IN THE SUPREME COURT OF SOUTH AFRICA

(APPELLATE DIVISION)

CASE NO. 8695

In the matter between

COMMISSIONER FOR INLAND REVENUE APPELLANT

and

SUNNYSIDE CENTRE (PTY) LIMITED RESPONDENT

CORAM: VAN HEERDEN, KUMLEBEN, HOWIE, SCHUTZ et SCOTT JJA

DATE HEARD: 2 SEPTEMBER 1996

DATE DELIVERED: 20 SEPTEMBER 1996

SCHUTZ JA

J U D G M E N T

SCHUTZ JA:

The Gross brothers, Solly and Mervyn, are the controllers of Sam Gross Holdings (Pty) Ltd ("SGH"). They exercise control over SGH and its subsidiaries in an informal manner, sometimes acting on the advice of their auditor, du Preez. Two wholly owned subsidiaries, the respondent, Sunnyside Centre (Pty) Ltd ("Sunnyside") and Agros (Pty) Ltd ("Agros") own fixed property in Pretoria. The brothers are the sole directors of all three companies.

Since 1955 Sunnyside has owned a building in Esselen Street, Sunnyside. It consists of shops and flats which are let out. Agros owns

a building in Prinsloo Street. The land was acquired in 1945 with a dilapidated butcher shop on it. Improvements were effected in later years, and, like the Sunnyside property, it produces rent. In 1981 a vacant stand next to the Prinsloo Street property came onto the market and Agros bought it at a cost of some R295 000. It was zoned for business and commercial purposes. Initially resort was had to the bank for bridging finance. Offering the Agros properties for security, application was then made to the Allied Building Society for bond finance. Difficulties were encountered in obtaining a bond, as it later transpired, because there was then a freeze on building societies lending on the security of commercial properties.

Although Agros could itself have raised a loan on the security of

its property but at a rate of interest higher than the building society rate, the Gross brothers decided to borrow at the lower rate, by using Sunnyside's property as security and with it as the borrower. This was possible because its property was partly residential. Accordingly Sunnyside borrowed R209 826 from the United Building Society ("UBS"). A first bond for R150 000 and a second for R59 826 were registered against its property. The proceeds of the bonds were paid to SGH - in the sum of R18 345 as repayment of an existing indebtedness, and the balance as an interest bearing loan,which was to be used by SGH to lend to Agros at interest, in order to fund its property acquisition. This was done. The ususal informality prevailed. Nothing was reduced to writing, and no agreement was reached as to the rate of interest and

terms of repayment between Sunnyside and SGH.

However, it was intended that eventually SGH would pay Sunnyside all the interest it had had to pay, and repay the capital sum in full. Sunnyside was not to suffer any loss as a result of the transaction. Whether, in addition, it was to gain from it will be discussed below.

A feasibility study had been done by du Preez. The contemplation was that it would take some years before rentals on the Agros property could be raised to a level that would match the interest burden. Later, it was planned, the rentals would exceed interest, so that, looking at the group as a whole, in the earlier years there would be a loss, to be succeeded by a profit.

Expectations were bedevilled by record high interest rates in the

early period, but after some years deficit was in fact followed by surplus. This situation may not have been reflected exactly in the differential between the interest received by SGH from Agros on the one hand, and paid to Sunnyside on the other. Nonetheless each year the Gross brothers would decide on charges in consultation with du Preez, and, broadly speaking, the interest charges reflected the anticipated swing of the wheel. Of course, what Sunnyside had to pay the UBS was unrelated to its interest receipts, so that there was a discrepancy between what Sunnyside paid and received in each year, as is revealed in the following table:

Tax year	Interest paid to UBS	Interest received from SGH
1983	R34933	R11641
1984	36658	12000
1985	41557	17669
1986	41021	14535
1987	34160	22540

