

IN THE SUPREME COURT OF SOUTH AFRICA

(APPELLATE DIVISION)

CASE NO: 72/89

In the appeal of

DARYL BURMAN

APPELLANT

and

COMMISSIONER FOR INLAND REVENUE

RESPONDENT

Coram: BOTHA, NESTADT et KUMLEBEN JJA; NICHOLAS et GOLDSTONE

AJJA.

Date heard: Friday 7 September 1990

Date delivered: Friday 23 November 1990

J U D G M E N T

GOLDSTONE JA:

I have had the privilege of reading the judgments of Nestadt JA and Nicholas AJA. The facts are fully set out in the judgment of Nicholas AJA and it is unnecessary to repeat them. As emerges therefrom, the sole issue in this appeal is whether the losses sustained by the taxpayer, Mr Daryl Burman ("Burman"), were of a capital nature. The conclusion reached by Nestadt JA and Nicholas AJA is that they were not of a capital nature and were therefore properly deductible in the assessment of Burman's taxable income. With respect, I have come to a different conclusion.

In this type of case the preliminary step is:

"to obtain clarity as to precisely what it is that appellant seeks to deduct."

per Corbett AJA in Stone v Secretary for Inland Revenue 1974

(3) SA 584 (A) at 592H. As it was put in New State Areas Ltd v Commissioner for Inland Revenue 1946 AD 610 at 627, it is necessary to ascertain the true legal nature of the transactions which gave rise to the losses.

The true legal nature of the transactions which gave rise to the losses in the present case was that they were a number of contracts of loan between Burman and property companies in the "Concord Group". The loans were made for the purpose of financing these companies and enabling them to purchase fixed property ie. the provision of working capital. What Burman seeks to deduct from his taxable income are the losses sustained on the loans by reason of the insolvency of the

companies.

It was the intention of Burman that as soon as possible his shares and loan accounts would be sold. The envisaged sale was to a public company. The purchase consideration would be paid by way of an issue of shares in the public company to Burman. Although, as pointed out by Nicholas AJA, Burman's evidence lacked clarity and detail, as I understand his evidence the shares in the property company would have been sold at their market value in return for shares in the public company having a similar value. The loan accounts would have been sold for shares in the public company having a value equal to that of the respective loan accounts. Burman would then have sold the shares in the public company on the market and thereby recouped his expenditure and realised a profit. It follows that the anticipated profit would come about by reason of the difference between the cost to Burman of his shares,

on the one hand, and the proceeds of the shares in the public company received therefor, on the other hand. No profit would accrue to Burman on the sale of the loan accounts. He would simply recoup his outlay in full. As it was put by Jennett J in the judgment of the Special Court:

"The purpose of the loans was in order to make a profit on the sale of shares."

The judgment in Stone v Secretary for Inland Revenue 1974

(3) SA 584 (A) is instructive in considering the main issue which arises in the present matter. In that case, it is recorded in the judgment of Corbett AJA (at 592 F) that counsel for the taxpayer submitted that:

"In each transaction appellant's purpose was to lay out the money, or engage his credit by way of

suretyship, in order to have the money returned, or his suretyship terminated, together with the agreed profit."

Corbett AJA analysed what it was that the taxpayer sought to deduct. At 592 in fine - 593 C the learned Judge of Appeal said:

"In regard to the loan transactions, what it is that the appellant seeks to deduct is the loss suffered by him by reason of the fact that the capital sum loaned to Kasmai proved irrecoverable. As a result of each loan agreement and of the fact that appellant had actually advanced the amount of the loan, appellant became entitled contractually to receive back from Kasmai the capital sum lent, together with the share of profit amounting to 20 per cent of the capital.

The stated case does not reveal what was to have happened if no profit was realised upon Kasmai's alleged contracts with the third parties concerned, or if the profit realised amounted to less than 20 per cent. Nothing appears to have been said about this at the time. Presumably, appellant was confident that a substantial profit would always be made and did not contemplate these contingencies. Be that as it may, Kasmai went insolvent and the appellant's right to recover the capital lent proved worthless. In essence, therefore, these two loans became bad debts."

The learned judge continued at 593 E - G:

"I have been at pains to emphasise what I conceive to be the true nature of the deduction claimed by

the appellant because, as I have indicated above, appellant's counsel tended to found his argument upon the 'expenditure' which it was said appellant had incurred in making these loans to Kasmai. But it is not this 'expenditure' which appellant claims to deduct: it is the loss of the loan capital by reason of it having become irrecoverable. Indeed, were it not for this loss there would be no question of any such deduction. No doubt, in characterising this loss regard must be had to the loan transaction itself; but that does not detract from the basic proposition that the true issue in this case is the deductibility of the loss. The importance of this analysis becomes apparent when one comes to apply the various tests relating to the distinction between expenditure and losses of a capital nature and those of a non-capital nature. Without clarity

upon this the tests may be misplaced and false analogies may be drawn."

After considering a number of authorities, Corbett AJA said
(at 594 H):

"It is sufficient for present purposes to observe that in this case, as far as the loan transactions were concerned, the irrecoverability of the capital loaned constituted a loss in the sense of an involuntary deprivation and, as I have already indicated, it is this loss that is the true substance of the deduction claimed."

An analysis of the facts of the present case, in my opinion, will yield a similar conclusion. Whatever Burman's intention, there is no question but that the transactions between Burman

and the property companies were contracts of loan. As between them Burman became contractually entitled to receive back the capital sums lent. As in Stone's case, the evidence does not reveal whether Burman or the companies contemplated what was to happen if the shares and loan accounts were not purchased by the public company. In any event, the companies became insolvent, and apart from small liquidation dividends, the loans became bad debts. As in Stone's case, section 11 (i) of the Income Tax Act, 58 of 1962 (the Act), was of no assistance to Burman as the capital amounts of the loans had never been included in Burman's income. Hence, the enquiry as to whether these bad debts are deductible in terms of the provisions of section 11 (a) of the Act.

The next stage of the enquiry was described as follows by Corbett AJA in Stone's case (at 594 in fine - 595 B):

"The central issue remains: was this loss of a capital or non-capital nature? One way of dealing with this issue - and one that has to me a logical appeal - is to ask what was it that was lost? The answer, I think, is clear: the appellant lost the capital which he had advanced by way of loan to Kasmai. The next enquiry follows as a natural corollary; was the capital lost fixed or floating (circulating) capital? If it was fixed capital, then the loss was of a capital nature; if floating (or circulating) capital, then it was a non-capital loss. These conclusions would be in conformity with the dicta of Watermeyer, C.J. - cited above - in which the concept of a 'loss' is identified with a loss of floating capital."

In New State Areas Ltd v Commissioner for Inland Revenue (supra)

at 620, Watermeyer CJ 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 manufactured article), and this is done for the purpose of making a profit, then the capital so employed is floating capital."

In the present case there was certainly no question of Burman's money "frequently changing its form". As far as one can glean from the record, loans were made once and for all to the property companies and they would have remained as such until purchased by the public company. There was no suggestion that if recouped the amounts of the loans would be utilised in

the making of further loans. It follows, in my opinion, that the moneys lent by Burman to the property companies were fixed capital. For this reason I cannot agree with the contrary conclusion reached by Nestadt JA and Nicholas AJA. That conclusion has insufficient regard to the absence of any intention by Burman that there would be any recurrence of expenditure: see Atlantic Refining Company of Africa (Pty) Ltd v Commissioner for Inland Revenue 1957 (2) SA 330 (A) at 336 C - F.

