



IN THE SUPREME COURT OF APPEAL OF SOUTH AFRICA

REPORTABLE

Case no: 358/02

In the matter between

**THE COMMISSIONER FOR THE SOUTH
AFRICAN REVENUE SERVICE**

APPELLANT

and

SA SILICONE PRODUCTS (PTY) LTD

RESPONDENT

Coram: HOWIE P, MARAIS, ZULMAN, CLOETE and HEHER JJA

Heard: 16 FEBRUARY 2004

Delivered: 5 MARCH 2004

Summary: Income Tax – Act 58 of 1962 s 11 (gA)(iii) – whether licence to use trade marks ‘property similar in nature’ to trade mark – whether conclusion of licence agreement ‘acquisition’ of such property.

JUDGMENT

HEHER JA:

[1] This is an appeal direct from the Income Tax Special Court (presided over by De Klerk J) sitting at Pretoria. The issue is whether an amount of R14,5 million claimed by the respondent as a deductible allowance in terms of s 11 (gA)(iii) of the Income Tax Act 58 of 1962 in its return for the 1995 financial year was improperly disallowed by the appellant.

[2] From about 1988 DB Silicones CC (“DBS”) carried on a small but successful business marketing silicone products under licence from Dow Corning Corporation of Michigan.

[3] The respondent is a subsidiary of a major participant in the South African chemicals industry. During late 1994 it negotiated for the acquisition of the business of DBS. At an advanced stage it instructed a trade mark attorney, Mr Derek Momberg, to ascertain whether there was an intellectual property component in a

proposed purchase and, if so, to value it with a view to claiming the tax benefits which might flow from an agreement of sale structured with regard to the provisions of s 11(f) or 11 (gA)(iii) of the Act. Those sections provided as follows at the relevant time:

‘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 within the Republic, there shall be allowed as deductions from the income of such person so derived-

...

(f) an allowance in respect of any premium or consideration in the nature of a premium paid by a taxpayer for-

...

- (iii) the right of use of any patent as defined in the Patents Act, 1978 (Act 57 of 1978), or any design as defined in the Designs Act, 1967 (Act 57 of 1967), or any trade mark as defined in the Trade Marks Act, 1963 (Act 62 of 1963), or any copyright as defined in the Copyright Act, 1978 (Act 98 of 1978), or

of any other property which is of a similar nature, if such patent, design, trade mark, copyright or other property is used for the production of income or income is derived therefrom; or

- (iv) the imparting of or the undertaking to impart any knowledge directly or indirectly connected with the use of such film, sound recording, advertising matter, patent, design, trade mark, copyright or other property as aforesaid:

Provided that-

...

- (dd) the provisions of this paragraph shall not apply in relation to any such premium or consideration paid by the taxpayer which does not for the purposes of this Act constitute income of the person to whom it is paid, unless such premium or consideration is paid under a written agreement formally and finally signed before 10 April 1984 by every party to the agreement;

...

- (gA) an allowance in respect of any expenditure (other than expenditure which has qualified in whole or part for deduction or allowance under any of the other provisions of

this section or the corresponding provisions of any previous Income Tax Act) actually incurred by the taxpayer-

- (i) in devising or developing any invention as defined in the Patents Act, 1978 (Act 57 of 1978), or in creating or producing any design as defined in the Designs Act, 1967 (Act 57 of 1967), or any trade mark as defined in the Trade Marks Act, 1963 (Act 62 of 1963), or any copyright as defined in the Copyright Act, 1978 (Act 98 of 1978), 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, 1952, or the registration of any design under the Designs Act, 1967, or the registration of any trade mark under the Trade Marks Act, 1963; 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-

(aa) where such expenditure exceeds two hundred rand the allowance shall not exceed for any one year such portion of the amount of the expenditure as is equal to such amount divided by the number of years which, in the opinion of the Commissioner, represents the probable duration of use of the invention, patent, design, trade mark, copyright, other property or knowledge, or one twenty-fifth of the said amount, whichever is the greater; . . .’

[4] In February 1995 the respondent received a written opinion from Momberg. He advised that the value of the business lay principally in the product franchise which DBS enjoyed and which was composed of two major elements: first, the Dow Corning products denoted by its trade marks and the right to repackage and sell under the trade marks, and, second, the distribution network established by DBS which was embodied in distribution agreements with sub-distributors and confidential information and copyright material in the form of customer lists, customer consumption patterns and product application know-how. (This second element was referred to throughout the proceedings as ‘the customer connection’.) Momberg regarded both these elements as intellectual property.

