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IN THE SPECIAL INCOME TAX COURT - PRETORIA

CASE NO: 10699

DATE: 19/3/2003

In the income tax appeal of:

APPELLANT **Appellant**

and

THE COMMISSIONER FOR THE SOUTH AFRICAN REVENUE SERVICES **Respondent**

JUDGMENT

VAN DER MERWE, J

This is the unanimous decision of the court.

On 14 February 1993 the then Minister of Transport and of Post and Telecommunications (the Minister) announced his intention to grant two licences to provide a national cellular telephony service. In April 1993 and

by *Government Gazette Notice* 316 of 1993 the Minister invited interested companies to apply:

> "(a) to the Minister of Transport and of Posts and Telecommunications in terms of section 90A(1) of the Post Office Act, 1958, for authority to construct, operate and maintain a national cellular radio telephony service on a non-exclusive basis; and
>
> (b) to the Postmaster General in terms of section 7 of the Radio Act, 1952, for a licence to be issued to use radio stations in the appropriate frequency bands in respect of the rendering of the service referred to in paragraph (a)."

In June 1993 the Minister published a document entitled "Invitation to apply for a licence to provide a national cellular radio telephony service". In its terms it invited tenders: "... for a licence to construct, operate and maintain a nationwide cellular radio telephony service on a non-exclusive basis."

"Licence" is defined in clause 1(t) of chapter 1 of that document as follows:

"Licence shall mean both –

(a) the authority given by the Minister to construct and operate a cellular radio telephony service in terms of section 90A(1) of the Post Office Act, 1958; and

(b) the licence issued by the Postmaster General in terms of section 7 of the Radio Act, 1952, conferring the right to use or cause any person in his employ who under his control to use a station;"

Licence fees are dealt with in clause 24, chapter 3 thereof, as follows:

"24(1). Both licensees shall pay –

(a) an initial basic cellular licence fee of R100 000 000,00 (one hundred million rand), payable

(i) prior to the commencement of commercial operations; or

(ii) by way of instalments agreed upon with the regulator.

(b) an ongoing annual licence fee of 5% of the net revenue of the licensee concerned, payable within 14 days after the end of each licence year.

(2) The licence fees shall be payable to the official designated by the Minister to receive such payment.

(3) Both licensees shall pay the following radio fees to the Postmaster General:

(a) a basic annual licence fee of R5 000 000,00 (five million rand);

(b) a fee of R20 000,00 (twenty thousand rand) annual licence fee for each 200 KHz channel granted to the licensee concerned."

It is clear that two distinct licences were to be issued. The first by the Minister to construct, operate and maintain the national cellular radio telephony service (the telecommunications licence) and the second by the then Postmaster General to use radio stations in appropriate frequency bands in respect of the rendering of the telephony service (the radio licence).

As appears from *Government Gazette Notice* 316 of 1993 and the document published in June 1993 the matter was dealt with under the applicable provisions of the Post Office Act, 44 of 1958 (the Post Office Act) and the Radio Act, 3 of 1952 (the Radio Act). Subsequent to the invitations referred to all sections of the Post Office Act dealing with telecommunications as well as the whole of the Radio Act have been repealed and substituted by the Telecommunications Act, 103 of 1996 (the Telecommunications Act). This, however, does not affect the matter as any authority issued in terms of a repealed act is deemed to have been given in terms of the Telecommunications Act, and any regulation in force immediately prior to the commencement of the Telecommunications Act shall remain of force and effect until amended or repealed.

The two successful applicants were the appellant and "A". The general terms and conditions are the same for both the telecommunications licences and were published in *Government Gazette* No 15232 of 29 October 1993, Notice 1078 of 1993. The licence fee in terms of clause 1.1 of the licence was a once-off amount of R100 million payable on date of the issue of the licence or in installments over a period of four years. The applicant and "A" paid the single amount of R100 million each. Licence fees and

other recurring fees payable in respect of the radio licence are not relevant and therefore not dealt with in this judgment.

