

B. 66/90

Case No. 483/88

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IN THE SUPREME COURT OF SOUTH AFRICA
(APPELLATE DIVISION)

In the matter between:

COMMISSIONER FOR INLAND REVENUE

Appellant

and

OCEAN MANUFACTURING LIMITED

Respondent

Coram: CORBETT CJ, BOTHA, SMALBERGER JJA NICHOLAS et

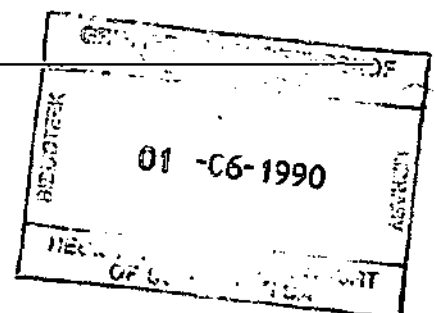
SMUTS AJJA

Heard:

Delivered:

10 May 1990

1 June 1990



J U D G M E N T

NICHOLAS AJA:

This appeal concerns an agreement ("the merger agreement") which was concluded on 24 October 1980. The parties were the following:

- (a) The fourteen persons who owned the 100 000 issued shares in Ocean Manufacturing (Proprietary) Limited ("the sellers");
- (b) The Brick and Potteries Company Limited ("the purchaser"), which I shall refer to as "B&P";
- (c) Ocean Manufacturing (Proprietary) Limited, which I shall refer to as "Ocean"; and
- (d) Finansbank Limited ("Finansbank").

B & P was incorporated as a private company in April 1902. Its main object was the manufacture of bricks, tiles, pipes and earthenware. On 29 December 1913 it became a public company and its shares were listed on the Johannesburg Stock Exchange ("JSE"). It had a number of subsidiaries. In about 1974 it acquired all the issued shares in Model Homes and Property Development Corporation

Limited ("Model Homes"), and property development and share dealing became the major business of the group of which B&P was the holding company. Towards the end of 1978, the B&P group encountered serious financial problems, and B&P was in danger of liquidation. A solution was found in a scheme of arrangement in terms of s. 311 of the Companies Act, 1973 which was duly sanctioned on 20 March 1979. Under the scheme B&P retained as "shell" companies with minimal assets and no liabilities fifteen of the companies in the group, namely, Model Homes and fourteen smaller subsidiaries. It appeared from its balance sheet for the year ended 30 June 1980 that Model Homes was then insolvent. The listing of B&P's shares had been suspended by the JSE, which indicated in April 1980 that unless appropriate action was taken before the end of August 1980 to acquire assets and to secure the reinstatement of its listing, the JSE would take steps to delist the shares.

Ocean was incorporated in the Republic of South

Africa on 19 January 1971. It was started by Capri

International Limited, a Zimbabwean company listed on the Zimbabwe Stock Exchange. As at April 1980 about 70% of the shares of Ocean were held by non-residents of the Republic of South Africa. Most of them, including Capri

International, were Zimbabweans. Ocean carried on business as a manufacturer and distributor of domestic refrigerators and freezers and an importer and distributor of electric appliances. Its business expanded rapidly from a turn-over of approximately R3 million in 1976 to R8.7 million in 1980.

In the same period its profit before tax increased from R8 000 to R564 000. At the end of 1979 Ocean required an injection of capital in order to maintain its growth and its liquidity position. In this regard its shareholders and directors were faced with problems: the company's borrowings were limited because of exchange control restrictions, and its shareholders were unable or reluctant to put additional loan or share capital into the company; and it was foreseen

that its Zimbabwean background and image might give rise to difficulties because of political considerations and pressures. Ocean's directors decided that its problems might be solved by obtaining the listing of Ocean on the JSE. They accordingly approached Finansbank for advice.

Finansbank carries on business as a merchant bank.

It had become involved in B&P as a result of making financial facilities available to Edglen Limited for it to acquire about 48% of the equity of B&P. Edglen encountered financial difficulties, and on 2 February 1977 Finansbank exercised its rights over 1 076 876 shares in B&P which Edglen had pledged to it as security. During 1978 Finansbank granted substantial loan and guarantee facilities to companies in the B&P group, and in consequence sustained losses. After the sanction of the scheme of arrangement referred to above, Finansbank exercised control of B&P, and it was anxious to revitalize the B&P group so as to recoup its losses.

