necessary to repeat this. In essence, what it amounts to is that the grower is paid by means of (a) monthly provisional payments and (b) a final annual payment. The provisional payments are based upon 90 per cent of an estimated price per metric ton of sucrose in cane, determined in a particular way, for the sucrose deliveries made. The final payment, made on 30 April each year, is based upon a finally determined price per metric ton for that whole year. This final payment is required to include what is termed "retention interest", calculated in accordance with an elaborate formula and designed, as I understand it, to compensate the grower

for the miller's retention during the year of such difference as there may be between the final price per metric ton and the provisional price therefor. In this case the R12 035 represents retention interest paid by a miller, Illovo Sugar Estates Limited, to the respondent during the 1985 tax year.

In delivering the judgment of the Special Court Melamet J said with reference to this amount of retention interest (at 416):

> "It is clear that such interest payments are part and parcel of the final payment of the sugar cane delivered by the grower to the appellant. It is thus part of the compensation for the product produced in the course of the farming operations of the appellant. It is part of the equalisation process for the products delivered to the mill. In our view the interest so received is Income directly derived from the farming operations of the appellant and falls to be dealt with in terms of s 26(1) of the First Schedule to the Income Tax Act."

In my view this reasoning cannot be faulted. The argument put forward, somewhat tentatively, by counsel for the appellant was that the moneys retained by

the miller in terms of the scheme of payment prescribed by clause 46 of the Sugar Agreement were a form of investment which carried interest and that, therefore, the interest did not constitute income derived from farming operations. I find this argument far-fetched. It is true that if a farmer invests surplus funds, even funds derived from farming operations, then interest paid on the investment would not normally be regarded as income derived from farming operations, but the present case is a far cry from that. The interest receipt does not derive from an investment of surplus funds: it is part and parcel of a scheme devised for the remuneration of the farmer for the sugar cane delivered by him to the miller. It is no doubt a healthy mechanism designed to ensure that there is not too great a disparity between provisional and final payments and to compensate the farmer for the delay in receiving the full price for his goods. The income which a sugar farmer derives from his farming operations is the price which he is paid by the sugar miller for his product. This includes retention

interest. The appellant's argument on this aspect of

the matter cannot prevail and the appeal must be dismissed.

I come to the cross-appeal relating to the item of income amounting to R71 025. This arises from an amendment to the Sugar Agreement which was published in the Government Gazette on 30 March 1984. Clause 37 of the original agreement provided as follows:

> "37. The cost of delivering cane to the mills to which growers are obliged under any existing contracts to deliver, or, in the absence of any existing contracts, to the mills to which they are or may subsequently be attached for quota purposes under this Agreement shall be calculated, apportioned and recovered by growers and millers in such manner and subject to such rules as may be laid down by the Sugar Association with the approval of the Minister."

As was explained in evidence, under the original Sugar Agreement growers were free to make their own arrangements as to the transport of cane to the sugar mills and over the years growers had established contractual arrangements with the various millers. The cost of delivery was borne by the grower, but in terms of

3 clause 37 he was entitled to be paid a cane transport
allowance by the SA Sugar Association in accordance with a certain formula. In addition, many growers enjoyed what were termed "mill site rights". These came about when a mill was closed down. In such a case it was a common practice for the new mill owner, who took over the cane supply which previously had gone to that mill, to say to the growers concerned: "we will make the site of that mill a mill site to which you may deliver your cane at your expense and we as miller will bear the cost of transporting the cane from there to the site of the new mill". Some growers also had arrangements with mills in which they received subsidies or "kick-backs" from the mill itself.

As a result of many anomalies in the organization of the sugar industry a Commission of Inquiry was appointed in 1980. The Commission recommended the elimination of these anomalies and the rationalization of the industry. In pursuance of these recommendations the Sugar Agreement was amended in 1984 by the substitution of a new clause 37. This is a

lengthy provision, portion of which is quoted in the judgment of the Special Court (at 417). The general effect of the new clause and regulatory action taken in terms thereof was explained in evidence. Growers were no longer permitted freedom of choice as to the mills to

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which they could deliver their cane. Delivery arrangements were generally rationalized with a view to efficiency and mill site rights were abolished. Furthermore, growers were made to bear the full cost of transport of cane to the mills and all forms of subsidization were prohibited.

In order to recompense growers for the loss of these rights and the additional burdens imposed upon them monetary compensation was paid to them by the Sugar Association. The amount of such compensation was assessed in each individual case and the quantum thereof depended upon the application of various criteria to the grower's particular circumstances. Compensation was paid in five instalments over a period and interest was paid to growers on the outstanding compensation not yet paid. The R71 025 in question constituted such interest

received during the 1985 tax year. It was held by the Special Court (at 417-18) that -

> "Such compensation was a capital sum paid for the loss of, or interference with the taxpayer's right to have or make its own arrangements for the transport of its sugar cane. Such compensation was under a similarly worded agreement held to be of a capital nature for purposes of taxation. Kommissaris van Binnelandse Inkomste v Transvaalse Suikerkorporasie Bpk 49 SATC 11
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> In view of the fact that there was not to be a payout in one lump sum of the capital, it was regulated that the Sugar Association would pay interest each year on the balance of the moneys due to the grower but being retained by the SA Sugar Association.
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> It is clear that the interest was derived from a capital sum due to the appellant retained by the SA Sugar Association. It was interest accruing on either a compulsory investment of a fixed amount by the appellant with the SA Sugar Association or on a compulsory loan of this amount by the appellant to the SA Sugar Association. If the capital sum had been paid in one lump sum and such moneys invested with or loaned to another institution, it is clear that such interest would not have been regarded as being derived from farming operations. In our view the position is not altered by the fact that such

investment or loan was not effected voluntarily but compulsorily.

We are of the view that the appellant has failed to discharge the omus of proving that such interest was derived from the farming operations conducted by the appellant."

Counsel for the respondent conceded that the compensation itself constituted a receipt, or rather a series of receipts, of a capital nature. The compensation thus fell outside the general ambit of respondent's income-earning operations from sugar farming, which, as I have said, consisted essentially of growing and marketing sugar cane.

Counsel submitted, however, that the interest payable on the compensation was derived from farming operations since this interest would not have accrued to respondent unless it had been conducting sugar farming operations and since the quantum thereof was determined by the peculiar features of respondent's operations. He furthermore pointed out that the transport, loading and delivery of respondent's cane formed an Integral part of respondent's farming operations.

It is true that respondent would not have

received the compensation and the interest had it not been carrying on sugar farming operations. In other words, the carrying on of such operations was a conditio sine gua non of these receipts. But I do not think that it follows from this that the interest was derived directly from farming operations; and here I would emphasize the word "directly". On the contrary it seems to me that the interest was not directly derived from farming operations. It was admittedly derived from the abolition of certain rights relating to the transportation and delivery of respondent's farming productsy but this, in my view, is too remote and tenuous a connection with respondent's actual farming operations for the interest to be regarded as having been derived from farming operations. The fact that the compensation was assessed in relation to the peculiar position of each farmer takes the matter no further.

Similar arguments were advanced in the Court a quo and rejected for similar reasons (see reported judgment at 41 D - 42 F). The cross appeal fails.

It is ordered:

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(1) That the appeal is dismissed with costs.

(2) That the cross-appeal is dismissed with costs.

M M CORBETT

HEFER JA) VIVIER JA)
NIENABER JA) CONCUR
HOWIE JA)