

158/93

Case No 605/90

IN THE SUPREME COURT OF SOUTH AFRICA
(APPELLATE DIVISION)

In the matter between:

ESSENTIAL STEROLIN PRODUCTS
(PTY) LIMITED

APPELLANT

and

THE COMMISSIONER FOR INLAND REVENUE...

RESPONDENT

CORAM: Corbett CJ, Van Heerden, Smalberger, Goldstone,
JJA, et Howie AJA.

DATE OF HEARING: 2 September 1993.

DATE OF JUDGMENT: 30 September 1993.

J U D G M E N T

CORBETT CJ:

In about 1968 Mr R W Liebenberg commenced

experimenting with certain chemicals for pharmaceutical purposes. With the assistance of a scientist and researcher, Dr K Pegel of the University of Natal, he discovered that two species of the hypoxis plant contained a substance known as B-Sitosterol-D-Glucoside (for reasons which will later emerge I shall refer to this as "the active substance") which proved very effective in the treatment of a medical condition known as prostata hypertrophy.

With a view to exploiting this discovery and in April 1970 Mr Liebenberg caused to be incorporated a company known as Vivokem (Proprietary) Limited, in which he was allotted ninety-five per cent of the shares and Dr Pegel five per cent. In the following year the name of this company was changed to Essential Sterolin Products (Proprietary) Limited. It is the appellant in the present appeal.

In order to market a medicine in a country it is normally necessary that it be registered by a medicines control authority; and before such registration is granted exhaustive tests have to be performed. For various reasons appellant did not seek registration for its products in South Africa but preferred to do so in West Germany. This it did through a West German corporation known as Hoyer GmbH and Company ("Hoyer"), which at all times acted as its distributor in West Germany. In addition, certain West German patents were registered to protect the use of the active substance for the treatment of prostatic hypertrophy. The patents did not cover the actual manufacture of the active substance since its existence and the process of its manufacture had been public knowledge for many years. Initially appellant's business modus operandi was to manufacture the active substance, dissolve it in a solvent and precipitate it onto what is termed "a carrier" in order

that it should assume monomolecular form. This was all done in South Africa. The active substance, in this form, would then be exported to Hoyer in West Germany. Hoyer, in turn, would add fillers, put the compound into capsules, and pack and market them under the registered trade mark "Harzol".

In about 1976 a Dr Hans Walker, of West Germany, who had himself done research on the hypoxis plant for his doctoral thesis, approached appellant, in the person of Mr Liebenberg, and offered his services in improving the appellant's turnover in West Germany and placing its product on other world markets, in return for a share in the business. His offer was accepted and acting on his advice, appellant established a so-called "front company" registered in Switzerland and known as Intermuti Pharma AG, with its head office in the Zug canton ("Intermuti Zug") through which to market its product. The reason given was that as a South African

company appellant would have no standing in international markets and its South African connection might prove to be a negative factor; whereas Switzerland was a "neutral" country and was regarded as a very good pharmaceutical source, in the sense that large pharmaceutical companies with good reputations were established there. Dr Walker was given a ten per cent share holding in Intermuti Zug, the remaining shares being held by appellant.

Thereafter appellant's product was supplied to Intermuti Zug which in turn sold it to Hoyer at a profit. As turnover increased, (which it did at a steady rate) the mark-up was increased so that Intermuti Zug could meet its own expenses, including Dr Walker's salary.

In due course, again on the advice of Dr Walker and in order to facilitate marketing in West Germany, a company was registered in West Germany as a wholly-owned subsidiary of Intermuti Zug. This company, known as

Intermuti Pharma GmbH of Eschwege, West Germany ("Intermuti Eschwege"), was used as the medium for the introduction onto the German market of a "generic" or patent medicine which contained the same active substance, but was sold "over the counter" (Harzol was supplied on medical prescription) under different packaging and a different trade mark. This gave a big boost to appellant's turnover.