Mr King, representing Ocean, approached Finansbank for advice. He was told that, having regard to the requirements and conditions of the JSE and the costs of a primary listing, the best solution to Ocean's problems appeared to be a "back-door listing" by means of a reverse take-over arrangement. Finansbank informed King that it controlled B&P, which could be made available for a reverse take-over, and that certain companies in the B&P group had assessed losses. Specific reference was made to the fact that the tax assessment of Model Homes for the year ending 30 June 1977 reflected an assessed loss of R775 304.

Intensive negotiations followed, culminating in the conclusion of the merger agreement on 24 October 1980. In terms of clause 3 of the merger agreement:

"3. The sellers (sc. the shareholders in Ocean) hereby jointly and severally sell to the purchaser (sc. B&P), who hereby purchases the shares (sc. all the issued shares in Ocean) from the sellers and on completion of the conditions precedent the risk and benefit are deemed to have passed from the effective date."

(The "conditions precedent" were set out in clause 2:

- "2.1.1 the approval, insofar as may be necessary, of the South African exchange control authorities to the sale in terms of this agreement by any of the sellers who are non-residents of their shares in the capital of the company;
- 2.1.2 the granting by the JSE of a listing of the new B&P shares on the basis that such shares shall rank pari passu in all respects with the other shares in the capital of Brick and Potteries after giving effect to the provisions of clause 2.1.3.;
- 2.1.3. the restructuring of the capital of Brick and Potteries to provide for the following, namely:-
 - 2.1.3.1. the conversion of the entire existing share capital of Brick and Potteries into shares of no par value;
 - 2.1.3.2. the consolidation of each of the existing shares on the basis that there will be one consolidated share for every existing 50 (fifty) shares;
 - 2.1.3.3. the increase in the authorised share capital of Brick and Potteries by the creation of

4 900 000 new shares in the
capital of Brick and Potteries;

2.1.3.4. a rights issue being undertaken
by Brick and Potteries on the
basis that shareholders (being
the holders of 65 000
consolidated shares) will be
entitled to 10 (ten) new B&P
shares at 98 cents per share
for each one consolidated share
held by them;

2.1.4 the passing of a resolution by
the shareholders of the
purchaser in general meeting:-

2.1.4.1. approving of the transaction
and

2.1.4.2. placing the new B&P shares
under the control of the
directors of the purchaser and
agreeing to their allotting
such shares in terms of this
agreement.

2.1.5.

2.2.

2.3.",)

Clause 4 provided:

"4. 4.1. In consideration for the acquisition of the shares the purchaser will allot and issue to the sellers the new B&P shares credited as fully paid.

4.2. The number of new B&P shares which each of the sellers is to receive pursuant to the provisions of clause 4.1 above shall be as set out in the schedule of shares."

Under clause 9.1 Finansbank undertook to underwrite the rights issue referred to in clause 2.1.3.4 at no cost, and it was agreed that the services of Finansbank as a merchant banker would be employed at an agreed fee by the purchaser (B&P)," for the purposes of assisting in the fulfilment of the conditions precedent as well as in respect of the transmuted listing statement and circulars to shareholders which will be issued to the purchaser in accordance with JSE requirements."

In terms of clause 11 -

"11. It is hereby recorded that the parties have agreed that:-

11.1 as soon as is reasonably possible hereafter the company (sc. Ocean) shall sell its business as a going concern to Model Homes & Property Development Corporation Limited (which is a subsidiary of Brick and Potteries) on reasonable terms and conditions; and

11.2"

The conditions precedent were duly fulfilled and effect was given to the provisions of the agreement. In practical terms the results were these:

- (a) The shareholders of Ocean acquired 75% of the shares in B&P as restructured;
- (b) B&P acquired the whole of the issued shares in Ocean;
- (c) B&P's existing shareholders got 25% of the new shares in B&P; and
- (d) B&P received R637 500 from the rights issue.

In regard to clause 11(1), it had been planned to

transfer the business assets of Ocean to Model Homes as from 1 January 1981, but delays were occasioned by a number of factors, including "the ramifications of the sale, as well as the question whether the assets should be sold or leased, the tax implications ...and the preparation of a formal agreement." In the result no formal agreement was prepared since this was not considered necessary, and the transfer of the assets at their book value took effect on 1 July 1981.

