Privy Council Appeal No. 42 *of* 1958

Ralli Estates Limited - - - - - - - - - *Appellants*

v.

The Commissioner of Income Tax - - - - - *Respondent*

FROM

THE COURT OF APPEAL FOR EASTERN AFRICA

JUDGMENT OF THE LORDS OF THE JUDICIAL COMMITTEE OF THE PRIVY COUNCIL, DELIVERED THE 30TH JANUARY, 1961

Present at the Hearing:

LORD TUCKER
LORD DENNING
LORD MORRIS OF BORTH-Y-GEST

[*Delivered by* LORD DENNING]

The question in this appeal concerns the income tax payable in East Africa by a company called Ralli Estates Limited. That company was incorporated in Tanganyika on 21st December, 1950, and ten days later, on 31st December, 1950, it obtained the right to occupy two sisal estates for a term of 99 years from 1st January, 1951. These two estates were known as the Lanconi and Mjesani estates and comprised some 23,469 acres. They were used for the growing of sisal, which is used for producing fibre out of which can be made string, ropes and many other things. The company made considerable profits in the years 1951 and 1952 by producing sisal on these two estates and exporting it abroad : and it is liable to pay income tax on those profits. But it says that, in calculating its income, there should be deducted several payments which amount to £174,600 altogether for the two years 1951 and 1952. The Commissioner of Income Tax declined to make any deduction on account of these sums. The company appealed to the High Court of Tanganyika and on 30th March, 1957, Crawshaw, J., dismissed the appeal. The company thence appealed to the Court of Appeal for Eastern Africa, who, on 22nd May, 1958, dismissed the appeal. Both courts held that the payments amounting to £174,600 were not revenue expenditure but capital expenditure, and were not deductible for purposes of income tax. The company now appeals to their Lordships' Board.

The principal statutory provision is section 14 (1) of the East African Income Tax (Management) Act, 1952, which says that " for the purpose of ascertaining the total income of any person there shall be deducted all outgoings and expenses wholly and exclusively incurred during the year of income by such person in the production of the income ".

The contest between the parties may be shortly stated thus : The company says that the payments amounting to £174,600 were made up of royalties payable at so much per ton of sisal exported, and they were therefore in the nature of a revenue expenditure. The Commissioner says that the payments amounting to £174,600 were part of the purchase price paid by the company for the two sisal estates, £70,300 being payable in respect of the Lanconi estate, and £104,300 in respect of the Mjesani estate. They were therefore capital expenditure.

These estates were at one time two of several estates in Tanganyika owned by enemy nationals. During the war of 1939–1945 and for some years thereafter they were under the control of the Custodian of Enemy Property. He leased them on short leases at a nominal rent but a royalty was payable by the lessees. These royalties were based on a sliding scale according to the grades of sisal produced and sold. Out of those royalties the Custodian paid the cost of capital improvements made by the lessees with his assent, e.g. buildings, machinery and replanting. In this way most of the royalties were " ploughed back " into the land by planting sisal for future use, or expended on the purchase of machinery, or used for factories and houses for workers.

After the war the Government of Tanganyika made an Ordinance under which the Government itself acquired the ex-enemy estates. It did so by the German Property (Disposal) Ordinance, 1948. Included amongst them were the Lanconi and Mjesani sisal estates. These were transferred to the Tanganyika Government who, on 1st July, 1948, became the owner of them. The Government entrusted the management of the two estates to *Ralli Brothers Limited*. It is to be noted that *Ralli Estates Limited* had not then been formed.

On 17th March, 1950, the Tanganyika Government issued a public notice in the Press whereby it invited applications for the purchase of the estates previously owned by enemy nationals, details of which were given in a catalogue of sale. Ralli Brothers Limited applied to purchase some of the estates and they were successful in regard to the Lanconi and Mjesani estates. Negotiations ensued as a result of which the Government, by letters of 30th September and 26th October, 1950, agreed to grant a right of occupancy of these two estates to Ralli Brothers Limited for 99 years from 1st January, 1951, at (i) a rent of 2s. per acre per annum, or (ii) a premium of £311,000, and (iii) a royalty on all sisal fibre exported from the two estates up to a total of £174,600 but reducible in certain circumstances.