There are two points of distinction between the facts of the present case and those in Stone's case. In the latter case the capital amounts of the loans were intended to be repaid to the lender directly by the borrower. In the present case the intention was that the capital amounts of the loans would be recouped

by means of payment in shares in the public company and the immediate resale of those shares on the market and that they would be repaid as part of the same transaction in which Burman's shares in the property company were sold. It appears to be these distinctions which have led Nicholas AJA to the conclusion that the loans in a case such as the present were:

"a component, together with his shareholding, of the member's interest in the company."

That approach, in my respectful opinion, ignores the commercial reality and legal consequences of the loans made by Burman. There is no question here of the loans having been fictitious or disguised transactions or that the usual consequences of a loan would not operate in respect thereof. At all times

the borrowers of the moneys were Burman's debtors and must have been so regarded by him. When Burman proved his claims against the estates of the insolvent property companies it would not have availed the liquidator to plead that Burman's intention had been to recover his loans in a manner other than by direct payments by the borrowers or that he did not intend to be repaid if he did not simultaneously sell his shares.

Nicholas AJA points to the common practice with small private companies of the issued share capital being minimal and the operating capital being provided by way of shareholders' loans. Insofar as this consideration is relevant, regard must be had to the reason for this practice. Until this year, dividends received from companies by individual taxpayers attracted liability for income tax. However, the repayment of a loan (save perhaps to a money-lender) would constitute a capital

repayment and would not attract liability for income tax.

Corporate profits were therefore more beneficially used in the repayment of loan accounts than in the declaration of dividends. In the present case Burman was a minority shareholder in the property companies. If the majority, for whatever reason, had decided to repay the loan accounts in whole or in part, Burman could not have objected and such repayments could hardly have constituted taxable income in Burman's hands.

In short, Burman's intention that he would be repaid the loans together with a sale of his shares in the property companies was in no way inconsistent with the loans being genuine and their having the legal consequences which usually flow from contracts of loan. However Burman regarded his shares and loan accounts, the fact is that he did indeed hold two different economic entities. His intention did not destroy or even mask the reality that if he made a profit in the manner

contemplated by him that profit would have come about only

because of an increase in the market value of his shares.

The value of his loan account could never have exceeded the capital amounts thereof which he lent to the property companies.

The frustration of Burman's intentions in no way prevented the loans from becoming bad debts.

It follows, in my opinion, that the loans made by Burman constituted fixed capital and the loss of the capital amounts thereof were not deductible in the computation of his taxable income. A similar conclusion was reached in ITC 1321, reported in (1980) 42 SA Tax Cases 269. In that case, too, shareholders, including the taxpayer, advanced funds on loan to six companies. According to the headnote:

"At all material times the intention of the companies was to resell the land at a profit. A prospective

purchaser would thus be able either to take transfer of a particular group of subdivisions or to purchase shares and loan account of the relevant company.

... Appellant divested himself of his investment by way of shares and loan account in four of the companies.

...

In support of his appeal it was submitted by appellant that the shares and loan account in issue were irrevocably linked and that, since the loss on the former had been allowed, the loss on the loan account should likewise be allowed; and also, in effect, that he should be regarded as an individual who had purchased land as a profit-making operation which had resulted in a loss."

In dismissing the appeal, Milne J said the following:

"The only way in which it would be possible to uphold the appellant's contentions would be to say that he must be regarded as being in the same position as an individual who decided to purchase land and who made a loss, having purchased such land as a profit-making operation, and that the losses must be taken to be incurred in the production of an income-producing venture. It is however, not possible to ignore the existence of the companies. The true position, in fact and in law, is that the appellant lent the company money in order to enable the company to acquire immovable property, and to assist the company with the running expenses incurred in respect of that immovable property. The company was carrying on the business of selling land for profit, not the appellant. Furthermore, the appellant concedes

that he is not a moneylender, and once the true position is, as it is in the view of the court, that this is simply a loan to a company, which has not been recovered in full, this is a loss of fixed capital (cf the well-known passage in the judgment of the Appellate Division in Stone v SIR 1974 (3) SA 584 and 36 SATC 117, and in particular the passage at 130 of the SATC report, where the distinction between fixed and floating capital is clearly drawn)."

I do not agree with Nestadt JA and Nicholas AJA that ITC 1321 is distinguishable from the present case. The only point of distinction is that in ITC 1321, the purchaser apparently paid cash for the shares and loan account whereas in the present case the shares and loan accounts were intended to be exchanged for shares in the public company. That distinction has no effect at all on the nature of Burman's loan accounts or on

the legal principles to be applied in the present case.

As appears from the judgment of Milne J, the taxpayer's argument was, inter alia, that-

"The disposal of the loan account should be seen as part and parcel of the shares as they are linked together."

That argument, (which was advanced on behalf of Burman in the present case), was rejected by Milne J, in my opinion, correctly. I cannot agree with Nicholas AJA that the similarities between that case and the present case are "surface similarities" or that it differs "toto caelo" from the present case.

Both Nestadt JA and Nicholas AJA rely upon ITC 1344 reported in (1981) 44 SA Tax Cases 19. I agree with Jennett J that

the decision in that case is only explicable upon the agreed facts which recorded, inter alia, that

"... it was at all relevant times his intention to sell the said shares and loan account as soon as the development was completed with a view to making a profit."

The intention expressed was that the shares as well as the loan accounts would indeed be sold at a profit. That is the basis upon which the case was approached by Grosskopf J, as appears from the passages of his judgment cited by Nicholas AJA. There are no facts which establish that in the present case.

On the main issue which arises I would dismiss the appeal.

It was common cause between counsel that there is an error

in the order made by the Special Court. That order reads as follows:

"In the final result, however, the appeal is allowed only to the extent that the assessment is set aside and the matter is remitted to the Commissioner to reassess appellant's liability for income tax on the basis that interest on funds borrowed to finance the purchase of shares is deductible from appellant's income."

However, in terms of an agreement which the parties entered into prior to the hearing in the Special Court it was agreed that:

"... interest paid is deductible subject only to an adjustment in terms of s 19 to the extent that the borrowings funded the purchase of shares."

The effect of the order of the Special Court is to allow the deduction only of a small portion of the interest paid by Burman and not, as agreed, all of the interest. I have difficulty in understanding how the provisions of section 19 of the Act might be of application. That notwithstanding, I am of the view that the Special Court should have made an order which reflected the parties' agreement.

Mr Melunsky, on behalf of Burman, submitted that if he failed on the main issue then Burman should still be awarded the costs of the appeal. He based that submission upon the necessity of Burman having to approach this Court for the variation of the order made by the Special Court. That order was at no time abandoned by the Commissioner. However, that point was conceded by the Commissioner's counsel in his heads of argument which were filed in this Court on 15 May 1990.

In my opinion, the most that could have been argued on behalf of Burman is that he was entitled to the costs incurred by him up to 15 May 1990 in consequence of the error in the order. The only relevant documentation would have been the terms of the agreement between the parties and the judgment of the Special Court. The costs in relation thereto are minimal and, in my opinion, do not justify a special order.

The following order is made:

1. The order of the Special Court is amended to read as follows:

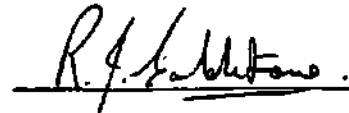
"The appeal is allowed only to the extent that the assessment is set aside and the matter is remitted to the Commissioner to reassess appellant's liability for income tax on the basis that the interest paid by him is deductible subject only to an adjustment

in terms of section 19 of the Income Tax Act No.

58 of 1962 to the extent that the borrowings funded

the purchase of shares."