In its return of income: financial year end 1994, the appellant claimed certain deductions for determining its taxable income, *inter alia* a deduction of R6 666 667,00 (i.e. one fifteenth of the amount of R100 million spread over a period of fifteen years), a deduction of R204 604,00 in respect of legal fees incurred and a deduction of R218 885,00 for tax services rendered by its auditors. The respondent disallowed the deductions referred to. The appellant objected to and appealed against the respondent's decision on the following grounds:

" (i) The amount of R6 666 667,00 claimed in respect of the licence fee is properly deductible in terms of section 11(gA) of the Act, or in the alternative, section 11(a) of the Act;

(ii) the amount of R204 604,00 claimed in respect of legal fees is properly deductible in terms of section 11(a) read with section 23(g) of the Act;

(iii) the amount of R218 885,00 claimed in respect of tax services is properly deductible in terms of section 11(a) read with section 23(g) of the Act."

Subsequently the respondent allowed the deduction in respect of the tax services. We are therefore now only concerned with the amount of R6 666 667,00 claimed as a deduction in respect of the licence fee and the amount of R204 604,00 claimed as a deduction in respect of legal fees.

Deduction in respect of the licence fee

The objection in terms of section 11(a) of the Income Tax Act, 1958 of 1962 (the Act) was abandoned. In our view correctly so. We say that for the following reasons. In *Income Tax Case No 1726, South African Tax Case Reports*, Vol 64, Part 4 2002, p236 Joffe P dealt with a similar claim for a deduction of the R100 million licence fee by Vodacom Group (Pty) Ltd. At p242E he said:

"... it is clear that the R100 million based licence fee has not been routinely incurred in the running of appellant's business. It constitutes expenditure that was incurred to found and lawfully commenced the

operation of appellant's income earning structure. The cost was not a cost incurred in the actual performance of the appellant's income earning operation but a cost in acquiring the right to perform these operations. That being so the R100 million licence fee is of a capital nature and is not deductible in terms of section 11(a) of the Act."

I agree with the aforegoing. The appellant in the present matter therefore correctly conceded that the R100 million licence fee is not deductible in terms of section 11(a) of the Act.

In its heads of argument and in argument before us, the appellant relied on the provisions of section 11(f) of the Act. The respondent agreed to the appellant relying on this ground though it was not contained in the notice of objection. In reply, however, this ground of objection was abandoned and correctly so.

Section 11(f)(dd) provides that the subsection shall not apply where the premium or consideration (the R100 million licence fee according to the appellant) "paid by the taxpayer (the appellant) ... does not ... constitute income of the person to whom it is paid".

The appellant correctly conceded that the payment of the R100 million to the respondent does not, for purposes of the Act, constitute income in the hands of the respondent.

The appellant's main contention is that pursuant to the provisions of section 11(gA) of the Act the appellant is entitled to claim the licence fee as an allowance amortising the fee over a 15 year period.

Joffe P dealt with a similar contention in *Income Tax Case 1726* (*supra)* at 242G-243A as follows:

> "Turning to the argument based on s 11(gA) of the Act appellant, conceded the expenditure is not expenditure incurred in acquiring by assignment from any other person any patent, design, trademark or copyright or any knowledge connected with the use of property. Appellant argued that the expenditure is nonetheless for the acquisition of 'property of a similar nature' as envisaged by s 11(gA) of the Act. The difficulty with this contention is that the ordinary grammatical interpretation of the phrase 'property of a similar nature' found in s 11(gA) means the acquisition of intellectual property, i.e.

> property which came into existence by the exercise of intellectual powers and to which the law accords the rights and protection of ownership and which may be exploited either by the inventor, or originator himself, or by others with his leave. The essential requirements therefore are that the taxpayer must pay an amount to a person who has property which he has created or developed by the use of his own intellect, the latter has disposed of the right to exploit which he created by his intellect to another and such disposal must be by way of an agreement which confers or passes on to the recipient well understood rights of an assignee to the property itself. See *Video Park Town North (Pty) v Century Associates and Another* 1986 2 SA 623 (T) at 633H-I. It is clear that the licence fee paid by the appellant does not comply with these requirements."