At about the time of the negotiations with Dr Walker a Mr Morris Joffe joined appellant as its managing director. He was of the view that the arrangements with Hoyer should be placed on a more formal basis and pursuant thereto a written contract ("the Distribution Agreement") regulating the supply of appellant's product (referred to in the contract as "the active substance") to Hoyer was concluded on 5 April 1977. In terms of this contract, which was to endure for 15 years (with the possibility of a two-year extension), Intermuti Zug

agreed to sell the active substance to Hoyer "on an exclusive basis" for distribution in West Germany and West Berlin for the treatment of "prostata adenom"; and Hoyer agreed to purchase all its requirements of the active substance exclusively from Intermuti Zug. The Distribution Agreement further regulated the purchase price of the active substance, the place and method of payment thereof, Hoyer's obligations in regard to the marketing and distribution thereof, the use of the Harzol trade mark and other related matters. In particular, Hoyer acknowledged that it had no proprietary or other rights in the relevant patents and appellant and Intermuti Zug warranted that they were the "beneficial owners" of the patents; Hoyer was obligated not to manufacture, sell or distribute during the currency of the Distribution Agreement and one year thereafter any product which competed with the product distributed by Hoyer under the distribution agreement. And Hoyer

acknowledged that the "confidential information" received from appellant and/or Intermuti Zug was "proprietary to" appellant and/or Intermuti Zug and gave certain undertakings of non-disclosure in regard thereto. The agreement contained a definition of "confidential information" from which it appears that it related to "valuable secret and confidential experience information and know-how" developed by and belonging to appellant and/or Intermuti Zug and relating to the active substance.

The Distribution Agreement also dealt with the sale of the active substance in its generic form and in this regard provided that Hoyer appointed Intermuti Exchwege as its commission agent to distribute the same -

".... so as to ensure that interested parties do not become aware that Hoyer is selling a generic product in addition to

Harzol for the treatment of prostata adenom".

In December 1977 appellant caused to be incorporated in the Netherlands Antilles a company known as Roecar Holdings (Netherlands Antilles) NV ("Roecar") in order that this company should hold the patents then registered in appellant's name. This was done to avoid having the patents registered in the name of a South African company. Ten per cent of the shares in Roecar were issued to Dr Walker and the balance to appellant. Roecar subsequently established a number of wholly-owned subsidiaries in Holland, West Germany, the United States of America and Switzerland in order to develop markets outside West Germany. These included Interbio Pharma AG of Zug, Switzerland ("Interbio Zug"), which was run by a Dr Max Ehrbar, who held two per cent shareholdings in Interbio Zug and Roecar.

In mid-1982 Mr Joffe resigned from appellant. Since Mr Liebenberg had by then withdrawn from active participation in the affairs of appellant and as far as appellant was concerned was in "semi-retirement" Mr Joffe's resignation gave rise to management problems. Mr Liebenberg went to Europe to discuss the matter with Dr Walker, Dr Ehrbar and Mr Jurgen Hoyer of Hoyer. By this stage the marketing of Harzol and the patent medicine equivalent had become about fifty per cent of the business done by Hoyer. Mr Hoyer indicated that his company would like to participate in appellant's international activities and to acquire a shareholding in the international group. As a result of these discussions and on 9 September a written agreement ("the Sale and Manufacturing Agreement") was entered into in Düsseldorf, West Germany between appellant and Hoyer in terms whereof Hoyer would acquire all the issued shares in Intermuti Zug and thirty-nine per cent shareholdings

in Roecar and Interbio Zug for a total consideration of DM16 750 000. A clause relating to the payment of the consideration (which was spread over a period of 3 years) contained the following provision (clause 4.2):

"The consideration of DM 16 750 000 includes an amount of DM 4 000 000 due in terms of the AGREEMENT TO ALLOW MANUFACTURE IN THE EVENT OF INABILITY, and no additional amount may be claimed under that agreement."

In another clause appellant undertook to assign or cause to be assigned to Roecar all registered patents not already held in that company's name.

The Agreement to Allow Manufacture in the Event of Inability ("the Inability Agreement") referred to in the above-quoted clause 4.2, was signed by one of the parties in Amsterdam on 10 September 1982 and by the others in Düsseldorf on 9 September 1982. The parties thereto were appellant, Interbio Zug, Roecar and Hoyer.

In clause 2 of the Inability Agreement it is recorded, inter alia, that appellant has the sole right to manufacture and to supply Interbio Zug with the active substance; and that Interbio Zug will supply the active substance to Hoyer for use in pharmaceutical products.