2. Save as aforesaid the appeal is dismissed with costs.



GOLDSTONE JA

BOTHA JA) CONCUR

KUMLEBEN JA)

IN THE SUPREME COURT OF SOUTH AFRICA

(APPELLATE DIVISION)

In the matter between:

DARYL BURMAN

APPELLANT

and

COMMISSIONER FOR INLAND REVENUE

RESPONDENT

CORAM: BOTHA, NESTADT, KUMLEBEN, JJA et NICHOLAS,

GOLDSTONE AJJA

DATE HEARD: 7 SEPTEMBER 1990

DATE DELIVERED: 23 NOVEMBER 1990

J U D G M E N T

NESTADT JA:

There is no dispute that the amount in question, viz, R76 398,00 represents losses incurred in the production of income. What is in issue is whether

appellant established that they were not of a capital nature (within the meaning of sec 11(a)). I assume, despite the wording of the agreement between the parties, that appellant also had to show that the deduction sought to be made was wholly laid out for the purposes of trade (within the meaning of sec 23(g)). I think he did both. In my view therefore the amount should have been allowed as a deduction from appellant's income.

If the loss in respect of the loans is deductible, so too is that resulting from appellant's liability under the suretyships. They share the same fate. I therefore confine my attention to the loans. There is no reason in principle why, even though appellant was not a money-lender, they should not qualify as expenditure of a non-capital nature. Stone's case is not contrary to this approach. The business of money-lending is given (at 597 G) only as an example of a loan being

circulating or floating capital. But there are other situations where this may be the case and where the loss resulting from the irrecoverability of the loan would accordingly be an allowable deduction. A number of reported judgments in both the United Kingdom and South Africa illustrate this (see Whiteman and Wheatcroft on Income Tax, 2nd ed, para 8-67; Silke on South African Income Tax, vol 1, 11th ed, para 7.43; Meyerowitz and Spiro, Income Tax in South Africa, paras 715-7). Many of the cases relate to loans between inter-connected companies; some to loans made by a trader for the purpose of obtaining business; and others to loan accounts of a shareholder in a private company to finance its activities. It would seem that what has to be determined is whether the loan was made in order to earn income apart from interest on the loan (Meyerowitz and Spiro, para 715). But no precise formula for doing this emerges. In these

circumstances the guidelines laid down for distinguishing between capital and revenue expenditure (as to which see New State Areas Ltd vs Commissioner for Inland Revenue, 1946 AD 610) have to be applied. Accordingly, the true nature of the transaction must be examined. One has to assess the closeness of the connection between the expenditure and the income-earning operations having regard to the purpose of the loan and to what it actually effects. In a case such as the present this involves taking account inter alia of the nature of the lender's business; the relationship between him and the company; the terms of the loan; its purpose; and its effect.

In a number of respects appellant's evidence lacks clarity. It does, however, establish that his acquisition of an interest in the companies was in furtherance of a scheme of profit-making. The idea (the Warren Street concept) was that he would, in exchange for

his shareholdings and loan accounts, acquire shares in the public company which it was contemplated would be formed. These would then be sold as soon as a stock exchange listing was obtained. When this scheme miscarried, a different modus operandi was evolved. This was the Concord project. But the principle of "quick profits" remained. Appellant's testimony in this regard was:

"If I can summarise, the intention throughout the property investment was in fact not investment or a rental dividend return but really was a speculative interest in property, interest acquired from the resale at a profit. --- Yes, that is correct, my lord."

In these circumstances the following finding of the special court was fully justified:

"It may be accepted that at all material times, commencing with the Warren Street concept, the intention of appellant with regard to his shares in the various companies was such that the proceeds received on any sale thereof would have been in the nature of revenue income. After the Warren Street phase appellant also at all material times intended and saw himself as divesting himself completely of his interests in

the companies...."

But the crucial issue concerns the status of the loans. They were made (by appellant as well as his co-shareholders) to provide the companies with working capital. I understand this to mean that the companies would thus have the finance to be able to pay for the properties which were being purchased by each of them. In these circumstances they were prima facie capital payments (cf Milnes (H.M. Inspector of Taxes) vs J Beam Group Ltd 50 T C 675 at 687 E) and the onus resting on appellant to show that they were revenue transactions may be said to be a heavy one. More especially is this so when it is borne in mind that the loans, unlike the shares, would not ordinarily be able to be sold, ie ceded, at a profit. On the other hand, however, appellant with justification regarded his shares and loan accounts as one indivisible economic unit or asset. The acquisition of the shares

took place when the loans were made and depended on them.

According to appellant:

"(E)very share you wanted, you had to lend so much money. I don't know whether that is called a premium on shares but it was a condition initially, that if you took up three or four percent shareholding, then for each share you had to lend so much money..."

His further evidence as to how he understood his interest in the companies would be realised is also significant. Having explained that there was no agreement as to repayment of the loans by the companies and that there was no provision for the payment of interest, he said:

"So you just saw yourself selling both shares and loan accounts ultimately? -- That is correct, my lord... And (the shares and loan accounts were) virtually a package which you saw of yourself as selling. -- That is correct, my lord... Do you understand a loan to mean something that would be repaid --- I understand that, yes. But as I say in my particular case it was not an investment in a company, it was only because I was told there was a profit that I put the money in, so whether it was shares or loans, it was part of the speculation just to get out again... (Y)ou felt that you might have been repaid loan accounts. --

No, not repaid loan account, paid for my loan account. I couldn't have been repaid loan account, we were going to sell out ...(T)he presentation to you, was that your interests both shares and loans, would ultimately be consolidated in shares which you could sell for a profit? -- Yes, that is this deal to Warren Street. Right."

It is true that appellant made a claim against the companies in liquidation for, so it would seem, repayment of his loan accounts (and in fact received a small liquidation dividend). But that cannot detract from the overriding intention that the loans were not to be repaid by the companies as borrowers. As indicated, recoupment would occur as part and parcel of the eventual realisation of the shares. That this is so, appears further from a passage in a letter of a Johannesburg firm of attorneys who were to handle the proposed public flotation. It is recorded that appellant and his associates intended that "(t)he shareholders of Warren will sell their shares and the claims on loan account against Warren to the public

company in exchange for shares in the public company and a certain amount of cash." Presumably the loan capital of each of the particular companies would first be converted into share capital. The resultant increased number of shares would entitle appellant to an allotment of shares in the proposed public company. These shares would then be sold at a profit which no doubt would have formed part of appellant's taxable income.

What has been stated shows, to my mind, that appellant was engaged, besides his profession, in another income-earning operation or business. His shares were his trading stock. And the money he outlaid for the loans, though his capital, was his floating capital. It was not invested in the ordinary sense. It was capital employed in his other business. To regard it otherwise would, I venture to suggest, be artificial. Nor were the loans, as was argued on behalf of respondent, made to preserve a

capital asset. They were a sine qua non to appellant acquiring the shares which would enable him to earn a profit. This involves taking account of the function of the loans. It is legitimate to do this (Plate Glass and Shatterprufe Industries Finance Co (Pty) Ltd vs Secretary for Inland Revenue 1979(3) S A 1124(T) at 1132A).

In the result, therefore, expenditure was incurred on acquiring an asset (the shares and loan accounts) which appellant hoped would be sold at a profit. However, the asset turned out to be substantially valueless. The consequential loss was, accordingly, of a non-capital nature. And the money expended in order to make the loans was laid out wholly for the purposes of trade. This was appellant's trade. It is this factor that distinguishes the present matter from cases such as ITC 1321 (1980) 42 SATC 269 and ITC 1327 (1981) 43 SATC 47. On the other hand, this case does not differ substantially

from that of ITC 1344 (1981) 44 SATC 19 in which a similar deduction was allowed.

