Privy Council Appeal No. 40 of 1985

Marine Management Limited *Appellant*

v.

Deputy Commissioner of Inland Revenue *Respondent*

FROM

THE FIJI COURT OF APPEAL

JUDGMENT OF THE LORDS OF THE JUDICIAL COMMITTEE OF THE PRIVY COUNCIL, DELIVERED THE 5TH MARCH 1986

Present at the Hearing:

LORD TEMPLEMAN
LORD ACKNER
LORD OLIVER OF AYLMERTON
LORD GOFF OF CHIEVELEY
SIR JOHN STEPHENSON

*[Delivered by **Lord Ackner**]*

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.

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 $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 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 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 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 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 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 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.

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:

Provided ..."

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 sub-section 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 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 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 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).

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