[5] Momberg noted that-

‘DB Silicones does not own the Dow Corning trade marks, but rather enjoys certain transferable rights. We understand that to date its user right has not been formalised, but that steps are being taken to record and render transferable the rights it has exercised to date and that the trade mark user agreement will provide *inter alia* that:

6.4.1 DB Silicone’s (sic) exclusive right to use the Dow Corning trade marks in its repackaging and distribution business since 1 July 1988 will continue for a period of 5 years; and

6.4.2 That (sic) such right entitles DB Silicones to transfer it to a third party, acceptable to Dow Corning, to whom it may wish to sell its business. As such Chemserve [respondent’s holding company] will acquire a 5 year user right to the Dow Corning trade marks.’

[6] Momberg made certain suggestions which, he advised, would conduce to bringing the agreements to be concluded within the terms of one or other of the aforementioned sections of the Act. In the result his suggestions were not implemented and, as will be seen, his assumptions as to the content of the agreements proved unwarranted in material respects. Although he was of the opinion that the trade mark rights alone were worth R10,27 million, Momberg advised the respondent

that, for valuation purposes, the customer connection could not practically be separated from the trade mark licence. He placed a market value of R14,87 million on the total intellectual property which the respondent was to acquire from DBS. Late in February 1995, however, following discussions with his client, consideration was given to valuing separately the trade mark licence and the customer list with the copyright in it. Not until shortly before the hearing in the Court *a quo* was Momberg instructed to prepare a revised valuation. He then valued the trade mark rights and the customer connection at R7,61 million each. He justified his valuation of the customer connection in the following words:

‘There appears to be a basis for significantly increasing the value of the customer list relative to the trademark licence – on the grounds *inter alia* that possession of it –

- will put Chemical Services into a strategically sound position to continue in the silicone market, using a competitive source of supply (e g GE or Wacher) were Dow Corning to terminate the trade mark licence and distributorship; and

- by the same token, will provide Chemical Services with not insignificant leverage to dissuade Dow Corning from any precipitous termination should it wish unilaterally to re-invest in this country.’

It is clear that these conclusions were founded on an assumption that the respondent had acquired the customer connection generated by the trade marks from DBS, giving rise to what he described in evidence as ‘a proprietary conflict between the trade mark owner and the distributor in the vital element of goodwill under the trade mark’ and ‘a different proprietorship in the two incidents’. As will become clear, this was an erroneous assumption.

[7] On 20 February 1995 DBS sold its business to the respondent as a going concern. The elements of the purchase price were R183 000,00 in respect of fixed assets, stock dependent on a valuation, R14,5 million for the trade mark rights and R650 000,00 in respect of goodwill. The agreement made no reference to the ‘customer connection’ or any of its elements.

[8] ‘[T]he sole assets’ were defined as ‘the fixed assets, the stock, the name “DB

Silicones” and the trade mark rights’.

‘[T]he trade mark rights’ were defined as

‘the rights of the seller to use the trade marks in respect of the business in terms of the trade mark licence agreement’.

A copy of the trade mark licence agreement between Dow Corning and DBS was annexed to the Sale of Business Agreement. It was undated. The evidence suggests that it was concluded in late 1994 or early 1995 although it was made effective from 1 July 1988.

The ‘goodwill’ was not the subject of definition.

[9] On 27 February 1995 Dow Corning consented to the assignment of the trade mark licence agreement to the respondent, ‘subject to all rights and obligations contained in said Trademark License’.

[10] The trade mark licence agreement contained several (unnumbered) clauses which have a bearing on the decision of this appeal:

‘Article II Ownership

All use of the trademarks by Licensee shall inure to the benefit of Licensor.

The ownership of the Trademarks, and the goodwill relating thereto, shall always remain vested in Dow Corning, both during the period of this Agreement and thereafter.

Licensee shall never challenge, contest or call into question the validity or ownership of the Trademarks or any registrations of the trademarks.

Article III Grant of Rights and Conditions Regulations Use (sic)

Dow Corning hereby grants to Licensee a non assignable and non-exclusive right to use the Trademarks in the Territory.

Licensee shall limit its use of the Trademarks to the products listed in Exhibit A, which are packed by Licensee for resale.

.....

Licensor shall have the exclusive right to file actions and receive awards for infringement of its Trademarks.

.....