I accordingly agree with NICHOLAS AJA that the appeal be allowed in the terms suggested by him.

NESTADT, JA

IN THE SUPREME COURT OF SOUTH AFRICA
(APPELLATE DIVISION)

In the matter between:

DARYL BURMAN..... Appellant

and

THE COMMISSIONER FOR INLAND REVENUE..... Respondent

CORAM: BOTHA, NESTADT, KUMLEBEN, JJA, NICHOLAS et
GOLDSTONE AJJA.

DATE OF HEARING: 7 September 1990

DATE OF JUDGMENT: 23 November 1990

J U D G M E N T

NICHOLAS AJA:

This appeal from the Eastern Cape Income Tax Special Court relates to the disallowance by the Commissioner for Inland Revenue ("the Commissioner") of deductions claimed by Mr Daryl Burman ("Burman") in his

return of income for the year of assessment ended 28 February 1983: namely the losses arising from loans to certain property companies; the amounts paid in terms of suretyships for the obligations of the said companies; and interest on money borrowed on overdraft to finance the purchase of shares in the said companies and to enable Burman to satisfy the suretyship obligations.

The facts

In the Special Court, over which Jennett J presided, the only witness was Burman himself, who is an attorney. His evidence was not seriously challenged by the Commissioner's representative, and the Special Court found no reason to doubt his veracity. His account of the circumstances which gave rise to his claim for the deductions was, it is true, general in its nature and it tended to be vague and to lack detail and documentary support. That was

possibly due to the fact that Burman was at the beginning of the relevant period a tyro in matters of business, having spent the whole of his working life in the State Attorney's office, more particularly in the conveyancing department; that he was not himself actively involved in the transactions concerned but played a minor and relatively passive part, and was not concerned in the day to day management of the companies; and that the relevant events occurred over a period of years from 1965 to 1982. Nevertheless, the Special Court was able to make clear findings (not challenged by the Commissioner) in regard to the material facts, so that the questions for decision are essentially questions of law.

Burman's story had its beginning in May 1965. He had recently resigned from the Civil Service because he wished to return to Cape Town, where he had lived most of his life, and the Department of Justice had refused to grant

him a transfer. He had obtained employment in Cape Town when a University contemporary, Mr Aaronson, who was also an attorney, persuaded Burman to run the conveyancing department of Aaronson's firm in Port Elizabeth. Aaronson held out the prospect of a partnership at the end of the then current financial year.

In Port Elizabeth he found that the partners in the firm engaged in property speculation, something which increased in 1967 when the firm was joined by Mr Harold Blumberg, whom Burman described as a "wheeler dealer in property". To judge by Blumberg's subsequent activities, that expression, as described in the American Dictionary of Slang ("an adroit, quick-witted scheming person"), aptly described him.

When Burman came to Port Elizabeth his financial resources amounted to no more than R2 000 in total which he used for the deposit on a house which he bought and for

transfer costs. At the end of the 1966 financial year he was offered a 20% interest in the practice. A goodwill of some thousands of rands was required and this was obtained by way of an overdraft from Nedbank which his partners arranged for him.

Burman became interested in property speculation after Blumberg came on the scene. The latter got together a group of people, each of whom contributed R10 a month for this purpose and a company named Dolphin Trust was formed. For various reasons Burman was not happy in Port Elizabeth, and he was anxious to go back to Cape Town. Blumberg told him that with property dealing he could make a quick profit within a short time and pay his debts and get out. He let Burman have "a very minimal interest" in some of the schemes he was putting together, and so Burman became involved.

Burman's first substantial investment was made in 1967 in a company named Louise Michael Development (Pty)

Ltd. This company had acquired a township in Port Elizabeth called Lovemore Heights. Burman was led to believe that within a reasonably short time all the 131 erven which had been opened up would be sold. He was called upon to put in R6 500 which he raised by increasing his overdraft with Nedbank to R10 000. There was a vigorous advertising campaign, and at a one-day sale about 100 erven were sold. But the resulting state of euphoria was of short duration. For various reasons the whole operation turned sour and many buyers withdrew from their contracts. The venture at that stage was a failure. Burman's financial situation was now parlous. The amount of his overdraft exceeded his annual income which was then about R8 000, and he could not afford to pay the interest on the overdraft. Seduced by the lure of quick profits with which he could retrieve his position, however, he continued to participate in Blumberg's schemes.

Blumberg's general modus operandi was to form syndicates composed of various members which would acquire properties and put them into companies, in which the members took shares and to which they advanced loans to be used as operating capital. Burman said:

"The way it was done was every share you wanted, you had to lend so much money.... it was a condition initially that if you took up three or four per cent shareholding, then for each share you had to lend so much money plus, of course, you had to put in your proportion of any costs at that stage."

The object of the loan money was to develop the property concerned, to keep it running and to cover the day to day expenses of the company. There was no agreement that the companies would pay interest on the loans (although it appears that, unbeknown to Burman, insignificant amounts of interest were at a later stage credited to his account) nor

was there any agreement in regard to the terms of repayment of the loans. Operating capital was also obtained by way of facilities afforded to the company concerned by a bank or building society, which facilities were guaranteed in terms of sureties furnished by the shareholders.

The main vehicle for the speculative operations was a company named Concord Development Holdings (Pty) Ltd into which most of the properties were put. As at 1982 this company owed Burman R36 774,36 on loan account. The so-called "Concord Group" played an important part in the operations after 1970. Burman said that ultimately everything he owned, with one or two minor exceptions, was in Concord Development Holdings.

In about 1969 Blumberg devised what was called the Warren street concept, with which it was intended to exploit the then buoyant state of the stock and share market. The idea was to put Concord into a company named Warren Street

Investments (Pty) Ltd which also acquired, provisionally, a number of trading companies with a profits record. There was then to be created a public holding company which would issue shares inter alios to the shareholders in Concord and other companies, and would obtain a Stock Exchange listing. On the day of flotation, it was envisaged, the shares would be sold by Blumberg and his associates (including Burman) who would recoup, with a profit, what they had put into the companies.

This concept was not realised. As Burman put it in his evidence, that South Sea Bubble burst, the whole exercise was one of futility because the Stock Exchange clamped down on this sort of flotation and "we had missed the boat".

The next scheme was a pure property portfolio put together in the Concord group which was to be sold "lock stock and barrel" to "one of these blossoming new generation

wonderboys, the Corlett Drive Estates, Tuckers, Mondeor, those Johannesburg companies". Burman said that he was now (1970-1971) absolutely desperate financially (his overdraft had increased to about R25 000) and he pinned all his hopes on a sale taking place. One offer was received, but it involved payment in shares and it was refused. The purpose was to realise the interest in cash, and shares were of no use.

After the failure of this scheme, Burman said, this was a very difficult period of his life, but he accepted that "the only way out of this was to have this package that could be marketed" and so they kept going, "but it never came to fruition and all that happened was that I kept on borrowing more and more money to put in".

Ultimately in November 1982 he became obliged to liquidate Concord Development and other smaller companies. With liquidation, Burman said, "I no longer had any

assets". His overdraft was called up and he was called upon to meet his suretyship obligations.

The Special Court Hearing and Judgment.