19(38 27 819 47 320
1989 ± 27 000 ± 31 000

Initially the appellant ("the Commissioner") allowed Sunnyside to deduct in full its payments to the UBS, but he then reversed his stance in respect of the years 1984, 1985, 1986 and 1987, and allowed as a deduction only so much as Sunnyside had itself received as interest. This involved revised assessments for the 1984 and 1985 years. Looked at in commercial terms the Commissioner ignored the swings and roundabouts of the longer term, and insisted that each tax year be judged separately. This appeal is concerned with the correctness in law of his stand as to how much interest may be deducted in respect of each of the four years mentioned. Both the Transvaal Income Tax Special Court and the Full Bench of the Transvaal Provincial Division have held in

Sunnyside's favour. The decision of the latter is reported as Commissioner for Inland Revenue v Sunnyside Centre (Pty) Ltd 1993(3) SA 940 (T).

Two complementary sections of the Income Tax Act 58 of 1962 are relevant. S 11(a) provided:

> "For the purpose of determining the taxable income derived by any person from carrying on any trade within the Republic, there shall be allowed as deductions from the income of such person so derived -(a) expenditure and losses actually incurred in the Republic in the production of the income, provided such expenditure and losses are not of a capital nature;"

S 23 (g) provided:

> "No deductions shall in any case be made in respect of the following matters, namely -
>
> (g) any moneys, claimed as a deduction from income derived

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

As the events out of which this appeal arises occurred in the fairly distant past, it is the erstwhile form of s 23(g) quoted which applies. Subsequently s 20 of the Income Tax Act 141 of 1992 deleted the words "which are not wholly or exclusively" and replaced them with the phrase "to the extent to which such moneys were not." The effect of the amendment was that moneys expended for a dual purpose may be apportioned so that that portion laid out for the purposes of trade may be deducted. But this appeal must be decided on the all or nothing principle embodied in the old subsection and the cases from which authority is to be sought are those that dealt with the prescription prior to amendment.

The word "trade" is defined in s 1 to include the letting of

property. It is common cause that the interest expenditure was incurred in the Republic and also that it was not of a capital nature. So that the questions posed by the appeal are twofold, (1) whether that expenditure was incurred in the production of the income from Sunnyside's trade (the remaining requirement of s 11(a)), and (2) whether the moneys expended were wholly and exclusively laid out for the purposes of that trade (the requirement of s 23(g)). If Sunnyside fails to obtain a favourable answer to either question it must fail, because a deduction may be made (where no special provision exists) only "if the expenditure passes the dual test of qualifying for deduction in terms of s 11(a) and, at the same time, of not being excluded by s 23" (per Corbett JA in Commissioner for Inland Revenue Nemojim (Pty) Ltd 1983 (4) SA 935 (A) at 951 F-

G. See also 947 A). The fact that Nemojim was concerned with s 23 (f) and not with s 23(g) (which is relevant to this case) does not affect the applicability of the statement.

I shall assume that during the tax years in question not only rent received from its lessees but also interest received from SGH was "income derived from trade". What is in issue is whether monies paid to the UBS during those years in excess of interest received ("the extra interest") were laid out or expended for the purposes of trade, and if so, whether they were wholly and exclusively laid out or expended for that purpose. If that was only partly the purpose - if there was also some other purpose - in other words if there was a dual purpose, then no deduction at all could be made: Solaglass Finance Co (Pty) Ltd v

Commissioner for Inland Revenue 1991(2) SA 257 (A) at 280 D - 282

G. That is the principle laid down in that case and it is squarely based on the statute. Accordingly I do not intend describing, comparing or distinguishing the facts, for as Botha JA says (at 281 E) "one can say no more than that the issue is to be resolved by examining the particular facts of each individual case." It is therefore merely of interest and not of importance that the finding in that case was "that the appellant's trading activities were geared to the achievement of a dual purpose: furthering the interests of the group's subsidiaries and thus of the group itself; and making a profit for the appellant (at 282 G)."