(The agreement concluded in pursuance of clause 11(1) will be referred to hereinafter as "the transfer agreement".)

There followed changes in the names of some of the companies concerned. B&P was renamed Ocean Manufacturing Group Limited; Ocean was renamed Ocean Manufacturing Appliances (Pty) Limited; and Model Homes was renamed Ocean Manufacturing Limited in order to preserve the goodwill of the business acquired by it from Ocean. For the sake of brevity and in order to avoid confusion, I shall continue to refer to the companies by their former names.

In respect of the years of assessment ended on 30 June 1981 and 1982 Model Homes (under its new name of Ocean Manufacturing Limited) submitted returns of its income together with supporting accounts, in which it set off against its taxable income certain assessed losses. The Commissioner for Inland Revenue declined to allow the set-off of such losses against the income of Model Homes, and on that basis issued the following revised assessments:

<u>Tax Year</u>	<u>Taxable Income</u> <u>(assessed loss)</u>
1981	R101
1982	(R2 223 174)

In disallowing the losses, the Commissioner relied on s. 103(2) of the Income Tax Act, 1962 which, as it stood at the relevant time, provided as follows:

"(2) Whenever the Commissioner is satisfied that any agreement affecting any company or any change in the shareholding in any company, as a direct or indirect result of which income has been received by or has accrued to that company during any year of assessment, has at any time before or after the commencement of the Income Tax Act, 1946, been

entered into or effected by any person solely or mainly for the purpose of utilizing any assessed loss or any balance of assessed loss incurred by the company, in order to avoid liability on the part of that company or any other person for the payment of any tax, duty or levy on income, or to reduce the amount thereof, the set-off of any such assessed loss or balance of assessed loss against any such income shall be disallowed."

Model Homes taxpayer lodged an objection on the ground that the provisions of s 103(2) of the Act were not applicable. On 21 May 1984 the objection was disallowed. Thereupon Model Homes noted an appeal to the Income Tax Special Court.

The appeal was heard by the Transvaal Income Tax Special Court, with KRIEGLER J presiding. No evidence was led. The facts which the parties considered relevant were set out in a Statement of Agreed Facts. In the judgment delivered on 20 August 1986 the appeal was upheld and an order was made that

"The assessments in respect of the appellant's years of assessment ended 30th June 1981 and 30th June 1982 are set aside. Such assessments are

referred back for recalculation by the Commissioner on the basis that the provisions of section 103(2) of the Act are applicable to neither and for correction of the possible arithmetical error in the 1982 assessment."

(The reason for the reference back "for correction" was that it appeared in the special court proceedings that "the assessment for the 1982 tax year erroneously reflected what had been a trading loss of R192 285 as a profit.")

In the special court the contention of the Commissioner's representative was that in considering whether s 103(2) was applicable, the agreement to be examined was not the merger agreement (which was referred to in **KRIEGLER J's** judgment as "the take-over agreement" or "the main agreement") but the transfer agreement (which was referred to in the judgment as "the subsidiary agreement"). **KRIEGLER J** said that he was convinced "as a question of law that the substratum of the argument was fallacious", and continued:

"It is clear that the main agreement, which

forms part of the dossier and the effect of which is explained in the Statement of Agreed Facts, constituted a multi-faceted and complex integration of many rights and obligations between a variety of parties. It arranged the inter-relationship between various categories of parties and carefully sought to ensure that the performance of each obligation was conditional upon the performance of all other obligations. Mr Swersky's description thereof as 'a complete package' is apt. The transfer by Ocean to Model of the former's business as a going concern was an integral, indeed an essential, component of the package. However, it was no more than that. It was not the primary purpose of the package but merely an essential component, as was the injection of capital into B & P (to be underwritten by Finansbank) and the relisting of B & P's shares on the Johannesburg Stock Exchange. The whole structure was interdependent, each component being necessary for the cohesion and success of the whole.

In those circumstances it is not permissible to isolate one term, in this instance clause 11, and to elevate it to the status of a substantive agreement"

The learned judge said further -

" ...The 'agreement affecting any company' which resulted in the receipt of income by Model is the main agreement, including the provision for the consensual take-over by Model of Ocean's business. Once one adopts that perspective the conclusion on the facts is unavoidable. We are

satisfied that the appellant has discharged the onus resting on it to establish on a balance of probabilities that utilization of Model's assessed loss was not the sole or main purpose of any of the parties who entered into the main agreement."