At the start of the hearing in the Special Court there was handed in by consent a document reading as follows:

"The appeal concerns the deduction of certain losses relating to interests in a property group and interest on loans raised to make such investments and to fund payments under suretyships related thereto. It is agreed that the only matter to be resolved is whether the losses in question represent expenditure incurred in the production of income not of a capital nature for the purpose of s.11(a). It is agreed that the expenditure and losses were actually incurred in the Republic. It is also agreed that interest paid is deductible subject only to an adjustment in terms of s.19 to the extent that the borrowings funded the purchase of

shares."

S.11(a) of the Income Tax Act 1962 ("the Act")

provides:

11. 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."

By reason of the agreement, the only questions in issue were whether the losses claimed as deductions were losses actually incurred in the production of income, and whether the losses were of a capital nature. The possibility mentioned in passing by Jennett J in the judgment of the Special Court that the deduction was hit by s.23(g) of the Act because the

loans as loans were not "laid out wholly and exclusively for the purposes of trade" accordingly did not arise. Nor does the contention now raised in the heads of argument submitted by counsel for the Commissioner that the losses were

"nie geheel en al of uitsluitlik vir bedryfsdoeleindes bestee of uitgegee nie en nie gemik op die voortbring van inkomste nie."

There was no issue between the parties as to the quantum of the losses and of the amount of the interest.

These had been set out in Burman's return of income:

"1. Verlies op leningsrekeninge en borgskappe verloor in Maatskappye van die sg 'Concord' groep, betrokke by spekulاسie in eiendomme en dorpsontwikkeling:-

(a)	<u>Leningsrekeninge</u>		
			60 249,31

(b)	<u>Borgskappe</u>		
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(i)	Nedbank.....	5 467,33	
	rente tot op		
	28/2/83	<u>206,71</u>	5 674,04

(ii)	Barclays	1 074,58	
	- 1/4 rente		
	tot op 28/2/83	<u>27,20</u>	1 101,78

(iii)	Trust Bank	7 285,44	
	rente tot op		
	28/2/83.....	<u>294,21</u>	7 579,65
(iv)	Boedel Hayward..	1 678,57	
	1/4 rente tot		
	op 28/2/83....	<u>82,87</u>	1 761,44
(v)	OPBV.....	642,77	
	rente tot op		
	28/2/83.....	<u>28,21</u>	<u>670,98</u>
Verlies vorentoe gedra			26 310,20 (<u>sic</u>)

- (2) Rente op oortrokke bankrekeninge,
welke skuld aangegaan is om lenings
in maatskappye, betrokke by
spekulاسie in eiendomme en
dorpsontwikkeling te finan-
sier

1.3.82 - 28.2.83

Nedbank	R3 617 31	
Barclays	<u>1 258 14</u>	<u>R 4 875,45</u>
		<u>R31 185,65</u>

The Special Court held by a majority (consisting of the learned President and the commercial member) that the losses were of a capital nature. The accountant member took a different view. An order was made as follows:

"The appeal is allowed only to the extent that the assessment is set aside and the matter is remitted to the Commissioner to reassess appellant's liability for income tax

on the basis that interest on funds borrowed to finance the purchase of shares is deductible from appellant's income".

In the judgment of the Special Court Jennett J said:

"It may be accepted that at all material times, commencing with the Warren Street concept, the intention of appellant with regard to his shares in the various companies was such that the proceeds received on any sale thereof would have been in the nature of revenue income. After the Warren Street phase appellant also at all material times intended and saw himself as divesting himself completely of his interests in the companies, i e his shares and his loan accounts, by selling them as a parcel. What this meant was that he would sell his shares and cede his loan account to a purchaser."

The court accepted that the loans were made in order to provide the companies with working capital, and that "the purpose of the loans was in order to make a profit on the

sale of shares".

The majority distinguished, however, between a sale of shares and a sale of a loan account. Having accepted that the shares were stock-in-trade, Jennett J said:

"Quite plainly the appellant's loan accounts can, in my view, never be equated with his stock-in-trade which were his shares even if it were intended that they be sold together....."

and that

".... it was never suggested that they (i.e. the loans) could ever have been disposed of at a premium so that any profit that the appellant might have hoped to derive on the loans would have had to have been achieved on the sale of shares."

On the basis that the loans were an entity separate from the shares, Jennett J proceeded to consider whether the capital used to make the loans was fixed capital or circulating

capital, and concluded that it was fixed capital.

The accountant member, on the other hand, did not accept that there was a dichotomy between the shares and the loan accounts. He considered that Burman's trading stock comprised the shares and the loan accounts together.

The narrow issue to be decided in this appeal is which view was correct.

Discussion

It is not unusual with small private companies for the issued share capital to be minimal and the operating capital to be provided by way of shareholders' loans. In such a case a shareholder's interest in the company has two components: his shares and his loan account. It may be objected that a shareholder's loan account as such is not an interest in the company. In its literal meaning a loan account is the formal record in the company's ledger of

credits and debits relating to moneys lent to the company; but in its usual business connotation it is the shareholder's claim against the company for the amount standing to his credit on loan account. Hence the shareholder is a creditor of the company. Ordinarily speaking, a creditor does not as such have an interest in the debtor company; what he has is a claim against the company for the amount of the debt. A shareholder with a loan account, however, is in a special position vis-à-vis the company. The loan is advanced for the purpose of enhancing his interest in the company and he is subject to restraints against getting repayment of the loan which are no less real for being unexpressed. In the ordinary case no interest or other consideration is payable by the company for the loan, and nothing is said regarding terms and conditions of repayment. In theory, the loan would be repayable on demand, but in practice no demand is likely to

be made so long as the company is in esse, unless it can obtain operating capital from somewhere else, for the obvious reason that the calling-up of a shareholder's loan is likely to drain the company of its life blood and thereby put its continued existence at risk. Even though it is not permanent capital, a member's loan is therefore a contribution to the capital of the company, and in a real, economic sense such loan is a component, together with his shareholding, of the member's interest in the company. Shares and loan accounts go in double harness, and a sale of shares by a shareholder in a private company is usually (one might almost say invariably) accompanied by a sale simul ac semel of any loan account owned by the seller. The reason is self-evident: the seller does not wish to leave his capital lying, unproductively from his point of view, in a company in which he has no interest; and the buyer does not wish to acquire shares in a company whose

capital structure is vulnerable to attack by a stranger.

On the evidence given in the Special Court Burman's operations followed the usual pattern: he acquired shares in property companies; he advanced monies on loan account to be used for operating capital; and it was his intention throughout that when he came to realise his interests, the shares and loan account would be sold as a single economic unit.

In my view therefore the majority of the Special Court erred in considering that when shares and a loan account in a company are sold there is a sale of separate entities and not a sale of a single interest in the company. What Burman had in contemplation was the sale, for one consideration, of his whole interest in each of the companies, not separate sales of shares and loan accounts. His stock-in-trade was not shares alone but interests in companies each comprising shares and loan accounts. There

is in my opinion no warrant for dividing the single price which it was contemplated would be obtained upon the sale of the single economic unit of shares and loan account between a price for the loan account (being its face value) and a price for the shares (being the balance).

The question to be decided turns on whether Burman's investment in each company (consisting of the shares and the loan account) was of the nature of fixed capital, or of floating (or circulating) capital. Ogilvie Thompson JA observed in Secretary for Inland Revenue v Cadac Engineering Works (Pty) Ltd 1965 (2) SA 511 (A) at 521 G - 522 B that expenditure "of a capital nature" eludes precise and comprehensive definition, but considered that the most useful general guide in determining what is almost invariably a somewhat evenly balanced and difficult problem

remains Watermeyer CJ's well-known, and often cited, summary of the authorities in New State Areas Limited v Commissioner for Inland Revenue 1946 AD 610 at 627 :

"The conclusion to be drawn from all of these cases, seems to be that the true nature of each transaction must be enquired into in order to determine whether the expenditure attached to it is capital or revenue expenditure. Its true nature is a matter of fact and the purpose of the expenditure is an important factor; if it is incurred for the purpose of acquiring a capital asset for the business it is capital expenditure, even if it is paid in annual instalments; if, on the other hand, it is in truth no more than part of the cost incidental to the performance of the income-producing operations, as distinguished from the equipment of the income-producing machine, then it is revenue expenditure, even if it is paid in a lump sum."