If Sunnyside's case be that it borrowed the capital that attracted the extra interest in order to re-invest it, and that that was the trade leading

to the expenditure, then it behaved remarkably unlike an investor. It did not concern itself with stipulating returns or terms of repayment. As a result there was no contract as to what interest was to be paid or how it was to be calculated. That determination would await a future ad hoc determination. As I shall seek to demonstrate later in this judgment, Sunnyside did not expect, even less contract for a profit on the reinvestment, whether in the short, medium or long term. Yet it was prepared to subject its own property to hypothecation. The real object of all this was, of course, to allow Agros to pay for its new acquisition. Mr Solly Gross said so in evidence expressly. When he was asked in cross-examination, "... the only party to benefit from that transaction was Agros. Do you agree with that?" he answered "I agree with that."

Agros could have borrowed directly. The only reason why Sunnyside was procured to borrow was to obtain less expensive money for Agros. Agros benefited, but there was no corresponding benefit for Sunnyside. Agros would earn additional rent, but Sunnyside would have no share in it. No wonder then the question and answer "So, this transaction . . . was in no way connected with the trade of Sunnyside Centre? . . . Not with the trade of Sunnyside Centre as such."

I shall not treat this last answer as the surrender of the legal pass. But at best for Sunnyside the undisputed circumstances and the concessions of its own witness make it clear that there was a purpose other than deriving income from its own trade. It is not even necessary to say that that other purpose was the overriding one, although it clearly

was at least that. It is enough that it was another. On that simple basis the appeal must succeed.

Nor do I think that that is the only ground for allowing the appeal. Sunnyside must also surmount the hurdles, variously expressed, of proving that the expenditure on extra interest was incurred in the production of income (s 11(a)), and that the moneys laid out or expended on the same were expended for the purposes of trade (s 23(g)).

I do not think that it has succeeded in doing so.

In de Beers Holdings (Pty) Ltd v Commissioner for Inland Revenue

1986(1) SA 8 (A) at 36 I - 37 C Corbett JA said:

> "It is true, as I have already indicated, that the absence of a profit does not necessarily exclude a transaction from being part of the taxpayer's trade; and correspondingly moneys laid out in a non-profitable transaction may nevertheless be wholly or

> exclusively expended for the purposes of trade within the terms of s 23(g). Such moneys may well be disbursed on grounds of commercial expediency or in order indirectly to facilitate the carrying on of the taxpayer's trade . . . Where, however, a trader normally carries on business by buying goods and selling them at a profit, then as a general rule a transaction entered into with the purpose of not making a profit, or in fact registering a loss, must, in order to satisfy s 23 (g), be shown to have been so connected with the pursuit of the taxpayer's trade, eg on ground of commercial expediency or indirect facilitation of the trade, as to justify the conclusion that, despite the lack of profit motive, the moneys paid out under the transaction were wholly and exclusively expended for the purposes of trade . . . Generally, unless the facts speak for themselves, this will call for an explanation from the taxpayer."

The Court a quo, in rejecting the argument that Sunnyside had had a duality of purpose, held that its functions were directed exclusively towards maintaining and increasing its own profitability (at 946 A). In so finding, the Full Bench, like the Special Court before it, was too

generous in its appraisal of the evidence given on the question of intended profitability. It is true that Sunnyside was not to lose, in the sense that it would eventually recoup from SGH the full capital and interest paid to the UBS, and that with the loose arrangements that prevailed there was a possibility that it would make a profit in addition. It is also true that each company in the group was run so as to make a profit, but it does not follow from this fact that each branch of each company's activities had to be profitable. That is as high as the case can be put. When one seeks for evidence that there was an intention that Sunnyside should be rewarded for its intervention one seeks in vain. This is not for lack of the right questions being asked. The President of the Special Court reproved Sunnyside's counsel for putting leading

questions, but when he recalled Mr Solly Gross he pressed him repeatedly and firmly on this matter. Mr Gross gave answers to the effect that it was the brothers' intention to make a profit out of increased rent (to be earned by Agros) and that there was an intention that the group or the holding company would profit from the overall transaction.