He proceeded to consider in turn each category of parties to the main agreement, and then set out the special court's conclusion:

"The conclusion to which we have come is that even if Model had had no assessed loss the whole transaction would have been so advantageous to each of the interested parties that they would still have struck the deal substantially along the lines and on the terms they did."

An appeal to the Transvaal Provincial Division was dismissed with costs on 13 April 1988. PREISS J (with whom KIRK-COHEN and VAN DER MERWE JJ concurred) agreed with KRIEGLER J that what had to be ascertained was whether the utilisation of the assessed loss was the sole or main purpose of the merger agreement. The Commissioner now appeals to this court.

The narrow question for decision in this appeal is

whether the transfer agreement is an agreement which falls within the ambit of s. 103(2) of the Income Tax Act. It cannot be disputed that it has all the characteristics set out in this provision:

1. It is an "agreement affecting any company"
(i.e. Model Homes).
2. As a direct result of the arrangement income was received by that company.
3. Presumptively the agreement was entered into solely or mainly for the purpose of utilizing that company's assessed loss in order to avoid tax liability.

It was held in the special court and in the Transvaal Provincial Division that the Commissioner was not entitled to disallow the set-off of the assessed loss against the income received. This conclusion was reached on the basis of a finding that the agreement to be considered was not the transfer agreement but the merger agreement. The

conclusion on the facts was that the taxpayer discharged the onus of establishing that the utilization of the assessed loss of Model Homes was not the sole or main purpose of any of the parties who entered into the merger agreement.

I am, with respect and for the reasons which follow, constrained to disagree with the courts below.

Clause 11 of the merger agreement did not itself create rights and obligations. It was an agreement to agree in future on "reasonable terms and conditions" and as such was not legally enforceable. Model Homes was not a party to clause 11. The merger agreement did not affect Model Homes, and neither directly nor indirectly did it result in income being received by Model Homes.

The transfer of Ocean's business as a going concern was not a component, essential or otherwise, of the "complete package" wrapped up in the main or merger agreement. It was not like "the injection of capital into B&P (to be underwritten by Finansbank) and the relisting of B&P's shares

on the Johannesburg Stock Exchange" referred to by KRIEGLER J. Those were conditions precedent, subject to the fulfilment of which the entire agreement was subject. The transfer was not a part of the reconstruction, which was in no way dependent upon it: the agreement contemplated in clause 11 was to be concluded after the reconstruction had been achieved. The transfer was an internal re-arrangement of assets between subsidiaries of B&P, and it formed no part of the "multi-faceted and complex integration of many rights and obligations between a variety of parties." This is made clear by paragraph 11.9 of the Statement of Agreed Facts:

"11.9 In summary the transaction, as a whole, was motivated on the part of Ocean shareholders by the desire to have a public listed company for all the incidental advantages to the Ocean Manufacturing group. The transaction would have taken place whether or not Model Homes had an assessed loss"

It follows from this that the transaction would have taken place whether or not clause 11 was included in the merger

agreement.

In my opinion therefore the learned judge's reasoning does not provide a sound basis for his conclusion.

The main argument advanced in this court by Mr Swerky on behalf of Model Homes was this. He conceded that "as a matter of legal form" there were two agreements - the merger agreement and the transfer agreement. Model Homes was not a party to the merger agreement, in the negotiation of which the parties were at arms' length and engaged in hard bargaining. "In legal form" Model Homes was a party to the transfer agreement, but as it was a wholly-owned subsidiary of B&P, it had "no independent mind, interest or purposes; it was formally carrying out what had already been agreed in substance between the parties to the merger agreement." The transfer of the business to Model Homes, though "in legal form" an agreement between Model Homes and Ocean, was "in commercial reality an implementation of an arrangement between Finansbank, B&P and Ocean and was nothing more than

an integral component of the merger of interest which had been provided for in the main agreement." He submitted that "there was, effectively, from an economic and business point of view, only one transaction."

I am at a loss to understand all this. The word agreement as used in s 103(2) connotes a contract, that is, an agreement which is legally binding and enforceable between the parties. Any implication that an agreement "in legal form" is something less than or different from such an agreement, is to be rejected.