In support of the finding that the capital used to make the loans was fixed capital, Jennett J relied on the judgment in Stone v Secretary for Inland Revenue 1974 (3) SA 584 (A). In that judgment Corbett AJA referred to the delineation of the distinction between fixed and floating capital and said (at 595 G - 596 H):

"Applying the distinction, thus described, to the ordinary case of a loan of money, there is no doubt, in my opinion, that the capital lent constitutes fixed capital. Such capital is not consumed in the very process of income production: it does not disappear to be replaced by something which

/ when received....

when received by the taxpayer forms part of his income. It is true that the lender does not retain ownership in the actual money which passes but, in an economic and accounting sense, it remains his capital and upon the termination of the loan (all being well) it returns to him intact. In the process wealth may be produced for the lender but this takes the form of a consideration, usually in the form of interest, paid by the borrower for the use of the capital; it does not consist of the augmented proceeds of the capital, which itself has disappeared in the process."

He then referred to a number of decided cases in which it was accepted that

"..... where the taxpayer can show that he has been carrying on the business of banking or money-lending, then losses incurred by him as a result of loans, made in the course of his business, becoming irrecoverable are losses of a non-capital nature and deductible."

and went on to say -

"The rationale of these decisions appears to be that the capital used by a money-lender to make loans constitutes his circulating capital and that consequently losses of such capital are on revenue account. I shall accept, for the purposes of this case, that these decisions are correct, provided that the business is purely that of money-lender and the loans are not made in order to acquire an asset or advantage calculated to promote the interests and profits of some other business conducted by the taxpayer (cf. Atlantic Refining Company of Africa (Pty.) Ltd. v. C.I.R., 1957(2) S.A. 330 (A.D.)). There is, however, in my view, no warrant for extending this principle to loans by persons who are not conducting a money-lending business."

The learned judge did not here decide that losses incurred as a result of loans are deductible only in the case of a banker or money-lender. That appears from a passage later

in the judgment (p 597 G) where he refers to "the conclusion that a loss of capital loaned would be deductible only if it was circulating capital, as in the case of a money-lending business". In other words the case of the money-lender is merely one example, and the question in every case is whether the loss is a loss of fixed capital or floating capital.

In my view Stone's case is not decisive in the present matter. For the reasons given above, this was not "the ordinary case of a loan of money". According to Burman's evidence, which was accepted by the Special Court, it was not intended that the loan should be repaid by the company. The intention was that Burman should recoup his expenditure as a result of a sale, at a profit, of the shares and loan account together. They were made, not for the purpose of acquiring a capital asset, but for the purpose of acquiring stock-in-trade (i e interests in

companies) which was to be realised at a profit.

In my opinion, ITC 1344, a decision of the Cape Special Court, reported in (1982) 44 SA Tax Cases 19, is directly in point. There the Secretary for Inland Revenue had disallowed the deduction of a loss on the sale of a shareholder's loan account. At the hearing of the appeal the facts were agreed by the parties. So far as they are relevant for present purposes, they appear from paragraphs 7 to 12 of the agreement, namely,

"7. In toto, appellant advanced to the Companies on Loan Account, the sum of R196 723,00 (appellant's total Loan Account).

8. In October/November 1974... the parties, including appellant, sold their shares and Loan Accounts in A and B to C (Proprietary) Limited.

9. Appellant's total Loan Account was sold at a loss of R147 301,00.

10. Appellant is not a moneylender.
11. Where persons acquire immovable property through private Companies owned by them, it is accepted common commercial practice for the shares of the Companies concerned to be nominal and to provide the finance required by the Companies by way of loans to the Companies by the shareholders, proportionate to their shareholding.
12. When appellant took up his shares in A and B and advanced his moneys on Loan Account to the said Companies, it was at all relevant times his intention to sell the said shares and Loan Accounts as soon as the development was completed with a view to making a profit."

The learned President of the court (Grosskopf J) said at 24

in fin - 25:

"It is clear on the agreed facts that the shares and loan accounts were acquired by the appellant for the purpose of resale at a

profit. The appellant was consequently, in our view, engaged in an operation of business in a scheme of profitmaking, viz to sell the shares and loan accounts at a profit. In fact the scheme produced a loss and not a profit. In our view such a loss was properly deductible".

And in regard to Stone, he said:

"Stone's case dealt with loans which were intended to be repaid by the borrower to the lender and in respect of which the borrower was to pay interest or some other consideration for the use of the capital borrowed. The present case concerns loans which were intended to be sold by the lender to a third party. The benefit which the lender hoped to derive from his loan was not the return of his capital with interest, but a profit on the sale and cession of the loan. The ratio for holding that, in loans of the former type, the capital lent constitutes fixed capital does not, in our view, apply to loans of the latter type (vide Stone's case (supra) at 595-6 (SALR) and 130 (SATC))."

I respectfully agree.

In my view there is no valid ground for distinguishing ITC 1344 from the present case. It is true that here there was no agreement or evidence in regard to the "accepted common commercial practice" referred to in para 11 of the agreement in that case. It is possible that the practice referred to is so notorious that an income tax special court would be entitled to take judicial notice of it. But however that may be, it does not appear from Grosskopf J's judgment that the existence of this practice formed part of the ratio decidendi. In this case it is clear from the evidence that the shares and loan accounts were acquired by the appellant for the purpose of resale together at a profit. It is clear also that when Burman acquired his shares and advanced moneys on loan account to the companies concerned, it was at all relevant times his intention to sell the shares and loan accounts together, in

order to make a profit, when that was judged to be opportune. Burman's unchallenged evidence was that he did not expect to get the loans repaid by the debtor company: he would just sell shares and loan accounts. The intention throughout was that he was not to get a "rental dividend return" but a "speculative interest in property, interest acquired from the resale at a profit"; the properties were in companies in which Burman had shares and loan accounts, and this was virtually a package which he saw himself as selling.

ITC 1321, decided in the Natal Special Court and reported in (1980) 42 SATC 269, does not support the Commissioner in the present case. There the appellant sought to deduct a loss incurred upon the realisation of his shares and loan account in A (Pty) Ltd. This was a managing company for five companies whose object was to sell land at a profit. The appellant had been obliged to advance funds to the managing company from time to time to

enable the associated companies to finance the cost of purchasing immovable properties and to provide the running expenses of the companies. In the 1976-7 tax year the appellant had disposed of his investment in A (Pty) Ltd consisting of shares and loan account at a loss of R1 415,00. For reasons which are not germane to the present enquiry, the Natal Special Court dismissed an appeal against the disallowance by the Commissioner of an objection to the inclusion of the amount of the loss in the appellant's taxable income. Notwithstanding some surface similarities on the facts, ITC 1321 differs toto caelo from the present. It was not the case of the appellant there that he had acquired the shares and loan account in A (Pty) Ltd as stock-in-trade for disposal at a profit; his purpose was to make a capital investment in order to derive profits from the sales of land by the associated companies.