Two months later, however, when the formal contract was concluded, it was made, not with Ralli Brothers Limited but with *Ralli Estates Limited,* a wholly-owned subsidiary formed by Ralli Brothers Limited for the purpose. The formal offer was contained in a letter of 20th December, 1950, addressed by the Tanganyika Department of Lands and Mines to Ralli Estates Limited : and it was accepted by Ralli Estates Limited on 31st December, 1950, under their Common Seal.

Moreover, the formal contract contained a very different description of the payments of £174,600. Whereas in the course of the negotiations they had been described as " royalties ", in the formal contract they were described as " balance of the purchase monies ". The description in the negotiations was contained in a letter of 30th September, 1950, which gave all the details of the proposed deal. A " royalty " was payable on every ton of line fibre exported by the company from Tanganyika. It was to be charged on a sliding scale based on the average f.o.b. price of line fibre at the rates shown in this table :

" TABLE OF ROYALTIES

Price of Sisal per ton f.o.b.	*Royalty per ton*
£70 or under	£1 0 0
£71 to £75	£3 15 0
£76 to £80	£5 19 0
£81 to £85	£8 3 0
£86 to £90	£10 10 0 "
and so on	and so on
until	until
" £146 or over	£56 18 0."

There was a limitation, however, contained in the letter of 30th September, 1950. It expressly provided that " Royalties will be payable until, in the case of each estate, the whole balance due by way of royalty (£174,600) is extinguished or until royalty has been paid on the tonnage liable to royalty (19,397 tons) whichever occurs the earlier ".

When it came to the formal contract, the self-same payments were described as " Balance of Purchase Monies ". They were to be paid by monthly instalments assessed by reference to the tonnage of line sisal fibre produced on the land and exported during the preceding month. The payments were to be calculated on a sliding scale at the rates shown in this Schedule, which contains figures identical with those in the Table of Royalties :

" SCHEDULE

Rates at which Balance of Purchase Monies to be calculated

Average F.O.B. Price of Line Sisal Fibre.	*Amount payable per ton.*
£70 or under	£1 0 0
£71 to £75	£3 15 0
£76 to £80	£5 19 0
£81 to £85	£8 3 0
£86 to £90	£10 10 0 "
and so on	and so on
until	until
" £146 or over	£56 18 0."

There was also an identical limitation in that the formal contract provided that: " The said monthly instalments shall be paid until such time as either the balance of purchase monies (£174,600) is paid or until the total fibre tonnage of 19,397 tons shall have been cut and accounted for, whichever shall first occur ".

In short, the formal contract provided that the £174,600 was not a royalty but was the balance of the purchase monies of a capital asset, reducible, it is true, in certain events, but nevertheless part of the purchase monies.

The reason for the change of nomenclature is not far to seek. After the parties had come in the negotiations to a provisional agreement, the Lands Department consulted the Income Tax Authorities: and in consequence, when drawing up the formal offer, changed the wording from " royalties " to " balance of purchase monies " and made corresponding adjustments. If they were truly the balance of purchase monies, payable for a capital asset, they would be capital expenditure and not deductible : whereas if they were truly royalties, they would be revenue expenditure and deductible.

The formal offer of 20th December, 1950, describing the payments as " balance of purchase monies " was accepted by the company : and it must be taken prima facie to be a correct description of the payments. But their Lordships hasten to add that the Courts are not bound by the description. The parties cannot alter the true nature of the payments by giving a different label to them. Just as parties cannot turn a tenancy into a licence by calling it one, so they cannot turn a revenue expenditure into a capital expenditure by saying that it is such. Everything depends in the last resort on the true nature of the payments as determined by the courts : and for this purpose it is legitimate to look at the course of negotiations as well as the formal contract.

