MARINE MANAGEMENT LIMITED A

v.

DEPUTY COMMISSIONER OF INLAND REVENUE

Present at the Hearing: B

Lord Templeman
Lord Ackner
Lord Oliver of Aylmerton
Lord Goff of Chieveley
Sir John Stephenson

C

Delivered by Lord Ackner (5th March 1986)

Income Tax—Deduction sought for interest on loan—loan used to buy shares in company—s.17(37) and s.19(f)(b) precluded deduction—share dividends not assessable income—management agreement entered into by company (whose shares were purchased) and taxpayer—management fee thereby derived—loan was an investment in property being shares, not in management agreement—so interest barred by s.19(f)(i)). D

Appeal against a dismissal by the Fiji Court of Appeal (See 29 FLR 39) of an appeal to it against a decision of the Supreme Court which had upheld an appeal from Court of Review which had allowed as a deduction from assessable income a sum of interest claimed but which the respondent had refused. The facts are set out in their Lordships Reasons. The taxpayer had claimed a sum of $57,778 charged to it for interest on a loan of $600,000, a sum borrowed to buy a company Fairmile Enterprises Limited (Fairmile) which owned 53.3% of the shares in a tour operator, Blue Lagoon Cruises Limited (Blue Lagoon). The arrangement otherwise was for Blue Lagoon to pay a substantial management fee to the appellant taxpayers 7½ of gross profits, (ceiling $130,000) and of course dividends. For the first year after the agreement, since Blue Lagoon's financial year ran from 1 June to 31 May and the management fee only became payable from 9 August 1978, only the proportion of the fee from 9 August to 31 May 1979 was paid. E F

The taxpayer showed in its accounts $57,778 as interest to the Bank on the loan for $600,000.

This deduction was disallowed, the taxpayer appealed to the Court of Review which held that the claim succeeded as to one half. The Court of Review said— G

> "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."

H

and further said—

A

"In my view the expenses viz the .... interest was partly incurred in relation either to an amount received or to income from property either of which will be exempted under s.17(37) of the Act and hence not deductible."

The Supreme Court held that the entirety of the interest claimed was incurred—

B

".... in purchasing the shares in Fairmile the income from which was exempt. It resulted in the company (taxpayer) being able to obtain a management fee, but it was not incurred in the production of that fee. The taxpayer appealed to the Fiji Court of Appeal. That Court dismissed the appeal. It held that the only possible investment by the taxpayer in respect of which the interest was incurred was the investment in Fairmile's capital; the only possible property
C was the parcel of shares in that company. It concurred with Kermode, J."

Their Lordships summed up the issue thus whether the interest—

".... the subject of this appeal, was incurred both in earning taxable income that is, the income derived from the management agreement, and in holding
D shares for the purpose of earning non-taxable income that is, the dividend paid by the company, and that it was entitled to a deduction for such part of that interest as was related to the production of taxable income (the income derived from the management agreement)."

Income Tax Act (Cap. 201) s.19 reads—

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

(a) ...

(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 *(c)* ...

(c) ...

(d) ...

(e) ...

(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,
G 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, or will not be included in chargeable income under any of the provisions of this Act;

(g) ...

H *(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 in Fiji:

Provided . . ."

The Courts below had held that the interest incurred was an expense wholely and exclusively laid out/expended for the purpose of the taxpayer's business, therefore the deduction was not prohibited by s.19(i). A

Held: S.19*(f)*(i) was not relevant because no dividend was received during the year.

The essential question was whether the deduction was prohibited by s.19*(f)*(ii). Their Lordships noted that the loan was to buy the capital of Fairmile and thus control Fairmile; its then intention was to get a management fee. Thus it achieved two sources of income, the fee and dividends. But no part of the payment was to acquire or purchase the management agreement—not then in existence anyway. B

As to dividends the expenditure of interest was caught by s.19*(f)*(ii) and s.17(3) (dividends from a company incorporated in Fiji received by a resident company are not assessable to tax). Thus the interest was an investment the income from which will not be included in total income or exempted. C

The management fee was not caught by s.19*(f)*(ii). Therefore the interest should be apportioned. The Court of Review's "equitable" approach of attributing one half of the interest as an expense incurred in achieving income from the management agreement, was correct. D

However the only property acquired by the loan money were the shares and not the management agreement. The income therefrom did not arise from the investment by the taxpayer, since the management agreement income did not arise from the investment by the taxpayer. Therefore the claim for deduction of interest was totally barred by s.19*(f)*(ii). E

Appeal dismissed with costs.

Judgment

This appeal concerns a claim to a tax deduction in respect of the payment of interest incurred during the year ended 31st May 1980 on monies borrowed by the appellant, Marine Management Limited, ("the taxpayer") to finance the purchase of certain shares. The facts out of which the claim arises can be shortly stated. F

The taxpayer is a limited liability company incorporated in Fiji. On 23rd February 1981 it filed its Return of Income for the year ended 31st May 1980. In this Return the taxpayer claimed as an expense the sum of $57,778.00 in respect of interest which it had paid. The basis of this claim was as follows. Blue Lagoon Cruises Limited ("Blue Lagoon") 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 were held by a company called Fairmile Enterprises Limited ("Fairmile"). The company was wholly owned by Mr Miller and his family, who had founded Blue Lagoon. In 1978 Mr Miller wanted to retire and Mr Wilson and Mr Quigg became interested in buying his interest in Blue Lagoon. They negotiated with Mr Miller and eventually they agreed to buy Fairmile for $800,000, thus giving them control of Blue Lagoon. For this purpose they formed the taxpayer with a capital of $500,000 in $1 shares. They arranged for the taxpayer to borrow G H

A $600,000 from the Bank of New South Wales which sum, together with $200,000 put up by the shareholders of the taxpayer, entitled the taxpayer to complete the purchase of Fairmile. It was the intention of Mr Wilson, who was a tour and marketing agent, and of Mr Quigg, who was an engineer, that Blue Lagoon should pay a substantial management fee to the taxpayer. Of the 210,000 shares issued, one each was issued to Mr Wilson and Mr Quigg, and 125,999 to New Zealand Pacific Marketing Limited, in which Mr Wilson held all but one of the issued shares, and
B 83,999 to a concern called Cantabrian Trust which was controlled by Mr Quigg.