In order to understand the evidence following it is necessary to define X and Y. X is the total interest that Sunnyside would pay to the UBS. Y is a profit to Sunnyside over and above X. Near the end of his questioning, which had not produced anything favourable to Sunnyside, the President asked a question and was answered:

> "Did it matter whether there would be a profit in Sunnyside from the loan agreement? I may not be an auditor, but if there was Y, assuming that we appropriate Y as a profit to Sunnyside over and above the UBS X. Now whether that Y remained with

Sunnyside, Sam Gross Holdings or Agros, it would not really have mattered to you, would it?... My lord, put it this way, it may not have mattered in which company the profit was, my lord. At the end result, the amount which would have flowed into my personal holding company [through which S Gross held his share in SGH] would have mattered, my lord."

Earlier the following had been said:

"President: Was there any reason why it should get anything above X? Was there any decision that it would get? . . . My lord, I don't know that there was exact decision as to whether it should make a profit or that it should just get its interest back, my lord."

And again:

"President: But was it ever agreed that that would have happened [that additional interest would be charged]? ... As I have said before, my lord, I cannot with exactness recall the incident at that time, my lord."

Nor is there any evidence that any extra (or additional) interest was

ever charged. The reason why there was and could be no evidence that Sunnyside set out to earn extra interest is that that was not the plan. The plan was to help Agros, as already explained. This conclusion on these facts must lead to the result, in accordance with the de Deera case, that in the absence of an explanation or the facts speaking for themselves in a manner favourable to Sunnyside, the moneys were not expended for the purposes of trade. There is no explanation. The facts do speak for themselves, but not in a manner favourable to Sunnyside.

The conclusion that there was no intention to earn profits eventually, also puts an end to the application of another of Sunnyside's arguments, that it is legitimate to deduct expenditure in one year that will bring in income only in a later year (cf Sub-Nigel Ltd v Commissioner

for Inland Revenue 1948(4) SA 580(A) at 589). Eventually, so it was

argued, and so it happened, the interest wheel would swing, and more interest would be received than was paid in a given year. But in my view, there being no intention ultimately to earn a profit, the object of the expenditure was not to earn income, merely to recoup expenditure.

However, Sunnyside has sought to bring itself under the heads of commercial expediency or indirect facilitation of its trade, mentioned in the de Beers case. Its trade is the letting of property. Both the Special Court and the Full Bench accepted this argument too.

It was expedient, so it was argued, to maintain the arrangement whereby SGH for a fee provided administrative services for all three companies and kept the only bank account, and acted as the "banker" of

the group in the sense that surplus funds of the subsidiaries would be lent to it at interest and capital would be lent to them at interest when they needed it. To my mind there is an atmosphere of unreality in this submission, that it was expedient that the directors of the holding company should be "kept sweet" in order to persuade them to continue to run affairs as they had in the past in the interest of the holding company and, more importantly, themselves. The simple fact is that by incurring a loss on interest Sunnyside was not buying favours or services or goodwill. What it was doing was helping Agros. One always goes out by the same door. There was no evidence, for instance, that Sunnyside lent assistance in order to ward off higher service charges, or to stave off a failure of Agros such as might ultimately have affected the

solvency of the group and even Sunnyside itself. Facts of that kind

might have been enough. But there were none.

A decision adverse to Sunnyside may be seen to work hardship, inasmuch as there would have been no difficulty in deducting the extra interest had the Gross brothers held both properties in a partnership, without employing separate companies. They might well have operated in that way had we not lived in a world of high rates of taxation and the income tax industry they have spawned. Companies are often used in a variety of ways to avoid tax. When a scheme works, no tears are shed for the Commissioner. That is because a taxpayer is entitled to order his affairs so as to pay the minimum of tax. When he arranges them so as to attract more than the minimum he has to grin and bear it.

The appeal is allowed with costs including the costs of two counsel.

The order of the Court a quo is set aside and replaced with the

following:

"1. The appeal is allowed with costs including the costs of two counsel.

1988 The order of the Transvaal Income Tax Special Court is set aside and replaced with the

following:

1989 The appeals against the Commissioner's assessments for

1984, 1985, 1986 and 1987 are dismissed. The assessments

are confirmed."

W P SCHUTZ
JUDGE OF APPEAL

VAN HEERDEN JA)
KUMLEBEN JA)
) CONCUR
HOWIE JA)
SCOTT JA)