Clause 3, headed "INABILITY TO DELIVER", reads as follows (appellant being referred to therein as ESSPROD):

"Should INTERBIO ZUG through the inability of ESSPROD to supply the ACTIVE SUBSTANCE to it, be unable to supply the ACTIVE SUBSTANCE to HOYER and/or any other distributors supplied by INTERBIO ZUG, then in such event but not otherwise ESSPROD grants to HOYER a sub-licence to manufacture the ACTIVE SUBSTANCE exclusively for supply to INTERBIO ZUG, and for no other purpose. ROECAR and INTERBIO ZUG hereby consent to the granting of such sub-licence to HOYER. HOYER shall, however, not be entitled to grant further sub-licences.

Should INTERBIO ZUG be unable to deliver the ACTIVE SUBSTANCE as aforesaid, it shall be presumed to be caused by the inability of ESSPROD to supply, unless the contrary is proved. HOYER will supply the ACTIVE SUBSTANCE to INTERBIO ZUG at the same price and on the same terms at which ESSPROD were supplying the ACTIVE SUBSTANCE immediately prior to its inability to deliver. ESSPROD assures that, at date hereof, this will be economically possible.

ESSPROD will lodge a full description of the manufacturing process of the ACTIVE SUBSTANCE with the Swiss notary, Dr. A. Renggli of Baarestasse 10, 6300 Zug, who will be authorised to release such description to HOYER, should HOYER's right to manufacture come into operation.

In consideration for the rights granted in terms hereof, HOYER shall pay to ESSPROD the sum of DM 4 000 000."

Clause 4 specifies, in effect, when Interbio Zug should be considered to be unable to deliver the active substance to Hoyer. Clause 5 is headed END OF INABILITY TO DELIVER and reads:

"Should the inability of ESSPROD to deliver the ACTIVE SUBSTANCE to INTERBIO ZUG come to an end, then ESSPROD shall notify INTERBIO ZUG who shall notify HOYER accordingly, and then, as from a date one year after receipt of HOYER of such notification, the licence and authority given to HOYER by ESSPROD in terms of 3 and as a result of such inability, shall lapse."

On 27 October 1982 two additional written agreements were entered into in order further to give effect to the whole transaction. The first of these was an agreement between appellant and Interbio Zug in terms of which appellant agreed to sell the active substance on

an exclusive basis to Interbio Zug for distribution; and Interbio Zug agreed to purchase all its requirements of the active substance exclusively from appellant and undertook that it (Interbio Zug) would not manufacture or cause to be manufactured (except by appellant) the active substance or any other substance or product covered by the patents. The second agreement generally substituted Interbio Zug for Intermuti Zug in the various agreements governing the marketing of the products containing the active substance.

These agreements were duly implemented.

During the year of assessment which ended on 28 February 1983 appellant was paid the consideration which had become due in terms of each of them. This included the DM 4 000 000 payable under the Inability Agreement and referred to in the Sale and Manufacturing Agreement. In a revised assessment issued early in 1986 respondent, the Commissioner for Inland Revenue, included in appellant's

taxable income the DM 4 000 000 paid in accordance with the Inability Agreement, which when converted to rands at the exchange rate obtaining on 9 September 1982 amounted to R1 847 148. For convenience I shall henceforth refer to this as the "inability consideration". Appellant objected to this inclusion and, its objection having been disallowed by respondent, appealed to the Special Court.

The appeal was heard in the Transvaal Income Tax Special Court, presided over by Goldstein J. The Court dismissed the appeal and confirmed the assessment. The necessary leave having been granted in terms of sec 86 A (5) of the Income Tax Act 58 of 1962 ("the Act"), appellant appeals direct to this Court.

In the Court below and in this Court three main issues were raised, viz -

- (1) whether the inability consideration constituted in appellant's hands a capital or revenue receipt;
- (2) whether or not the inability consideration constituted in appellant's hands a receipt in terms of par (g)(iii) of the definition of "gross income" in sec 1 of the Act, as being a premium or like consideration for the use or the right to use a process; and
- (3) whether or not appellant received the inability consideration from a source within or deemed to be within the Republic of South Africa.

The Special Court held that the inability consideration fell within par (g)(iii) and that it was derived from a source within the Republic. The Court consequently found it unnecessary to deal with the capital or revenue issue.