The statement and findings were criticized in this matter on behalf of the appellant but in our view wrongly so.

Section 11(gA) of the Act 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, there shall be allowed as deductions from the income of such person so derived –

(gA) an allowance in respect of expenditure ... actually incurred by the taxpayer –

(i) in devising or developing any invention as defined in the Patents Acts, ... or in creating or producing any design as defined in the Designs Act ... or any trademark as defined in the Trade Marks Act ... or any copyright as defined in the Copyright Act ... or any other property which is of a similar nature; or

(ii) in obtaining any patent or the restoration of any patent under the Patents Act ... or the registration of any design under the Designs Act ... or the registration of any trade mark under the Trade Marks Act ... or under similar laws of any other country; or

(iii) in acquiring by assignment from any other person any such patent, design, trade mark or copyright or

> in acquiring any other property of a similar nature or any knowledge connected with the use of such patent, design, trade mark, copyright or other property or the right to have such knowledge imparted,
>
> if such invention, patent, design, trade mark, copyright, other property or knowledge, as the case may be, is used by the taxpayer in the production of his income or income is derived by him therefrom: provided that - ..."

The provisos are not relevant.

The applicant relies on section 11(gA)(iii) only. It is, however, necessary to briefly discuss the other two subsections as well.

Section 11(gA)(i) deals with a taxpayer who himself devised or developed any invention or who created or produced any design or any trade mark or any copyright as defined in the respective acts or any property which is of a similar nature and incurred expenses in doing so.

Section 11(gA)(ii) deals with a case where the taxpayer incurred costs in obtaining any patent or the restoration thereof or the registration of any design or trade mark. The reference to a copyright or property of a similar nature is understandably absent.

Section 11(gA)(iii) deals with a case where the taxpayer incurred costs in acquiring by assignment such a patent, design, trade mark or copyright or other property of a similar nature or knowledge connected with the use of such patent, etc.

The right to deduct expenditure in respect of all three subsections is subject to the taxpayer using the patent, etc in the production of his income or income is derived by him therefrom.

It is common cause that the appellant did not pay the R100 million to acquire by assignment from any other person any patent, design, trade mark or copyright or any knowledge connected with the use of such property. It is, however, the appellant's case that it acquired property of a similar nature.

The issue is therefore whether the "licence fees" paid by the appellant constitutes an expenditure incurred "in acquiring ... any other property of a similar nature (to a patent, design, trade mark or copyright)" as contemplated in section 11(gA)(iii) of the Act.

In our judgment the ordinary grammatical interpretation of the phrase "property of a similar nature" found in section 11(gA) means and was intended to mean the acquisition of intellectual property i.e. property which came into existence by the exercise of intellectual powers and to which the law accords the rights and protection of ownership and which may be exploited either by the inventor or originator himself or by others with his leave, i.e. by assignment or possibly some other form of transfer.

The essential requirements of the section 11(gA)(iii) therefore are that:

1. The taxpayer must pay an amount to a person who has property which the latter created or developed by the use of his own intellect;

2. the latter has disposed of the right to exploit what he created by his intellect to another;

3. such disposal must be by way of an agreement which confers or passes on to the recipient the rights of an assignee to the property itself.

The licence fee was paid by the appellant to the Post Master General on behalf of the Minister. That does not constitute payment for property which the Post Master or Minister created. They therefore also did not dispose of a right to exploit what they created by their intellect. It was argued that in terms of the applicable statutes the rights disposed of to the appellant vested in the Minister and/or Post Master General. There is no merit in that argument. No property which came into existence by the exercise of intellectual powers vested in the two functionaries or was disposed of by them.

The R100 million licence fee was paid for the issue of a licence whereby the appellant obtained the leave or authority of the regulator to conduct a telecommunication service. The issue of such a licence does not

amount to the assignment of a right nor does it pass any proprietary interest. A licence is an authorization which has no characteristics of intellectual property. Licences simply regulate. It is "nothing more than a dispensation which passes no interest in its subject matter".

