A

DEPUTY COMMISSIONER OF INLAND REVENUE

v.

MARINE MANAGEMENT LIMITED

B

(Supreme Court—Kermode, J.,—August 1982)

Appellate Jurisdiction

C

Income Tax—deduction of interest—not incurred in production of income

M. J. Scott for Apellant
G.M.G. Johnson for Respondent

D Appeal by Deputy Commission of Inland Revenue against a decision of the Court of Review whereby it allowed an appeal in respect of an assessment for income tax levied on the respondent as to items which the respondent had treated as deductible from the taxpayer's total income.

These items were interest payments. The facts (summarised below) were not in dispute.

E

A certain David Neale Wilson and Stanley Harold Quigg wished to acquire an interest in Blue Lagoon Limited, a tour operating company, 53.3% of whose shares were owned by Fairmile Enterprises Limited in which all the shares were held by Claude Ivan Millar Wilson and Quigg arranged to purchase Fairmile for $800,000. They formed a company Marine Management Ltd. (Respondent) which borrowed $600,000 from a Bank. $120,000 was provided by the shareholders of respondent. The respondent was to manage Blue Lagoon for
F a substantial management fee of 7½% gross receipts of Blue Lagoon (ceiling $130,000). In the respondent's accounts was $57,778 being interest on the loan of $600,000. The respondent claimed this interest as a deduction from assessable income.

G The respondent argued that the interest on the loan should be set off or be a deduction against the management fee charged by respondent, which was income in the accounts of Fairmile. The deduction was disallowed.

The respondents argument was set out in the Review judgment—

"..... it raised a loan from the Bank to buy Fairmile and thus got control of Blue Lagoon,
H thus to obtain for itself a management fee." "It should be entitled to set off against the income (management fee) interest it was to pay the bank.....the interest is an expense incurred in producing the income."

The court considered the Income Tax Act s. 19*(f)* and was of the view that the interest paid by the respondent was apportionable-one half should be regarded as an expense incurred in respect of the Blue Lagoon shares, i.e. that it was an expense incurred in earning the management fee.

Under s.17(37) of the Act dividends from a company incorporated in Fiji received by a Fiji resident are exempt from tax.

S.19 of the Act read—

"19. In determining total income, no deductions shall be allowed in respect of.....

(b) any disbursement or expense not being money wholly and exclusively laid out or expended for the purpose of the trade, business, profession, employment or vocation of the taxpayer;

.....

.....

(f) any expense incurred in respect of—

(i) any amount received, receivable or accrued which is not included in total income or, if so included, is exempted under section 16 or 17 of this Act, or is not included in chargeable income under any of the provisions of this Act;

(ii) any investment or property the income arising from which will not be included in total income or, if so included, will be exempted under section 16 or 17 of this Act, or will not be included in chargeable income under any of the provisions of this Act;

.....

.....

(h) interest, other than interest actually incurred in the production of income or interest in respect of a loan obtained by a taxpayer to purchase his own residence: Provided that in the case of interest in respect of a loan obtained by a taxpayer to purchase his own residence—

(i) he maintains only one residence;

(ii) any deduction shall not exceed two hundred dollars per annum; and

(iii) such deduction shall not continue on a change of residence except on enforced change."

Held: The expenditure of the loan moneys involving payment of interest was solely and exclusively in connection with the respondent's business.

.....the expenditure was not for two separate purposes.....but for two or more purposes connected with the company's business.

the learned Judge said:—

"S.19*(b)* does not have any application to this case....if the (Review) meant this when it said the (respondent) was entitled to succeed on s.19*(b)*". I agree.

.....(Review) erred when it came to consider s.19*(f)*.

.....In Fiji Regulation "interest has to be actually incurred in the production of income".

A So far as the management fee was concerned, the expense of the interest in my view played no direct or relevant part in earning the management fee. (This) was earned solely as a result of the efforts of the company in the course of its business. The production of the fee involved no expenditure of interest.

The payment of the interest on the loan "was a payment independent of the assessable
B income (management fee) and was not an expenditure incurred in the course of its production"

The....interest....was incurred in purchasing the shares in Fairmile the income from which was exempt. It resulted in the (respondent) obtaining a management fee; it was not incurred in the production of that fee. S. 19*(f)* (ii) prevented the com-
C pany from claiming a deduction for any part of the interest. Apportionment did not arise; if it had, the interest could be apportioned. S. 19*(f)*".....wholely and exclusively....." would preclude apportionment.