In my view the issue as to source is decisive of this appeal and I accordingly turn immediately to that.

It is not suggested that any of the provisions in the Act relating to deemed source is applicable. Consequently the limited (but by no means simple) issue is whether or not the inability consideration was received by appellant from a source within the Republic.

The only evidence placed before the Court *a quo* was that of Mr Liebenberg, who was called to testify on behalf of the appellant. The foregoing recital of the essential facts is gleaned from his evidence and the various contracts referred to by him. In his judgment the President of the Special Court stated that Mr Liebenberg impressed him as an "honest and reliable witness" and I deduce that he accepted his evidence in its entirety. Certain aspects of the evidence, not hitherto noted, call for comment.

In recounting how the total consideration of DM 16 750 000 payable to appellant in terms of the Sale and Manufacturing Agreement and the Inability Agreement came to be determined Mr Liebenberg stated in evidence that he calculated the net asset value of Intermuti Zug at DM 12 750 000 and the interest in the goodwill attaching to the shares sold in Interbio Zug, which was to become the selling company in the place of the Intermuti companies, at DM 4 000 000. At the suggestion of Hoyer's legal adviser, a Dr Böhme, however, the DM4m was, as it were, allocated to the conditional right to manufacture granted to Hoyer in terms of clause 3 of the Inability Agreement. It appears that this arrangement held out certain tax advantages to Hoyer. Mr Liebenberg stated, quite frankly, that the possibility of an inability on the part of appellant to manufacture and supply the active substance had never entered his mind and "would also never arise". The amount of the active

compound in a shipment of 50 kilograms was 250 grams. It was cheap and easy to produce. According to him, the first precipitation of the active substance onto the carrier was performed in his kitchen. In the unlikely event of his having to leave South Africa he could, as he put it -

".... in my suitcase..... take out enough supply of this active compound to see me through for two or three years and start manufacturing at a different site, taking one key personnel with me to set up a new manufacturing unit...."

Asked about the references to confidential information concerning the active substance in the Distribution Agreement and in par 3 of the Inability Agreement, Mr Liebenberg said:

"Our know-how and our knowledge was merely the fact that we had developed B-Sitosterol Glucoside and we thought - and we still think so - that putting it onto a

carrier in monomolecular form is of most importance when it comes to its effectivity when being used by a patient. It gives better absorption."

He further emphasized that the active substance was of no use or value to appellant unless it could be sold as a medicine; and this could only occur in West Germany where the necessary registration had been obtained. Accordingly, the active substance had no value whatever in South Africa. In West Germany, moreover, appellant was protected by patent from competition in the marketing of products containing the active substance for use as a medicine in the treatment of prostata hypertrophy.

Despite Mr Liebenberg's evidence, appellant's counsel assured the Court *a quo* that the Disability Agreement was not "a sham" and must be taken at its face value. That was appellant's attitude on appeal as well. It seems to me that that is the only proper approach.

One cannot go behind the clear provisions of the contract. Similarly, I think that the confidential information referred to in the agreements must be treated as a reality.

The legal principles to be applied in determining whether or not an amount was received from a source within the Republic have been stated in a number of decisions of this Court, more particularly in Commissioner for Inland Revenue v Lever Bros and Another 1946 AD 441; Commissioner for Inland Revenue v Epstein 1954 (3) SA 689 (A); Commissioner for Inland Revenue v Black 1957 (3) SA 536 (A). These authorities point out that the Legislature, probably aware of the difficulty of doing so, has not attempted to define the phrase "source... within the Republic" and has left it to Courts to decide on the particular facts of each case whether an amount was or was not received from such a source. As

was stated by Watermeyer CJ in the Lever Bros case, *supra*
(at 450) -

".... the source of receipts, received as income, is not the quarter whence they come, but the originating cause of their being received as income, and.....this originating cause is the work which the taxpayer does to earn them, the *quid pro quo* which he gives in return for which he receives them. The work which he does may be a business which he carries on, or an enterprise which he undertakes, or an activity in which he engages and it may take the form of personal exertion, mental or physical, or it may take the form of employment of capital either by using it to earn income or by letting its use to someone else. Often the work is some combination of these."

