73/98

REPUBLIC OF SOUTH AFRICA

THE SUPREME COURT OF APPEAL OF SOUTH AFRICA

Case No. 405/96

In the matter between:

THE COMMISSIONER FOR INLAND REVENUE — **Appellant**

and

DATAKOR ENGINEERING (PTY) LIMITED — **Respondent**

Coram: NIENABER, HARMS and ZULMAN JJA, MELUNSKY and NGOEPE AJJA

Heard: 8 SEPTEMBER 1998

Delivered: 21 SEPTEMBER 1998

JUDGMENT

HARMS JA/

HARMS JA:

[1] This is an appeal by the Commissioner for Inland Revenue against a judgment of the Transvaal Income Tax Special Court (Wunsh P) in which it upheld an appeal by the taxpayer against an assessment for normal tax for the year of assessment which ended on 31 March 1990. In the assessment the Commissioner had reduced the taxpayer's assessed loss by R18 807 524,00 by virtue of the provisions of s 20(1)(a)(ii) of the Income Tax Act 58 of 1962, claiming that the amount represented a so-called compromise benefit.

[2] The taxpayer, Datakor Engineering (Pty) Ltd, was originally known as GBS South Africa (Pty) Ltd. It was finally liquidated on 15 August 1989. A scheme of arrangement in terms of s 311 of the Companies Act 61 of 1973 was thereafter proposed by a then unrelated company, Datakor Ltd. The scheme was confirmed on 23 January 1990, the taxpayer was discharged from liquidation, its name was changed to its present name and it became a wholly-owned subsidiary of the proposer, Datakor Ltd. The latter was obliged, in terms of the scheme, to provide the taxpayer with certain funds and these, together with some other amounts, were to be applied by the

receivers to pay the administration expenses, the net amounts due to secured creditors, the claims of preferential creditors and, as far as a balance remained, a pro rata payment to concurrent creditors.

[3] The unpaid balance of the claims of the concurrent creditors claims was to be capitalised by the taxpayer by the creation of a number of redeemable preference shares in the taxpayer equal to the face value of the claims. As consideration the concurrent creditors waived payment of these claims. In the event they received a dividend of 43,48 cents in the Rand. For every 100 cents of the claims not paid, a share with a nominal value of one cent was to be issued with a premium of 99 cents. The shares were to be renounced by the creditors in favour of Datakor Ltd. Although the evidence is that the scheme was implemented according to its terms, there are some discrepancies between the requirements of the scheme and the financial statements of the taxpayer, but these are not of any great moment.

[4] The essence of this type of scheme is that -

> "the claims of the creditors, as reduced by a capital amount paid to them in terms of the scheme, are converted into preference share

capital and the creditors are then deemed to have renounced their entitlement to the issue and allotment of such preference shares in favour of a person (usually the offeror) nominated by the company. The rights of all the creditors under such arrangement are confined to the right to claim payment of the dividends receivable by them under the arrangement."

[Getz and Jooste *Section 311 of the Companies Act: Preserving the Assessed Loss* 1995 Acta Juridica 56 at 64.]

[5] Before the arrangement the share capital of the taxpayer consisted of 500 000 shares of R1,00 each. A further 100 ordinary shares of R1,00 were issued pursuant thereto to the proposer with a share premium of R5 736 000,00. The arrangement, however, obliged Datakor Ltd to subscribe for ordinary shares at an allotment price of R6 511 000,00. The shortfall of R775 000, it seems, was made up by an interest free loan from Datakor Ltd to the taxpayer.

[6] The amount waived by concurrent creditors by virtue of the fact that they no longer had any further claims against the company amounted to R18 997 499,00. In

the scheme of things, 18 997 499 cumulative redeemable shares each with a nominal value of one cent and a share premium of 99c, were issued to the creditors. This gave rise to a share premium account of R18 807 524,00. The taxpayer's balance sheet reflects these facts and shows that the taxpayer no longer had any current liabilities. The cash flow statement demonstrates, furthermore, that the full proceeds of the issuing of the redeemable preference shares were used to liquidate accounts payable. The amount credited to the preference share premium account because of the creation of these shares and which was used to extinguish liabilities to that amount was the amount which, according to the Commissioner, could not form part of an assessed loss in terms of sec 20(1)(a)(ii) of the Act.