S.19 *(h)* had no application.

Appeal allowed.

D Order of Court of Review set aside.

Assessment of Commissioner of Taxation confirmed.

Cases referred to:

Lee v. Commissioner of Taxation (NSW) A. T. D. Vol 3, 78.
Amalgamated Zinc (De Bavay's Ltd.) v. The Federal Commissioner of Taxation (1935) 54 C.L.R. 295

E KERMODE. Mr Justice.

Judgment

The appellant in this appeal is the Deputy Commissioner of Inland Revenue. He is authorised by section 3 subsection (3) of the Income Tax Act, subject to any
F express directive by the Commissioner to the contrary, to exercise the powers of the Commissioner. The Deputy Commissioner being dissatisfied with the decision of the Court of Review has referred this matter to this Court.

There are four reasons given by the Deputy Commissioner for his dissatisfaction which I will be referring to later in this judgment.

G It is not in dispute that the relevant provisions of the Income Tax Act Cap. 201 which the Court of Review had to consider are three subsections of Section 19 of the Act which refer to items which are not deductible from a tax payer's total income.

Subsection *(h)* was deleted from the Act by Act 21 of 1980 with effect from 1st January
H 1980. The appeal before the Court of Review was in connection with the assessment of the respondent's income for the year ended 31st May 1980.

There is no dispute in this appeal about the facts found by the Court of Review and I can do no better than repeat its clear recital of those facts. The Court said in its judgment: A

> "Blue Lagoon Cruises Ltd. is a company operating out of Lautoka and conducts tours throughout the Yasawa Islands off Western Viti Levu. It is a public company, but 53.3% of its shares are held by a company called Fairmile Enterprises Ltd. (which I shall hereafter refer to as "Fairmile"). That was a company wholly owned by Claude Ivan Millar who had founded Blue Lagoon Cruises Ltd. (which I shall call "Blue Lagoon") and his family, who thus controlled Blue Lagoon. In 1978 Millar wanted to retire and David Neale Wilson and Stanley Harold Quigg became interested in buying his interest in Blue Lagoon. Wilson was a tour and marketing agent and was interested in two companies already operating in Fiji, New Zealand Pacific Marketing Ltd. and Tapa Tours Ltd., and Quigg was an engineer, at that time managing Air Pacific Ltd. on secondment from Qantas, but about to leave Air Pacific and return to Qantas. The two of them negotiated with Millar and eventually they agreed to buy Fairmile for $800,000, which would thus give them control of Blue Lagoon. To enable them to finance this arrangement, they formed a company called Marine Management Ltd. with a capital of $500,000 in $1 shares, of which 210,000 were issued, one each to Wilson and Quigg, 125,999 to New Zealand and Pacific Marketing Ltd. in which Wilson held all but one of the issued shares, and $3,999 to a concern called Cantabrian Trust which was controlled by Quigg. They arranged for Marine Management Ltd. to borrow $600,000 from the Bank of New South Wales, which sum together with $200,000 put up by the shareholders of Marine Management Ltd. enabled that company to complete the purchase of Fairmile. It should perhaps be said that both Wilson and Quigg realised that the talents of both of them would be fully utilised for some time in the management of Blue Lagoon, and they intended that Blue Lagoon should pay a substantial management fee to Marine Management Ltd. Accordingly when, with the acquisition of Fairmile, Wilson and Quigg came into a position where they became directors of Blue Lagoon, and the former chairman, one of the first actions of the diretors was to engage Marine Management Ltd. to manage Blue Lagoon and to pay that company a fee of 7½% of the gross receipts of Blue Lagoon, with a ceiling of $130,000. That sum has now been paid for two years, although for the first year, since Blue Lagoon's financial year goes from 1st June to 31st May, and the management fee became payable only from 9th August 1978, only that proportion from 9th August to 31st May, 1979 was paid. B C D E F
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> When Marine Management Ltd. caused its accounts to be prepared, it showed among its expenses a sum of $57,778 which had been paid as interest to the Bank of New South Wales in respect of the loan of $600,000, to which I have previously referred. The Commissioner of Inland Revenue disallowed the deduction. Marine Management Ltd. objected, and the Commissioner disallowed the objection. Marine Management Ltd.....thereupon appealed to this Court. G
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> The appellant's argument, put succintly, is that it raised a loan from the Bank to buy Fairmile, and thus get control of Blue Lagoon, and its intention in controlling Blue Lagoon was to obtain for itself a management fee. It did so, H