Nothing was disclosed in the Statement of Agreed Facts as to the way in which the transfer agreement was concluded or as to its terms. Mr. Swersky may well be correct when he suggests that its terms and conditions were imposed on Model Homes and Ocean by B&P, in which the former shareholders in Ocean had acquired a controlling interest. But it is accepted in the Statement of Agreed Facts that an agreement having legal consequences was concluded between

Model Homes and Ocean.

On the facts there is no basis for the submission that there was here, effectively and from an economic and business point of view, only one transaction. Although it is correct that the transfer agreement would not have been entered into but for the merger agreement, the fact is that they were discrete transactions, and the transfer agreement, although contemplated by clause 11, was in no way a component of the merger agreement.

The conclusion is that what has to be considered is the purpose of the parties to the transfer agreement in entering into that agreement. It could not be disputed that the sole purpose was to utilize the assessed loss of Model Homes to avoid liability for tax, and that is abundantly clear from the Statement of Agreed Facts. There could be no other purpose. With the completion of the reconstruction, Ocean, with its profitable business, became a fully owned subsidiary of B&P, and there could be no point, apart from

tax avoidance, in transferring that business to another fully-owned subsidiary having an assessed loss.

In an alternative argument, Mr Swersky submitted that on a proper interpretation, the expression "any agreement affecting any company" in s 103(2) "is restricted to an agreement which affects the control of the company or one which affects any person's right to participate in the profits or dividends of the company."

In my opinion there is nothing to warrant that interpretation. Any is "a word of wide and unqualified generality. It may be restricted by the subject-matter or the context, but prima facie it is unlimited." (Per INNES CJ in R v. Hugo 1926 AD 268 at 271). "In its natural and ordinary sense, any - unless restricted by the context - is an indefinite term which includes all of the things to which it relates." (per INNES JA in Hayne & Co v. Kaffrarian Steam Mill Co Ltd. 1914 AD 363 at 371.)

In regard to the subject-matter there is nothing

in s. 103(2) to suggest that the word any was used in a limited sense. S 103(2) does not impose a tax, but relates to agreements designed for the avoidance of tax liability. It should be construed in such a way as to advance the remedy provided by the sub-section and suppress the mischief against which it is directed. The Commissioner's powers should not be restricted unnecessarily by interpretation. (See Glen Anil Development Corporation Limited v. S.I.R. 1975(4) SA 715(A) at 727 H-728 A). In regard to the context, s 103(2) relates to "any agreement affecting any company or any change in the shareholding in any company..." In using the words I have underlined, the legislature has provided for the sort of case referred to by counsel; it is unlikely that it could have intended that it should be covered also by the earlier words.

Counsel sought to rely on the eiusdem generis rule.

A single species (in this case "any agreement affecting any change in the shareholding in any company") does not constitute a genus. (See Craies on Statute Law 7th ed, 181. "Unless you can find a category", said FARWELL LJ in Tillmans & Co v. SS Knutsford (1908) 2 KB 385, 403, "there is no room for the application of the eiusdem generis doctrine.")

Another argument by Mr Swersky was this. The legislature could not have intended that a company which had suffered a loss (and, as a result, had an assessed loss) would not be able to make up that loss and turn the company into a profit-making concern by acquiring other business assets. S 103(2) was not designed to counter this or to prevent a taxpayer from setting off the consequent profits against the assessed loss.

That is no doubt correct if the sole or main purpose of the acquisition is only to make profits. What s 103(2) is aimed at is an agreement which has tax avoidance

as its sole or main purpose.

In regard to the order to be made, Mr Southwood, senior counsel for the Commissioner, pointed out that in the 1981 tax year, Model Homes did not receive income under the transfer agreement, and in consequence s 103(2) did not apply. The assessments should, therefore, be revised. It was not contended by the respondent that this should affect the costs of appeal.

The following order is made:

- (a) The appeal is upheld with costs, including the costs of two counsel.
- (b) The order made by the Transvaal Provincial Division is set aside and the following is substituted:
 - (i) The appeal is allowed with costs, including the costs of two counsel.
 - (ii) The order made by the special court is set aside and the following is substituted:

"The assessments in respect of the years of assessment ended 30 June 1981 and 30 June 1982 are set aside and referred back to the Commissioner for re-assessment in the light of this judgment and for correction if necessary of the possible arithmetical error in the 1982 assessment."

NICHOLAS AJA

CORBETT	CJ	
BOTHA	JA	Concur
SMALBERGER	JA	
SMUTS	AJA	