[7] Any person carrying on a trade within the Republic is entitled to set off against his income any balance of assessed loss incurred within any previous year which has been carried forward from the preceding year of assessment. This is subject to two provisos, the second being of relevance, namely that -

> "the balance of assessed loss shall be reduced by the amount or value of any benefit received by or accruing to a person resulting from a

> concession granted by or a compromise made with his creditors whereby his liabilities to them have been reduced or extinguished, provided such liabilities arose in the ordinary course of trade."

[S 20 (1) (a) (ii).]

The taxpayer had an assessed loss which was brought forward from previous years of R8 540 219,00. Its so-called tax loss for the year under consideration amounted to R15 090 168. It sought to carry the sum of these amounts over to the next tax year but, as mentioned, the Commissioner reduced this amount by the amount of the share premium account due to the issue of the preference shares.

[8] The court below and counsel during argument divided the provisions of subparagraph (ii) into its so-called elements. It is a useful exercise but it may tend to disguise the interrelationship between the elements and may lead to a failure to consider the statutory provision as a whole. Bearing this in mind, I nevertheless intend to do the same. The elements of the quoted paragraph from the section are the following:

(a) the balance of assessed loss shall be reduced <u>by the amount or value</u>

(b) of any benefit received by or accruing to a person

(c) resulting from a concession granted by or a compromise made with his creditors

(d) whereby his liabilities to them have been reduced or extinguished

(e) provided such liabilities arose in the ordinary course of trade.

The argument was focussed upon the underlined words and phrases. In the court below it was held against the taxpayer that (b) and (c) had not been shown to have been absent. On the other hand, it held that the Commissioner had failed to prove (a) and that he was thus not entitled to invoke the provision in order to disallow the loss. Point (e) was never in issue and little attention was given to point (d), probably because it was common cause that the taxpayer's liabilities to its crditors had been extinguished.

[9] It is convenient to deal first with issue (c), namely whether any alleged benefit derived by the company resulted "from a concession granted by or a compromise made with his creditors". In this regard the court below held that the since the creditors surrendered their rights to the proposer, Datakor Ltd, for no consideration

they, in the result, received something less than the face value of their claims. This can only be ascribed to a concession if not a compromise. Significance was attached to the fact that s 311 of the Companies Act was invoked in order to facilitate the rearrangement of the rights of creditors.

[10] This reasoning is not entirely correct. The section does not concern itself with the relationship between the creditor and some third party, but with that between the creditor and the taxpayer. A concession granted to a third person (in this case Datakor Ltd) seems to me to be beside the point. What has to be determined is whether the creditor granted a concession to the taxpayer.

[11] It is difficult to come to grips with the argument of the taxpayer on this aspect of the case. Having conceded that the liabilities of the taxpayer to the creditors were extinguished by means of a contract, counsel was invited to classify the contract, an invitation he was hesitant to accept. It was not suggested that the agreement was an innominate contract. The only other possibility that springs to mind is that the contact was a classic *transactio*, also known as a compromise. In consideration for a waiver of their claims the creditors received something different, namely shares. But, said

counsel, unless one knows that the shares were worth less than the claims it has not been established that a concession was granted to the company by the creditors. In other words, it may be that the shares might have been worth more than their issue price in which event the creditors relinquished nothing. I cannot accept the argument. The Act is not concerned with the benefit received by the creditor, but with the benefit received by the debtor. The mere substitution of a creditor's claim with a share, even a redeemable preference share, amounts to a concession. An enforceable obligation is replaced with something of a completely different nature. In the case of debts, all the assets of the company are available to satisfy the claims of creditors whereas, in the case of redeemable preference shares, only profits available for dividends or the proceeds of a fresh issue of shares may be used to redeem the shares (s 98 (1) of the Companies Act 61 of 1973). The right to redeem vests in the company and the creditor cannot enforce a "right" to redemption. In this regard the dictum of Nicholas AJA in *AA Mutual Insurance Association Ltd v Century Insurance Co Ltd* 1986 (4) SA 93 (A) at 101C-H is instructive:

"The right to redeem under the special resolution is one solely for the

benefit of the company. It was not created in the public interest. Until the enactment of s 43 [of the Companies Act 46 of 1926, now s 98 of the 1973 Act] (which was introduced into our companies legislation by s 21 of Act 23 of 1939 (as amended by s 23 of Act 46 of 1952)), it was considered that the public interest required that shares should not be redeemable - the general rule was that a company could not issue redeemable preference shares, because redemption would amount to an illegal purchase by the company of its own shares. See *Trevor v Whitworth* (1887) 12 AC 409; Pennington's *Company Law* 4th ed at 192. The interests of creditors cannot be affected by a waiver by the company of its right to redeem - on the contrary their interests are best served if there is no redemption. The company may redeem none or all or any of the redeemable preference shares, as it pleases and as determined by the board of directors. No member, nor anyone else, has grounds for complaint if the company decides not to redeem any shares. Nor can the rights of any person other than the

company be affected if the company enters into an agreement by which it renounces *pro tanto* its right to redeem any particular shares. There is nothing in s 43 . . . or in the common law, which obliges the company to redeem or which prohibits an agreement not to exercise the right of redemption, unless, possibly, the effect of the agreement is to deprive the shares concerned of their character of redeemable preference shares, eg by providing that they are under no circumstances to be redeemed."

[12] I now turn to deal with the second question, question (b), namely whether any benefit was received by or accrued to the taxpayer. In finding against the taxpayer, Wunsh P first traced the chequered history of arrangements of this sort. (It can be found in the quoted article of Getz and Jooste. See also *Ex parte De Villiers and Another NNO: In re Carbon Developments (Pty) Ltd (In liquidation)* 1993 (1) SA 493 (A).) He then held that any arrangement or dispensation by which a company is protected from action by its creditors so as to enable it to continue with its business, whether by means of a subordination agreement or the capitalisation of the claims,

must redound to its benefit. The company is discharged from liquidation. Its creditors are replaced by a shareholder, who, as the holder of redeemable preference shares, cannot sue the company for repayment of the capital when redemption becomes due.

[13] The taxpayer joins issue with these findings, relying mainly on the arguments advanced by Getz and Jooste at 67 - 68. Their basic premise is that the conversion of a debt into redeemable preference shares is merely a change in the form of the company's liability because the extent of the obligation, and the obligation to repay, remain as before. Counsel shied away from this proposition, but relied upon the statement of the authors (at 68) following upon the said premise, namely that it is -

> "arguable that in substance, if not in form, a redeemable preference share is analogous to an obligation to repay a debt in that a company has either an actual (if the shares are redeemable on or before a fixed date) or a contingent (if the shares are redeemable at the option of the company) obligation to repay to the holders of the shares the issue price thereof."

[14] The views of Wunsh P are similar to those of RDJ *Schemes of Arrangement - A New Development* (1989) 28 Income Tax Reporter 7 at 10 - 11 who argued that the effect of the scheme is to rid the company of its creditors and that the fact that the ownership of the company has been altered in that the capital structure has been changed does not detract from the fact that the creditors' claims no longer exist in any form. The author also pointed out that there are vital differences between, on the one hand, a preference share and, on the other, a creditor's claim. These differences are highlighted by Prof Blackman in 4 (1) *LAWSA* par 103 (reissue):