A and should therefore be entitled to set off against its income—the management fee—the interest which it has to pay the Bank for the loan through which it became entitled to get the management fee. In other words, the interest is an expense incurred in producing the income."

The Court considered section 19(*f*) of the Act and was of the view that the interest paid by the Company was apportionable and came to the conclusion that one half
B of the interest should be regarded as an expense incurred in respect of the Blue Lagoon shares. The Court allowed the appeal to the extent of one half of the interest being of the view that the proportion was a permissible deduction.

Although the Court of Review did not specifically state that half the interest was allowed as a deduction as being an expense incurred in respect of the management fee, it is apparent that it was of that view.

C Under section 17(37) of the Act any dividend from a company incorporated in Fiji received by or accrued to a resident company is exempt from basic and normal tax. The dividends passed from Blue Lagoon to Fairmile and from Fairmile to the respondent company. No attempt has been made to tax this income in the hands of the respondent company.

Mr Scott in opening his argument for the appellant, pointed out that there has
D been no cross appeal by the company and the Court of Review's allowance of one half of the interest as a deductible item cannot be varied if in fact the Court should have allowed the total amount of interest as a deduction. Mr Scott contends the interest is not deductible at all and is not in any event apportionable in the circumstances.

There are certain relevant findings and comments in the Court of Review's Judg-
E ment which I consider require to be stated before I consider the issues involved. The extracts indicate how the Court arrived at its decision.

At page 27 of the Record the Court on considering the credibility of Mr Wilson said:

"I have however, no reason to doubt anything in his evidence—so far as it goes, save that I do not accept that his principal interest in Blue Lagoon was the
F management fee. His concern with Blue Lagoon was the income."

At page 28 the Court stated:

"In this case there are two main items of income, first the dividend income which the taxpayer received as the holder of a 53.3% interest in Blue Lagoon and secondly the management fee, and there is one main item of deduction, namely
G the interest....."

At page 30 the Court in comparing the Fiji and Australian legislation said:

"It will be seen that in Fiji interest has to be actually incurred in the production of income whereas the Australian section allows to be deducted all losses and outgoings to the extent to which they are incurred in gaining or producing the assessable income."

H Also on the same page the Court stated:

"I have no doubt that here the interest is payable on capital sums which themselves are employed in the production of income, and the Australian cases treat interest payable on capital utilised in the production of income as an outgoing incurred in gaining income and thus deductible....."

The last quotation from the Court's judgment which I desire to quote is at page 31:

> "Now, here, the expenditure of interest is related to the production of two matters of income, the management fee and the dividends, in the sense that if there had been no loan and consequently no expenditure for interest there would have been no management fee and no dividends. In my view the expense, viz, the expenditure for interest was partly incurred in relation either to an amount received, or to income from property either of which, will be exempted under section 17 (37) of the Act and hence not deductible."

The Court went on to conclude its judgment after the last quotation and apportioned the interest and allowed the appeal as to half the interest.

Mr Scott with his usual industry has produced a number of authorities and has greatly assisted the Court by furnishing photocopies of judgments of most of the authorities he relies on.

I will deal seriatum with the four reasons for dissatisfaction which I will treat as grounds of appeal. The first ground is:

> "1. The Court of Review erred in law in holding that the taxpayer company's deduction claim was not barred in its entirety by Section 19*(b)* of the Income Tax Act."

There was no finding as to nature of the business of the respondent company. On the facts all it did was to borrow a large sum of money to acquire a capital asset i.e. shares in Fairmile which company derived income from dividends paid to it by Blue Lagoon. The only active business the Company appears to have done was to provide management for Blue Lagoon at a fee not exceeding $130,000 per annum.