Counsel for the Commissioner put forward another

ground for contending that the losses were not losses of floating or circulating capital. He quoted a number of extracts from Burman's evidence which, he said, showed that although it was originally his object to make a quick profit out of the sale of his interest in property companies, this object disappeared in the course of time and he exerted himself and bought further shares and made loans only in order to rescue the companies from shipwreck and bankruptcy. He referred to the case of Sub-Nigel Ltd v CIR 1948 (4) SA 580 (A) at 599 where reference was made to the principle that expenditure incurred to preserve a capital asset is expenditure of a capital nature and not deductible. In this case, however, the expenditure to which Burman referred was incurred to preserve his stock-in-trade or floating capital, and hence was deductible.

The losses sustained in respect of the suretyship transactions stand on the same footing as the loans. What

Burman did by entering into these transactions was to "pledge or lend his credit" so as to enable the companies concerned to obtain finance for the carrying on of their operations. The liabilities accrued and Burman had to pay them in accordance with the suretyships. Like the losses on the loans, these losses were losses of floating capital. (Cf Stone (supra) at 598.)

Conclusion

In my opinion the losses claimed in Burman's return of income were properly deductible. I would make an order allowing the appeal with costs, and ordering that the order of the Special Court be set aside and that there be substituted therefor the following:

"The assessment is set aside and the matter referred back to the Commissioner for reassessment on the basis that the deductions claimed by the taxpayer be allowed."


H C NICHOLAS

LL

Case No 282/1989

IN THE SUPREME COURT OF SOUTH AFRICA
APPELLATE DIVISION

In the matter between:

TAYLOR & HORN (PROPRIETARY) LIMITED

Appellant

and

DENTALL (PROPRIETARY) LIMIED

Respondent

CORAM: JOUBERT ACJ, VAN HEERDEN, E M GROSSKOPF,
NIENABER JJA et NICHOLAS AJA

HEARD: 2 NOVEMBER 1990

DELIVERED: 23 NOVEMBER 1990

JUDGMENT

VAN HEERDEN JA:

The appellant carries on business as an importer, supplier and distributor of consumable dental material and equipment. It has some 1 800 customers including individual dentists, clinics, dental institutions and hospitals. During 1974 the appellant and a West German corporation ("ESPE") concluded an oral agreement. In terms thereof the appellant was granted the exclusive rights to market and distribute in the Republic products developed and manufactured by ESPE. The agreement was later reduced to writing and was still extant when the appellant initiated the undermentioned proceedings against the respondent.

Two of the products covered by the agreement are Impregum and its successor, Impregum F, which are patented rubber denture materials developed and manufactured by ESPE. (For convenience I shall refer to both products as Impregum.) The substance is used for making impressions for dentures, removable prostheses and full crowns, and permits a dentist to

obtain an accurate impression in a single procedure.

The appellant has been distributing Impregum in the Republic since 1974. As a result of the appellant's efforts in promoting Impregum it has become the most used dental impression material in the country. It is also the most important product marketed by the appellant, its sales representing - at least until 1987 - 18% of the appellant's total sales. The growth in the popularity of Impregum is demonstrated by the appellant's sales of the material during the period 1974 to 1986. In 1974 total sales of Impregum amounted to some R140 000; in 1986 the corresponding amount was nearly R770 000.

During 1987 the appellant experienced a marked drop in the volume of sales of Impregum. It then discovered that the respondent - which is also a local supplier of consumable dental material and equipment - was distributing Impregum in the Republic. The product was being sold in the original packaging in

which it had been placed by ESPE before distribution to its various agents. The respondent merely affixed to the outside of the packaging a sticker proclaiming that it (the respondent) was the supplier thereof. The respondent did, however, disseminate advertising material favourably contrasting its prices for Impregum with so-called regular (and higher) prices.

When the respondent refused to give an undertaking to desist from supplying Impregum, the appellant initiated motion proceedings in the Witwatersrand Local Division. The main relief sought by it was an order restraining the respondent from distributing Impregum for so long as the appellant enjoyed the exclusive distributorship rights in respect of the product in the Republic. The application was opposed by the respondent and a number of factual disputes arose. Since the appellant did not apply for an order referring such disputes for the hearing of oral evidence, nothing more need be said about them.

The respondent did not seriously contest the appellant's averments that from 1974 it had sought to extensively promote the use of Impregum in the Republic; that the appellant alone had devoted time, money and effort in promoting the sale of the product, and that through the appellant's efforts local demand for Impregum had developed. As regards the respondent's intrusion into the market the appellant alleged:

"... the Respondent has not purchased its supplies of IMPREGUM from ESPE It is ... plain that the Respondent procures its supplies of IMPREGUM from distributors in Europe or elsewhere other than ESPE, and that by recourse to "grey marketeering", it is able to sell IMPREGUM in the Republic at prices lower than that customarily offered by the Applicant [appellant]."

In support of the above allegations the appellant filed supporting affidavits made by one Skogstad, the managing director of ESPE. These related to the distribution network of ESPE and to restrictions imposed on the sale of products by exclusive distributors in various parts of the world. For

reasons which will appear, I do not find it necessary to particularise Skogstad's averments.

In its opposing affidavit the respondent stated that it had been distributing Impregum in South Africa for a period of some three years, but that for reasons which had nothing to do with the launching of the proceedings it was not then doing so. The respondent furthermore said that the Impregum distributed by it had been purchased "from distributors in Europe who in turn procure[d] it from ESPE or its agents". It was also made clear that in the future the respondent might resume supplying Impregum obtained from such distributors.

The court a quo found that at all material times the respondent knew i) that for many years the appellant had been the largest, if not the sole, distributor of Impregum in the Republic; ii) that the appellant's supplies from ESPE stemmed from a contractual relationship with ESPE and iii) that the

appellant had actively promoted the use of Impregum. The court also found that in essence only the appellant had spent time, money and effort in creating a market for Impregum. It rejected, however, the appellant's contention that the respondent had engaged in unlawful competition with the appellant. The gist of the court's reasoning appears from the following extract from the judgment:

"I see no reason to extend the lex Aquilia to this case so that it may be used to prevent the importation into this country of goods already being sold here in competition with the manufacturer's appointed distributor of those goods in this country and at prices sharply competitive with those of the appointed distributor. In my view, as well, the public has a considerable and positive interest in the activity of any businessman who is able by the exercise of his own ingenuity and knowledge of the market to supply the same product honestly at sharply competitive prices. The action is not available for the purpose of enforcing or establishing a monopoly, for it would otherwise amount to saying that anybody who by expenditure of time and trouble and money has established a market for himself in goods for which he has been appointed the sole distributor ... should for the foreseeable

future be entitled to regard that market as his personal prerogative untrammelled by competition from any outside source."

In the result the court a quo dismissed the application with costs, but subsequently granted the appellant leave to appeal to this court.

In order to obtain the order sought by it, the appellant had to prove inter alia that the respondent's distribution of Impregum was unlawful vis-à-vis the appellant; i e, that it infringed a right of the appellant. Notwithstanding the paucity of the respondent's averments as to its sources of supply, counsel for the appellant conceded, rightly in my view, that it does not appear from the papers that the respondent acted unlawfully in obtaining its supplies of Impregum. In particular it was conceded that it does not appear that the respondent procured or induced a breach of contract on the part of its suppliers. It was also not disputed that the respondent became the rightful owner of the Impregum purchased by it. But,

contended counsel for the appellant, by virtue of the appellant's exclusive distribution rights the respondent could not dispose of its supplies in competition with the appellant. In this regard it was argued that one and the same act may be lawful if performed by a member of the public but unlawful if carried out by a competitor of the person harmed by the act. In support of this proposition counsel relied upon a dictum in the judgment of the U S Supreme Court (per Mr Justice Pitney) in International News Service v The Associated Press 248 US 215.