> "Although there are similarities with debt, the redeemable preference share is not debt. The right to redeem is not created in the public interest, and is solely for the benefit of the company. The interests of the creditors cannot be affected by a waiver by the company of its right to redeem; on the contrary, their interests are best served if there is no redemption. The company may redeem none or all or any of the redeemable preference shares, as it pleases and as determined by the board of directors. No member, or anyone else, has grounds for

complaint if the company decides not to redeem any shares. Nor can the rights of any person other than the company be affected if the company enters into an agreement by which it renounces *pro tanto* its right to redeem any particular shares. There is nothing in the section, or in the common law, which obliges the company to redeem, or which prohibits an agreement not to exercise the right of redemption, unless, possibly, where the effect of the agreement is to deprive the shares concerned of their character of redeemable preference shares, for example by providing that they are under no circumstances to be redeemed.

Where the redeemable preference shareholder has a right that the company redeem his shares and the company does not have available profits or is in fact unable to issue fresh shares to cover the obligations, the redeemable preference shareholder will not be able to enforce his right, and his only remedy is an order for the winding-up of the company."

[15] This, and the quoted dictum of Nicholas AJA, I believe, support the reasoning of Wunsh P set out in par [12] above and at the same time dispose of the taxpayer's argument. The obligation to repay is not the same in each instance. And without wishing to imply that it would have made any difference, there is in any event no evidence that the shares in question were redeemable on a fixed date. Also, the argument appears to miss the point because it is rather related to the quantification of the benefit, something I shall deal with. The provision in question concerns itself with "any benefit", words of a wide and indeterminate meaning. Whether the benefit is affected or reduced by other factors is, for this part of the investigation at least, of no consequence. The benefit, in the words of the Act, is to be found in the reduction or extinction of the debt, something which and the extent of which, as said before, is common cause. Indeed, the concession by the creditors (to waive the balance of their exigible claims against the taxpayer in return for a nebulous "right" of redemption of redeemable preference shares) must of necessity translate into a benefit to the taxpayer.

[16] As far as (a) is concerned, the Special Court made a number of findings which

can be summarized as follows. The trigger for the application of the provision is the "amount or value" of the benefit. That implies an amount ascertainable in monetary terms. The Commissioner bore the onus of proving that an ascertainable money value can be ascribed to the benefit. It is not possible in this case to quantify the amount or value of the benefit because the benefit was not derived without any cost since the preference shares carry a dividend and have to be redeemed.

[17] Wunsh P was conscious of the provisions of s 83(7)(c) of the Act, although he did not make specific reference to its exact terms. It provides that at any appeal against a decision of the Commissioner, the objector "shall be limited to the grounds stated in his notice of objection". The Commissioner may agree to an amendment of such grounds and the Special Court may, on good cause shown, permit an amendment - neither of which occurred in this case. The grounds upon which the case went against the Commissioner were, in the words of Wunsh P, "not advanced as such in the letter of objection nor, indeed, articulated in the submissions advanced" during argument. But, he held, the matter had been sufficiently indicated in the letter of objection and that he had raised the issue during argument. The fact that the court

raised the matter during argument is, in the light of the wording of the subsection, irrelevant. The correct test is to look at the substance of the objection without being unduly technical or rigid *(Matla Coal Ltd v Commissioner for Inland Revenue* 1987 (1) SA 108 (A) 125I-J).

[18] Unfortunately, the learned President did not state where in the notice of objection the point was raised. The experienced legal representatives representing the taxpayer did not realise that they had raised the point - a strong indication that it had not been raised. Neither party offered any evidence nor asked any question concerning the issue. As I read the notice of objection, the point was not raised. Counsel did not submit otherwise. The notice, no doubt, dealt with the question of the "value" of the benefit but, contrary to the approach of the Special Court, stated that the benefit had to be found in the financial statements of the taxpayer - the taxpayer remained indebted to the same extent as before and, recognising the accounting principle of substance above form, the financial statements disclosed "no benefit accruing in consequence of the arrangement." (The underlining appears in the original.) This was not the issue considered by Wunsh P.