The payment of interest on the moneys borrowed could be considered as an expense solely for the loan raised to purchase a capital asset from which income accrued. It could also be considered as being paid for two purposes. firstly for acquisition of the Fairmile shares and secondly to obtain control of Blue Lagoon so that it was in a position to obtain a management fee for itself from that company.

A difficulty that arises in this appeal is that Australian tax law differs from the English law and also Fiji law and this has to be borne in mind when considering Australian and English authorities. So far as the Fiji section 19*(b)* is concerned section 23*(g)* of the South African Income Tax Act is very similar. It provides:

> "23. No deductions shall in any case be made in respect of the following matters. namely
>
> *(g)* any moneys claimed as a deduction from income derived from trade. which are not wholly or exclusively laid out or expended for the purposes of trade."

Section 51(1) of the Australian Income Tax Assessment Act deals with allowable deductions and is as follows:

> "Losses and outgoings—(1) All Losses and outgoings to the extent to which they are incurred in gaining or producing the assessable income. or are necessarily incurred in carrying on a business for the purpose of gaining or producing such income. shall be allowable deductions except to the extent to which they are losses or outgoings of capital. or of a capital. private or domestic nature. or are incurred in relation to the gaining or production of exempt income."

A Section 37 of the U.K. Income Tax Act 1952 is also similar to the Fiji provision and covers non deductible items. It reads:

"No sum shall be deducted in respect of

(a) disbursements or expenses, not being money wholly or exclusively laid out or expended for the purposes of the trade....."

B The U.K. and Fiji provisions make no reference to capital expenditure or to revenue producing expenditure.

This point was considered by Williams J. in Civil Appeal 9 of 1974. *The Commissioner of Inland Revenue v. Motibhai & Co. Ltd.*

"The U.K. and Fiji Acts make no reference to capital expenditure or to revenue producing expenditure, but the number of decisions touching upon section 37 C of the U.K. Act which refer to capital expenditure and revenue expenditure are too numerous to mention. In deciding whether an item of expenditure is deductible from income the Courts have frequently considered whether or not it was a capital expenditure."

I am not in this appeal concerned with a claim to deduct capital expenditure but with a claim to deduct interest paid on a loan utilised to obtain a capital asset which produced D income.

The Australian provision specifically excludes outgoings of a capital, private or domestic nature but unlike the Fiji provision (i.e. section 19*(b)*) it permits of apportionment of outgoings.

The previous Australian law was in some respects similar to the present Fiji provision. In *Lee v. Commissioner of Taxation (N.S.W.)* ATD Vol. 3 78 interest paid on E borrowed money secured by mortgages over 2 properties one of which was used as a residence was held not to be deductible. It was held that it was not money "wholly and exclusively laid out for the production of the assessable income".

The facts in the instant case indicate that the respondent company borrowed money to purchase the shares in Fairmile resulting in it obtaining control of Blue Lagoon. The Court of Review accepted that obtaining the management fee was one F of Mr Wilson's objectives. The purchase resulted in the company deriving non assessable income from Fairmile as a result of that company receiving non taxable income from Blue Lagoon.

One of the reasons for purchasing the shares in Fairmile was for the company to obtain control of Blue Lagoon and through such control to later procure for itself a management fee.

G Section 19*(b)* is concerned with "money wholly and exclusively laid out or expended for the purpose of the.....business.....of the taxpayer".

I do not think there can be any doubt on the facts that the expenditure of the loan moneys involving payment of interest was solely and exclusively in connection with the company's business.

H There is not in this instance as in *Lee's* case, an expense incurred on both income and non income bearing assets. Nor in my view was the expenditure for two separate purposes, one business and the other non business, as in the South African cases Mr Scott relies on. The expenditure was for two or more purposes connected with the company's business.

I hold the view that section 19*(b)* does not have any application in this case and if the Court of Review meant this when it said the company was entitled to succeed on section 19*(b)* I agree with the Court. The first ground of appeal fails. A

The second and fourth grounds of appeal can be considered together. They are as follows:

"2. The Court of Review erred in law in holding that the taxpayer company's deduction claim was not barred in is entirety by Section 19*(f)*(ii) of the Income Tax Act; B

4. The Court of Review erred in law in holding that apportionment was (i) legally permissible and (ii) factually justifiable. in the taxpayer's appeal."