In due course, a management agreement was entered into between the taxpayer and Blue Lagoon, the management fee being agreed at 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 runs from 1st June to
C 31st May, and the management fee only became payable from 9th August 1978, the proportion from 9th August to 31st May 1979 only was paid.

When the taxpayer 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 its loan of $600,000 referred to above. This deduction was disallowed by the Commissioner of Inland Revenue. The taxpayer entered an objection which the Commissioner disallowed and the taxpayer appealed to the Court of
D Review. On 17th December 1981 the Court of Review held that the taxpayer's appeal succeeded as to one half of the interest claimed. In essence the reasons given for that decision were as follows:

> "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
E 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 Deputy Commissioner of Inland Revenue, the respondent to this appeal, appealed to the Supreme Court of Fiji, which on 16th August 1982 allowed the
F appeal, holding that the entirety of interest claimed "was incurred in purchasing the shares in Fairmile, the income from which was exempt. It resulted in the company being able to obtain a management fee, but it was not incurred in the production of that fee".

The taxpayer appealed to the Fiji Court of Appeal. On 28th July 1983 the Fiji Court of Appeal dismissed the taxpayer's appeal, holding that the only possible
G investment by the taxpayer in respect of which the interest was incurred was the investment in the capital of Fairmile, and the only possible property was the parcel of shares in that company. The Court of Appeal concurred with the view expressed by Kermode J. in the Supreme Court that the investment played no direct or relevant part in earning the management fee and that the fee was solely derived from the management activities of the company.

H The taxpayer's case in substance is that the interest, the subject matter of this appeal, was incurred both in earning taxable income that is, the income derived from the management agreement, and in holding shares for the purpose of earning non-taxable income that is, the dividend paid by the company, and that it was entitled to a deduction for such part of that interest as was related to the production of taxable income (the income derived from the management agreement).

The statutory provisions relevant to this appeal are to be found in section 19 of the Income Tax Act (Cap. 201). ;As at 1st June 1979, section 19, so far as it is material to this appeal, read as follows:

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

(a) . . .

(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;"

(c) . . .

(d) . . .

(e) . . .

(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, 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, or will not be included in chargeable income under any of the provisions of this Act;

(g) . . .

(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 in Fiji:

The taxpayer conceded that paragraph 19*(h)* barred any claim while it remained in force. It was removed from the Act as from 1st January 1980 and therefore it is accepted that the taxpayer could have no claim from 1st June 1979 to 31st December 1979, a period of seven months.

At all levels it has been held, and in their Lordships' view rightly held, that the interest incurred was an expense wholly and exclusively laid out or expended for the purpose of the taxpayer's business. Accordingly the deduction was not prohibited by section 19*(b)*. The essential question was whether the expense was prohibited by section 19*(f)*. Section 19*(f)*(i) was not relevant because no dividend was received during the year. The vital subsection is therefore section 19*(f)*(ii).

The taxpayer's case is that it raised a loan from the Bank to buy Fairmile, and thus to get control of Blue Lagoon. Having acquired control, its intention was to obtain for itself a management fee. Having obtained the management agreement, it achieved two sources of income, firstly, the dividend paid on the shares which it had acquired and secondly, the management fee paid under the management agreement. Thus, the expenditure of interest related to the production of two sources of income. In so far as it related to the dividend, the expenditure of interest was caught by section 19*(f)*(ii) and by section 17(37) being "dividend from a company incorporated in Fiji received by or accrued to a resident company" and hence not deductible. However, so far as the expenditure for interest was incurred in relation to achieving the income obtained from the management agreement, this was not caught by section 19*(f)*(ii). Accordingly the total sum of interest expended should be

A apportioned. The Court of Review had adopted the equitable approach of attributing one half of the interest as an expense incurred in achieving the income from the management agreement and this was the correct decision.

Mr Handley, on behalf of the taxpayer, accepted that, in considering the application of section 19*(f)*(ii), there must first be identified the "investment or property". He further accepted that the Court of Appeal had rightly concluded that the only
B investment by the taxpayer in respect of which the interest was incurred was the investment in the capital of Fairmile, and the only property was the parcel of shares in that company. At the time of the purchase there was, of course, no management agreement in existence and accordingly, by its purchase, the taxpayer obtained no such asset. True enough the purchase gave the taxpayer the opportunity to achieve a management agreement and the income arising therefrom and no doubt this was its sole or predominant motive for the purchase. This does not however result in the
C expenditure of the $800,000 being a dual purpose expenditure. The money was paid for the acquisition of one and only one asset, no part of the consideration being attributable to the acquisition of a management agreement which, indeed, was not then in existence. Thus the management agreement income did not arise from the investment by the taxpayer and accordingly the claim for deduction of the interest is totally barred by virtue of section 19*(f)*(ii).

D Their Lordships will humbly advise Her Majesty that this appeal should be dismissed. The appellant must pay the respondent's costs.

Appeal dismissed.