A 846/2001

IN THE HIGH COURT OF SOUTH AFRICA

(TRANSVAAL PROVINCIAL DIVISION)

Case Number: A846/2001

Date: ~~20 March, 2002~~

22/3/2002

In the matter between:

COMMISSIONER FOR THE
SOUTH AFRICAN REVENUE SERVICE Appellant

and

KAJADAS COSMETICS (PTY) LTD Respondent

JUDGMENT

ROUX, J

This is an appeal against the judgment and order of the Transvaal Income tax Special Court which set aside the assessments of normal tax, levied on the Respondent, for the years 1994, 1995 and 1996.

The sums of R162 000-00, R180 000-00 and R266 400-00 were claimed as deductions in the relevant years of assessments. The Receiver of Revenue disallowed the deductions as it was considered that Section 11(a) or 11(b) of Act 58 of 1962 was inapplicable. That decision was the basis of the hearing in the Court *a quo*.

Section 11 of Act 58 of 1962 insofar as it is relevant, and as it read prior to 1 January 2001 being the date upon which it was amended by section 15 of Act 59 of 2000, reads as follows:

> "*11 General deductions allowed in determination of taxable income.-*
>
> *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;*
>
> *(b) expenditure and losses actually incurred outside the Republic in the production of the income, provided such expenditure and losses are not of a capital nature."*

On the 31st of August 1993 the Respondent concluded a written contract with a French company, S.A. Matis, in Paris. It is described as an "*Exclusive Distribution Contract.*" Matis manufactures "beauty products" which are, I imagine, those pots, powders and pomades which are found, mainly, on ladies dressing tables.

The Respondent was obliged to purchase these products from Matis and enjoyed the

exclusive right to sell them in Southern Africa. It is recorded that the agreement would endure for 5 years but would automatically be renewed for a further period of 5 years at a time unless terminated in accordance with the provisions thereof.

I do not intend to make further reference, save one, to the contract. It seems clear that the Respondent's profit would represent the difference between what it paid Matis to purchase the goods and the sum for which it sold them to the Southern African public.

It is clause 19 of the contract which is the hub of the matter. It provides:

> "*An annual fee will be paid by the Distributor (*ie. Respondent*) to cover licence of distribution rights amounting to US$100 000 (One Hundred Thousand US Dollars). It will be subjected to maximum escalation of 10% per annum.*"

The amounts paid in terms of this clause are those which the Respondent claims are deductible. As the payments were made in Paris section 11(b) of the Act is applicable.

In the Court *a quo* the learned Judge appears to have considered the yearly payment as significant in conjunction with the right to acquire the stock that the Respondent would sell. He put it as follows:

> "*The acquisition of an exclusive distribution right of a sought after product for a lengthy period, clearly is a valuable capital asset and the price paid for that right is a capital expenditure. However where on the facts the accent seems to be on the purchase of stock, where the period is relatively short or the right is not an enduring right or were the expenditure is a recurring annual 'licence' fee the expenditure is in the nature of costs of conducting the business operation, not setting it up. It is incidental to the conducting of the operation as distinguished from the establishing or extending the equipment of the income producing machine. The link is closer to the running of the business than to establishing the business.*

It seems to me as if the purpose of the expenditure in the present matter was not so much to obtain the distribution rights than to obtain stock."

I cannot, with respect, subscribe to this view. The authoritative view is different. I refer to ***New State Areas Ltd 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.*"

Counsel also referred us to an Australian judgment ***Hallstrom (Pty) Ltd v FCT***, (1946) 3 AITR 436.

The following is, in my judgment, a robust and practical way to approach the matter:

"*What is a outgoing of capital and what is a outgoing of revenue depends on what the expenditure is calculated to effect from a practical and business point of view, rather than upon the juristic classification of the legal rights, if any, secured, employed or exhausted in the process.*"

In the instant matter the Respondent acquired the right to be the exclusive vendor of Matis' products in a vast area. For this the Respondent had to pay. Matis could quite simply have distributed its products via many outlets and dealers. To acquire the exclusive rights was to create the income earning machine. [***Secretary for Inland***

Revenue v Cadac Engineering Works (Pty) Ltd, 1965 (2) SA 511 (AD)]

It represents a capital asset.

Further I refer to the remarks of Marais J.A in ***Rand Mines Mining & Services Ltd v Commissioner for Inland Revenue***, 1997 (1) SA 427 (A). He held that the cost of acquiring a managing agreement cannot be regarded as revenue expenditure.

It follows that I cannot agree with the finding of the Court *a quo*. In the result the appeal succeeds with costs and the assessments of the Receiver of Revenue are reinstated.

JP ROUX
JUDGE OF THE HIGH COURT

I agree.

SJ MYNHARDT
JUDGE OF THE HIGH COURT

I agree.

WPN SCEALES
ACTING JUDGE OF THE HIGH COURT