Mr. Borneman contended that, if you look at the course of negotiations, you will see that payments were truly royalties. He compared them with payments which a lessee of a coal mine or a sand pit makes on every ton of coal or sand that he digs and takes away. Such payments are,

of course, revenue expenses and must be deducted in order to ascertain his income. Even though the asset is a wasting asset, the payments are regarded as payments in the nature of rent. They are payments for the use of the mine or the pit. So here, says Mr. Borneman, the payments were made for the use of the "sisal potential" of the two estates.

Now if the royalties under consideration were the royalties under the short leases granted before 1950, there would be a great deal to be said for Mr. Borneman's analogy. The Custodian before 1950 used to let the estates for short periods at more or less nominal rents but royalties were paid on a sliding scale according to the grades of sisal produced and sold. Such royalties were no doubt revenue expenses comparable to the royalties on a sand pit. The sisal plants have an average life of 7 or 8 years. The royalties were in such cases paid for the use of the sisal plants for the term of the short lease. The lessee was entitled to cut and take away the leaves of the plants and make them into fibre and sell it. Thus he made his income and the royalty was an expense wholly and exclusively incurred in the production of the income. The lessee did not do any replanting of sisal except with the consent and at the cost of the Custodian.

But their Lordships are of opinion that Mr. Borneman's analogy does not fit the 99 years right of occupancy here under consideration. This was a long-enduring right very different from the short leases. The royalty was not payable throughout the 99 years but only for an indeterminate period at the beginning, probably only a few years. It was not payable on all the sisal fibre produced during the 99 years but only until the total amount paid was £174,600, or until 19,397 tons of fibre had been exported, whichever was the earlier. As it happened the price of sisal was so high that the whole amount of £174,600 was paid off in 2 years.

Their Lordships reject, therefore, the contention that this was a true royalty and turn to Mr. Borneman's second contention. He said that it was in any case a payment of an income nature. It was, he said, a fluctuating payment which "rose or fell with the chances of the business" (quoting Rowlatt, J., in *Jones* v. *Commissioners of Inland Revenue* (1919) 7 Tax Cas. 310 at p. 315) and it was a payment "for the use" of the sisal potential "as they are using it" (quoting Rowlatt, J., again in *Mackintosh* v. *Commissioners of Inland Revenue* (1928) 14 Tax Cas. 15 at p. 19). It was therefore, he said, on the authorities an income receipt in the hands of the recipient: and he asked their Lordships to hold that it was a revenue expenditure in the hands of the payer.

Their Lordships are not disposed to accept this argument. They consider that the cases about income receipts have no relevance here. Payments which are income receipts in the hands of the recipient are not necessarily revenue expenditure in the hands of the payer. Their Lordships are concerned here with payments by the company, not receipts by them.

Their Lordships prefer therefore to turn back to the words of the Act and ask whether the payments were expenses wholly and exclusively incurred "in the production of the income" of the payer: and this means that you must look at the purpose of the payments. Were they paid in order to acquire a capital asset? or for a capital purpose? If so, they are capital expenditure. But if for an income purpose, they are revenue expenditure. For instance, if a price is paid for freehold land, or a premuim (properly so called) is paid for a long lease, it is not an expense incurred in the production of income, but in the production of capital. It is not deductible as revenue expenditure, no matter whether the price or premium is paid by a lump sum or by instalments. And this is true even when the lease is of a wasting asset, such as a coal mine, see *Mallett* v. *Staveley Coal and Iron Co. Ltd.* (1928) 13 Tax Cas. 772, at p. 778 by Rowlatt J. Again, if a manufacturer expends money on machinery or plant which is used again and again in his manufacturing operations, it is capital expenditure, and is not deductible in assessing his income, no matter whether he pays for it cash down or by instalments.

But if a trader pays money for trading stock which he means to sell to customers as soon as he can, it is an expense incurred in the production of income, no matter whether it is paid in a lump sum or by instalments: and it is deductible. Likewise with a rent, properly so called, which is paid for a lease out of which the lessee gets an income. It is a revenue expenditure and deductible.