[19] The question of onus was also not argued in the court below and the judgment on this point was given without the benefit of counsel, although before us the taxpayer did seek to support the findings in this regard. It is useful to start with s 82 of the Act:

> "The burden of proof that any amount is . . . subject to any . . . set-off in terms of this Act, shall be upon the person claiming such . . . set-off . . . ."

The taxpayer claims that the amount reflected in its financial statements as representing the share premium consequent upon the issuing of the preference shares and which was used to extinguish its liabilities, should be set off against its income. In other words, the financial statements show a fixed amount in respect of which the taxpayer wishes to claim the advantages of s 20 of the Act. (Cf *Ochberg v Commissioner for Inland Revenue* 1931 AD 215 220 *in fine* - 221.) The Commissioner disallowed that amount as being a benefit. The amount was fixed, it was ascertained

[20] The court below relied upon *Commissioner for Inland Revenue v Butcher*

Bros (Pty) Ltd 1945 AD 301 319 (although I think that pp 322-323 were intended) and De Koker *Silke on South African Income Tax* par 18.27 for its conclusion summarized in par [16] above. The latter work does not support the finding and appears to the contrary -

> "It would seem that the Commissioner is entitled to tax any receipt or disallow any claim for deduction, set-off or exemption and leave it to the taxpayer to prove that he is wrong."

In *Butcher* at 322 *in fine*, Feetham JA is reported to have said the following:

> "The assessment in dispute, made by the Commissioner under sec. 7 (1) (d) [of the Income Tax Act, 1925], can only be allowed to stand if some "amount" accrued to or was received by the company in the tax year ended 30th June, 1935, by virtue of its rights under the building clauses in the lease, and it is essential for the Commissioner, in order to support his assessment, to show that some amount has accrued to or been received by the company by virtue of such rights. (*Vide Ochberg v Commissioner for Inland Revenue (supra)*)."

[21] The reference to *Ochberg* has been given. There this Court, per Roos JA, was called upon to deal with the precursor of the present s 82 which was to all intents and purposes identical to it. The argument considered by Roos JA raised the issue whether there was an initial onus upon the Commissioner to prove that the amount taxed is income liable to taxation. Somewhat tersely, he held that the contention would make the section meaningless and useless and that the section "means that an amount received by the taxpayer, on which an assessment has been made by the Commissioner, is taxable unless the taxpayer shows that it is not income."

[22] To return to *Butcher*. The question was whether an amount had been received or had accrued as a premium or like consideration in respect of the grant of a right of the use or occupation of certain premises in a particular tax year as part of the taxpayer's gross income. The taxpayer had entered into a lease of fifty years' duration. The tenant was obliged to erect a building on the property to the value of not less than £55 000. The building was erected and the Commissioner contended that the erection of the building to that value constituted the receipt by the taxpayer of that amount as a premium in the year the building was erected. It is obvious that the taxpayer had

received no "amount", but only the right to the return, after fifty years, of the property with the building thereon. In this context it was held that the Commissioner had to show the receipt of an amount during the tax year under consideration. In the present instance, as I have shown, the amount is a fixed amount and not an assessed amount. The dictum is, therefore, of no assistance in answering the present question. I therefore conclude that the court below erred in placing the onus on aspect (a) in the circumstances of this case upon the Commissioner.

[23] Because the issue was not raised in the notice of objection, the question whether on a proper interpretation of the provision the "benefit " to the taxpayer should be valued with reference to the alleged cost of or the liability created by the redeemable preference shares, or, for that matter, the pre-compromise value of the creditors' claims against the taxpayer, does not require consideration and I prefer to say no more on the subject.

[24] In the result the appeal is upheld with costs and the order of the Special Court is altered to read : "The appeal is dismissed".

L T C HARMS
JUDGE OF APPEAL

NIENABER JA)
ZULMAN JA) Concur
MELUNSKY AJA)
NGOEPE AJA)