See *Video Park Town North (Pty) Ltd v Century Associates & Another* 1986 2 SA 623 (T) at 632E-G; 633H-I; *Rex v Maharaj*, 1957 1 SA 107 (A); *Basson t/a Repcomm Repeater Services v Post Master General* 1994 3 SA 224 (SE).

The payment of R100 million was therefore not an expenditure incurred for requiring by assignment property of a similar nature to a patent, design, trade mark or copyright.

The deduction in respect of legal fees

The appellant claims that it is entitled to a deduction for legal expenses incurred in drawing up several agreements relating to the cellular network by reason of the general deduction provisions of section 11(a) as read with section 23(g) of the Act.

The general principle is that legal fees will be allowed if they were incurred in the production of income. If the expense to which it relates was incurred for drawing agreements relating to the income earning structure of the appellant then the expense itself will of a capital nature. See *Port Elizabeth Electric Tramway Co Ltd v CIR* 1936 CPD 241 (8SATC13).

Legal expenses incurred in the acquisition of a capital asset are not deductible. This means that legal expenses incurred in the creation of a right to receive income will be of a capital nature. Only expenditure incurred in the actual earning of the income itself will be treated as an allowable deduction.

It is therefore necessary to have regard to the purpose for which the expenditure was incurred and to what it is most closely linked. It is therefore also necessary to look at the purpose of each of the agreements that are relevant.

The first agreement is the so-called "infrastructure sharing agreement" legal fees in the amount of R27 150,81 were incurred.

As its name implies, the agreement deals with the sharing of infrastructure facilities, whether by imposing mutual obligations upon the parties to construct base stations. This agreement has as its object the securing of an enduring advantage which is inherently of a capital nature. The purpose of the agreement is to reduce the outlay of fixed capital expenditure.

The second agreement is called the "interim roaming agreement" between the appellant and “A”. Legal fees to the extent of R56 367,86 were incurred.

The purpose of this agreement is to facilitate that customers of each party thereto may obtain access to the services while roaming on the network operated by the other party. Again this relates to the infrastructural arrangements and the necessity of utilizing each others lines because of the inherent nature of a call. Much of the agreement relates to securing the confidentiality of information which is of a capital nature. This agreement was signed on 25 February 1994 and endured until 31 October 1994.

The outlay on this agreement is on capital account.

Thirdly there are two "interconnection agreements" on which R60 542,66 were expended each. The first of the two "interconnection agreements" was between the appellant and “A”. The purpose of the agreement is to deal with the terms and conditions subject to which messages are conveyed to and from each others network. This is done at what is called the "interconnection". The obligation imposed is to establish an interconnection that facilitates the "seamless" transmission and reception of messages between the networks of each operator.

This agreement related to the infrastructure that is necessary to be established in order for a network to operate. It is therefore of a capital nature and the legal costs are consequently also of a capital nature.

The second of the two "interconnection agreements", is between appellant and “B”. This agreement is also concerned with ensuring that the infrastructure necessary for cellular calls to be made and received are in place. The agreement *inter alia* provides that the agreement is concluded to ensure that any message originating on “B”'s system may, if so required, be conveyed to its intended destination by means of a telecommunications line which the appellant is authorized to construct, maintain and use in terms of

its licence and conversely that a message originating on the appellant's line may, if so required, be conveyed to its intended designation through “B”'s network. In order to achieve this, it is necessary that there be a seamless interconnection of the respective networks.

This agreement too was of an enduring nature and related to the infrastructural requirements each party was required to adhere to so as to ensure a seamless interconnection. The legal costs are therefore also of a capital nature.

In view of the aforegoing there is no merit in the appellant's appeal.

The appeal is dismissed.

W J VAN DER MERWE
PRESIDENT

MR J H DU PLESSIS
ACCOUNTANT MEMBER

MS A C TEICHERT
COMMERCIAL MEMBER