(See also Epstein's case, *supra*, at 698 E; Black's case, *supra*, at 541.) In a particular case there may be a number of causal factors relevant to the ascertainment

of source and, here it would seem, it is appropriate to weigh these factors in order to determine the dominant or main or substantial or real and basic cause of the receipt (Black's case, supra, at 543 A - C). In a number of cases in our Courts reference has been made (in various forms) to the following remarks of Isaacs J delivering the judgment of the High Court of Australia in the case of Nathan v Federal Commissioner of Taxation (1918) 25 CLR 183, at 189 - 90:

"The Legislature in using the word 'source' meant, not a legal concept, but something which a practical man would regard, as a real source of income (T)he ascertainment of the actual source of a given income is a practical, hard matter of fact."

(See Rhodesia Metals Ltd (In Liquidation) v Commissioner of Taxes 1938 AD 282, at 300; 1940 AD 432, at 436; Lever Bros case, supra, at 454.)

In applying these general principles, the Courts have adopted certain rules and criteria for locating the source of particular types of accrual or receipt, such as dividends, annuities, director's fees, interest, payment for services, rent, royalties and so on. None of these would seem to have relevance to the somewhat unusual character of the inability consideration. In seeking the originating cause of this amount one must, in my view, have regard to the factual matrix underlying and giving rise to the agreement in terms of which it became payable and then apply thereto the basic principles outlined above.

Of fundamental importance in this case is that at the time when the Sale and Manufacturing Agreement and the Inability Agreement were entered into the business operations from which appellant derived its income were conducted predominantly outside South Africa. This was so of necessity because there was no market whatsoever

for appellant's product in South Africa. Indeed the only country where it could be sold was West Germany. Moreover, because of the patents and trade marks registered there West Germany was the only country where there was, for the time being, protection against competitors marketing products containing the active substance for the treatment of prostata hypertrophy and using the trade marks. The distributor for and part manufacturer of these products was a West German corporation, Hoyer; and Hoyer was bound by means of contracts entered into in Europe to purchase all its supplies of the active substance from appellant's Swiss and German subsidiaries; to manufacture the final product and distribute it in West Germany; and to refrain from manufacturing, selling or distributing any competing product. In short, the whole foundation of appellant's business rested upon the rights flowing from registration, the patent and trade mark rights and the

contractual rights vis-a-vis Hoyer, all of which were acquired and exercised in West Germany.

It is true that the active substance was manufactured by appellant itself in South Africa and exported to West Germany (via one of appellant's European subsidiaries) in its monomolecular form. But that is the only South African connection, apart from appellant itself being located here. Moreover, that was only part of the process of manufacture. The product could not be marketed in the form received in West Germany by Hoyer. Hoyer still had to add fillers, put the compound into capsules and package them before placing the product on the West German market.

The inability consideration was an ingredient of the reorganization of the business and the grant to Hoyer of a substantial interest therein. By that stage the marketing of the products containing the active substance had become a major segment of Hoyer's business

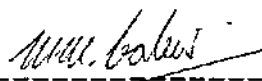
and, of course, Hoyer was paying a large sum of money for the acquisition of this interest. The purpose of the Inability Agreement was to ensure that Hoyer always had a supply of the active substance giving it the right and know-how to manufacture it in the event of appellant being unable to do so; and the purpose of the inability consideration was to compensate appellant for this potential deprivation of the exclusive right, as between itself and Hoyer, to manufacture the active substance. This all arose from the reorganization of a business predominantly conducted in Europe by European subsidiaries of the appellant. And finally the inability consideration was linked not merely to an inability to supply the active substance from South Africa, but to an inability to supply it from anywhere in the world.

In all the circumstances I am of the opinion that the originating cause of the receipt of the

inability consideration, and therefore the source thereof, was not within South Africa.

The appeal is allowed with costs, including the costs of two counsel, and the order of the Special Court is altered to read -

"The appeal is allowed. Appellant's revised assessment for the tax year ended 28 February 1983 is set aside and the matter is referred back to the Commissioner for such reassessment as may be necessary."



M M CORBETT

VAN HEERDEN	JA)	
SMALBERGER	JA)	
GOLDSTONE	JA)	CONCUR
HOWIE	AJA)	