Applying this reasoning, their Lordships ask whether these payments amounting to £174,600 were paid for a capital asset or capital purpose: and the answer, even on the documents which passed during the negotiations, is that they were paid for a capital asset or at any rate for a capital purpose. It is obvious, of course, that the yearly rental of 2s. an acre (which represented the unimproved value of the land) was paid for an income purpose. But the premium of £311,000 and the royalty of £174,600 were, according to the catalogue, together payable "for the unexhausted improvements on the land, including leaf, building, machinery and equipment". In the important letter of 30th September, 1950, the premium and the royalty are taken together as representing the "total net capital value" of the estates as is shown by the table set out therein:

"Estate	*Total Net Capital Value*	*Premium Payable*	*Balance due on Royalty*	*Fibre Tonnage on which Royalty Payable*
Lanconi ...	£191,500	£121,200	£70,300	7,809 Tons
Mjesani ...	£294,100	£189,800	£104,300	11,588 Tons"
which come to	£485,600	£311,000	£174,600	19,397 Tons

In that table the premium and royalty, added together, make up the "total net capital value" and are obviously paid for the capital asset represented by 99 years right of occupancy of the unexhausted improvements. Whether that right be properly called a lease does not matter. It is a long enduring interest which is of a capital nature: and the payment for it is a capital expenditure. It is true that in some circumstances a reduced amount is payable. The tonnage liable to royalty, as the table says, was only 19,397 tons: and on that tonnage it takes a royalty of £9 a ton, or just over, to make up £174,600. So that if the royalty averaged less than £9 a ton for the 19,397 tons, the total sum payable would be less than £174,600. But the fact that a reduced amount is payable in certain circumstances does not alter the nature of the payment. It is still a payment for a capital asset and must be reckoned as capital expenditure.

On this view the formal contract did no more than express the true nature of the payments. It made explicit that which was previously obscured by the use of the word "Royalty".

The only way in which the payments of £174,600 might be said to be an income expenditure would be if they were payments made in respect of the actual leaf potential on the estates at the time of disposal. Now we know what the estimated leaf potential was. It was 19,397 tons. Mr. Carson, a director of Ralli Estates Limited, said that the 19,397 tons was "an estimate of the line fibre growing on the estate which would be recovered from the mature and immature sisal growing on the estate at the time of the sale". If the royalty of £174,600 was paid in respect of this tonnage, it would look as if the royalty was a true royalty payable on the fibre which could be got out of the plants growing on the estates at the time of the sale (just like sand out of a pit) but with a maximum of £174,600. The company would then be paying for the use of the leaf as they used it. But the company is not in a position to put forward an argument on this footing. There is no evidence to show that the sums amounting to £174,600 were paid in respect of the 19,397 tons. Mr. Carson himself said in evidence: "I did not know how the £174,600 was arrived at": and when Mr. Wood (who was the secretary of the

Committee which valued the estates) was called to say how the £174,600 was arrived at, the company objected and no evidence was given upon it. So we must take it that the £174,600 was simply part of the one composite payment of £485,600 (£311,000 plus £174,600) payable for the total net capital value. It is on a par with the premium. In short it is part of the purchase monies for a capital asset. It is therefore a capital expenditure and not deductible.

Their Lordships have considered the Land Laws of Tanganyika to which Mr. Bechgaard referred, but even assuming that a right of occupancy is different from a lease, and accepting the special interest which an occupier has in unexhausted improvements, they see nothing in those laws to affect the general question of capital or revenue expenditure which they have discussed.

Their Lordships find themselves in agreement with the decision of Crawshaw, J., and of the Court of Appeal for Eastern Africa. They will humbly advise Her Majesty that the appeal should be dismissed. The appellants must pay the costs.

(39413) Wt. 8109—53 120 2/61 D.L.

In the Privy Council

RALLI ESTATES LIMITED

v.

THE COMMISSIONER OF INCOME TAX

DELIVERED BY LORD DENNING

Printed by HER MAJESTY'S STATIONERY OFFICE PRESS,
DRURY LANE, W.C.2.

1961