In that case A gathered news as a result of organisation and the expenditure of labour, skill and money. Such news was telegraphed daily to A's members throughout the United States. B made a practice of obtaining the news through inter alia early publications in newspapers of A's members and of sending it telegraphically to its own customers who then also published the news in their newspapers. The court

held, by a majority, that B's conduct constituted unlawful competition. B contended that once the news had been published by A's members, A no longer had the right to control the use to be made of it; that it became the common possession of all to whom it was accessible, and that any purchaser of a newspaper has the right to communicate the intelligence which it contains to anybody and for any purpose. With reference to these contentions Mr Justice Pitney said at p 239 (and this is the passage upon which counsel for the appellant relied):

"The fault in the reasoning lies in applying as a test the right of the complainant [A] as against the public, instead of considering the rights of complainant and defendant [B], competitors in business, as between themselves. The right of a purchaser of a single newspaper to spread knowledge of its contents gratuitously, for any legitimate purpose not unreasonably interfering with complainant's rights to make merchandise of it, may be admitted; but to transmit that news for commercial use, in competition with the complainant - which is what defendant has done and seeks to justify - is a very different matter."

This passage must, however, be read in context for Mr Justice Pitney immediately went on to say:

"In doing this defendant, by its very act, admits that it is taking material that has been acquired by complainant as a result of organization and the expenditure of labor, skill and money, and that defendant in appropriating it and selling it as his own is endeavoring to reap where it has not sown, and by disposing of it to newspapers that are competitors of complainant's members is appropriating to itself the harvest of those who have sown."

It is clear, therefore, that in the view of Mr Justice Pitney the nub of B's objectionable conduct lay in the misappropriation of a product of A's in the competitive struggle. B did nothing to gather the news save for parasitically copying A's product, i e, the intelligence gathered by A and transmitted to its members. Hence the dissemination of the news by B was not based upon any constructive effort on his part (cf Callmann, The Law of Unfair Competition Trademarks and Monopolies, 4th ed, vol 2, chap 15, p 2).

A similar situation obtained in Schultz v

Butt 1986 (3) SA 667 (A). With reference to inter alia International News Service this court held that B had engaged in unlawful competition with A by using one of A's hulls - evolved over a long period with considerable expenditure of time, labour and money - to form a mould with which to make boats in competition with A.

It will be observed that in both the above cases B competed with A by, in a very real sense, selling A's product as if it were its own product. Because this amounted to the filching of the fruits of another's skill, labour, etc, it was held to be unlawful competition.

In casu there is no question of a copying or appropriation of a product of the appellant's by the respondent. Impregum is manufactured by ESPE; the appellant merely has an exclusive right - vis-à-vis ESPE - to sell Impregum in the Republic. True, the respondent sold the same product as the appellant, but it did not acquire its commodities by utilising the

appellant's product or business values. Indeed, apart from the fact that the supplies sold by the parties were all manufactured by ESPE, the respondent's activities in procuring and selling Impregum were completely divorced from the corresponding activities of the appellant. It is clear, therefore, that the above cases do not assist the appellant.

I agree with the court a quo that the real grievance of the appellant appears to be that the respondent has been capitalising on the market for Impregum built up as a result of the appellant's expenditure of effort and money. The question then arises whether a mere utilisation of a market built up by a competitor - without any form of adoption of his product or performance - is unlawful.

It has often been said that competition is the life blood of commerce. It is the availability of the same, or similar, products from more than one source that results in the public paying a reasonable

price therefor. Hence competition as such cannot be unlawful, no matter to what extent it injures the custom built up by a trader who first marketed a particular product or first ventured into a particular sphere of commerce. But, as was said in Dun and Bradstreet (Pty) Ltd v S A Merchants Combined Credit Bureau (Cape) (Pty) Ltd 1968 (1) SA 209 (C) 216, competition may be rendered unlawful by the manner in which a competitor conducts his trade etc.

As far as I am aware, it has never been suggested that the exploitation of a market established by a competitor for a particular product, or type of product, is in itself a form of unlawful competition. On the contrary, it appears to be generally accepted that, in the absence of statutory protection, the published idea or concept of a trader on which his product is based, may be freely taken over by a competitor even if the trader has already through his efforts built up a demand for his product. (Cf Cadbury

Schweppes Pty Ltd and Others v Pub Squash Co Pty Ltd

(1981) 1 All E R 213, 218 I.) Take the case where a manufacturer was the first to conceive the idea of marketing beer in cans. His brand of beer so marketed proved to be immensely popular with the result that his competitor also began marketing his own beer in cans.

It can surely not be contended that the competitor acted unlawfully merely because of his exploitation of a demand created by the manufacturer's efforts and originality. (Cf Adcock-Ingram Products Ltd v Beecham S A (Pty) Ltd 1977 (4) SA 434 (W) 437 F-G; Agriplas (Pty) Ltd and Others v Andrag and Sons (Pty) Ltd 1981 (4) SA 873 (C) 878, and Callmann, op. cit., vol 2, chap 15, pp 63-64.)

To revert to the facts of this appeal, let us assume that the agreement between ESPE and the appellant did not confer upon the latter a sole agency, but that until the respondent began distributing Impregum the appellant de facto was the sole agent of

ESPE in the Republic. Also assume that the respondent obtained its supplies from ESPE because of the conclusion of a second, non-exclusive, agency agreement. I fail to see how, in the postulated case, it can possibly be said that the respondent acted unlawfully merely because it reaped the fruits of a market for Impregum created by the appellant's prior efforts. Exploitation of an existing market can therefore not be equated with the copying or appropriation of another's product or performance.

In the result it seems clear that the appellant must stand or fall by the contention that because of the existence of the exclusive supply agreement between it and ESPE, nobody may lawfully market Impregum in the Republic in competition with the appellant. Acceptance of this contention would certainly lead to startling consequences. It would mean that for as long as the sole agency endures the appellant would enjoy a monopoly, akin to that derived

from a patent, in regard to the commercial distribution of Impregum in this country. It would also mean that the agreement which created purely contractual rights between the parties thereto, would in effect bind would-be competitors no matter from what source or however honestly they obtained supplies of Impregum. A further result would be to impose an unwarranted restriction on the right of ownership of a person who legitimately acquired supplies of Impregum (cf Consumers Distributing Co Ltd v Seiko Time Canada Ltd 10 DLR (4th) 161, 174). It is therefore not surprising that Callmann, op. cit., vol 2, chap 9, pp 6-7, remarks:

"If a dealer purchases the manufacturer's goods from a seller who is under no contractual obligation and then sells in the exclusive area without misleading the public, there is little likelihood that action against the dealer, either by the manufacturer or his exclusive distributor, would succeed. Such an interference with the manufacturer's contractual arrangement with his exclusive distributor would be incidental to, and the normal consequence of competition."

In Schultz (at p 679) this court held that fairness and honesty are relevant criteria in deciding whether competition is unlawful, and that in judging of fairness and honesty regard is to be had to boni mores and the general sense of justice of the community. Applying these criteria in the light of the above considerations I do not think that the respondent's intrusion into the market for Impregum - albeit created by the appellant's efforts as the sole local distributor of ESPE - would be condemned by the community as unfair or unjust in a legal sense.

The appeal is dismissed with costs, including the costs of two counsel.

H.J.O. VAN HEERDEN JA

JOUBERT ACJ

E M GROSSKOPF JA

CONCUR

NIENABER JA

NICHOLAS AJA