It is when the Court of Review came to consider section 19*(f)* that it erred in my view. The Court was of the view that the interest related to the production of two matters of income "in the sense that if there had been no loan and consequently no expenditure for interest there would have been no management fee and no dividends". C

That statement may be factual but the Court appears to have overlooked or not considered the fact it had earlier noted in its judgment that in the Fiji legislation "interest has to be actually incurred in the production of income". D

So far as the management fee was concerned the expense of the interest incurred in my view played no direct or relevant part in earning the management fee. The fee was earned solely as a result of the efforts of the company in the course of its business. The production of the fee incurred involved no expenditure of interest.

Mr Scott quoted a South African case which is almost on all fours with the present case. While the case is not binding on this Court. it is of persuasive value since the South African legislation is similar to the Fiji legislation. E

The case is Income Tax Case No. 296 (1934) 7 SATC 353. The case dealt with a claim to deduct interest. The appellant had set up a private company in which he held 90% of the shares and under the articles of association of the company was entitled to hold the office of managing director at a substantial salary. He sought to deduct from his salary the interest paid by him on the sums borrowed to pay for his shareholding and to cover his advances to the company. F

It was held, dismissing the appeal. that the salary drawn by the appellant had been earned by his energy and ability as managing director and not by the expenditure of the interest by him on the moneys borrowed the liability for which had been incurred for the purpose of ultimately earning dividends from the company's activities. G

The Court in that case mentioned that it had to find that the expenditure was incurred in the direct production of the income before it could come to any conclusion in favour of the appellant. It found no such direct connection between the expenditure and the production of the income.

Dixon J. in the *Amalgamated Zinc (De Bavay's) Ltd. v. The Federal Commissioner of Taxation* [1935] 54 C.L.R. 295 on which the Court of Review also relied at p. 310 of the Report stated: H

"What is important is the entire lack of connection between the assessable income and the expenditure. None of the assessable income arose out of the

A business in the course of which the taxpayer became liable to the charge. The sources from which the assessable income did arise included no operations in the course of which the payment was made. It was a payment independent of the production of the income, not an expenditure incurred in the course of its production."

The final statement can be applied to the facts in the instant case. The payment
B of the interest on the loan was a payment independent of the assessable income (management fee) and was not an expenditure incurred in the course of its production. The management fee was solely derived from the management activities of the company.

The whole of the interest in the instant case was incurred in purchasing the shares in Fairmile the income from which was exempt. It resulted in the company being
C able to obtain a management fee but it was not incurred in the production of that fee. It follows that section 19*(f)*(ii) operates to prevent the company from claiming any part of the interest as a deduction.

The question of apportionment in my view does not arise. Had the question arisen however I would have agreed with the Court of Review that the interest could be apportioned.

D The language used in section 19*(b)* would preclude any apportionment if that section had application. The words "wholly and exclusively" leave no doubt about that.

Section 19*(f)* however is couched in different terms and I agree with the Court of Review "that only the expense related to those matters (i.e. the matters referred to in section 19*(f)* is not deductible".

E It follows from the foregoing that the appellant succeeds on the second ground of appeal but fails on the fourth.

There remains the third ground which is as follows:

"3. The Court of Review erred in law in holding that the taxpayer company's deduction claim was not barred as to seven twelths thereof by Section 19*(h)*
F of the Income Tax Act."

I am unable to appreciate why Mr Scott argues in the alternative that the Court should have apportioned the deduction because section 19*(h)* was deleted from the Act with effect from 1st January 1980. I do appreciate that the Section was only in force for 7 months so far as the company's 1980 return was concerned. It appears to me that section 19*(h)* only had to be considered if the interest was not "actually
G incurred in the production of income". Such interest was already excluded from section 19*(h)* because on the facts it was interest incurred in production of income and delegation of section 19*(h)* in the circumstances made no difference in my view.

The Court of Review did not seek to apportion the interest under section 19*(h)* and in my view was correct in that approach.

The third ground fails.

H The appeal is allowed.

The Court of Review's order allowing the appeal is set aside and the Commissioner's assessment is confirmed.

The appellant is to have the costs of this appeal and of the appeal to the Court of Review.

Appeal allowed.

[Note: An appeal against this decision is reported at 29 FLR 39]