Article IV Term of the Agreement

Unless terminated earlier under Article VII herein, this Agreement shall be effective on the date first set forth above and shall terminate on 31 December 1994 with the understanding that this term

will be automatically extended from year to year thereafter unless the Agreement is terminated by either party to this agreement by a sixty (60) day prior written notice to the other party.

.....

Article V Assignment and Sub-Licences

Licensee shall not transfer or assign this Agreement. Licensee shall not allow any third party to use the Trademarks, without the express written consent of Licensor.

Article VI Reservation of Rights

Dow Corning expressly reserves the right to use the Trademarks and also reserves the right to grant to others the right to use the Trademarks in the Territory.'

[11] On 1 March 1995 Dow Corning and the respondent concluded a distributor agreement valid for five years from that date. Clause 11 provided that the use of the trade marks would be governed by the trade mark licence.

[12] On 23 June 1995 a deed of cession and assignment was concluded between DBS and the respondent in respect of all the former's rights under the trade mark licence agreement for a consideration of R14,5 million it being agreed further 'that the assignment includes an assignment of the whole of the goodwill of the business of the Assignor in

relation to the said agreement [the trade mark license agreement]’.

[13] When the respondent submitted its tax return for the 1995 year it included a deduction for the allowance provided for in s 11 (gA)(iii) of the Act. The appellant disallowed the deduction. The respondent appealed to the Income Tax Special Court.

[14] The Special Court heard Mr Engelbrecht, managing director of the respondent’s holding company, who was not a signatory to any of the agreements. His evidence was of no assistance in resolving the disputes. Momberg also testified. His evidence was largely of interest in relation to the valuation but it also highlighted once more his misconception in relation to the acquisition of the customer connection by the respondent. He testified:

‘There are very, very many silicone products and applications all requiring, from a sales point of view, specific knowledge of the requirements of the particular industry and the specific custom and my analysis of that information was that that was crucial to being able to access the market and it prompted the question – were Dow Corning to terminate the license, whoever owned that business and had this customer connection, the real customer connection could then approach another

supplier – and there are many in the world – although Dow Corning is the leader – and substitute those products and virtually keep the turnover going. So, it is against that general background I saw that there was a scope to independently value the customer connection as held by D B Silicones *because it wasn't proprietary to Dow Corning, it was held by D B Silicones*. Although the two were linked in the total product franchise there was actually a proprietary conflict between the trade mark owner and the distributor in the vital element of the goodwill under the trade mark.'

(My emphasis.)

[15] It is clear from this passage that Momberg continued to believe that although the customer connection had been developed in consequence of the use by DBS of the trade marks, the ownership in the connection resided in DBS and could therefore be transferred by DBS to the respondent. But this belief was irreconcilable with the terms of the trade mark licence agreement: DBS did not acquire the customer connection built up through the use of the trade marks and could not have transferred it to the respondent.

[16] The Court *a quo* decided that the respondent had been entitled to the allowance

for expenditure of R14,5 million incurred in purchasing the business: the sale assets included the trade mark licence and the customer connection was to be found in the ‘basket’ of rights which necessarily accompanied the licence. The trade mark licence, the learned President said, was property similar in nature to the trade mark itself ‘although leaner, truncated and abbreviated’, and the know-how and knowledge associated with the market for the product identified by the trade mark was ‘connected with the use of the trade mark and also in the present case, with the lesser “other property of a similar nature” i e the trade mark licence, as meant in section 11 (gA)’. Further, so the Court found, the respondent ‘bought that knowledge from DB Silicones and bought “the right to have such knowledge imparted” as meant in s 11 (gA).’

[17] Before this Court the respondent maintained its stance that the ‘trade mark rights’ included the licence and the customer connection and that it had paid R14,5 million for those rights.

[18] To qualify for the allowance under s 11 (gA) the property, on the acquisition of

which a taxpayer spends money, must be a patent, design, trade mark or copyright or 'any other property of a similar nature'. The respondent's counsel submitted that the trade mark licence was property similar in nature to a trademark. The expression, properly interpreted, requires, in my view, that any property which is similar in nature shall possess fundamental characteristics common to those possessed by the specifically identified properties; minor or superficial similarities will not of themselves suffice. This narrow interpretation is consistent with the manifest intention behind the creation of the allowance, *viz* the stimulation of investment in intellectual property which is commercially productive and likely to provide an enduring economic advantage to the Republic. The common natures of the identified properties, in the sense which I have discussed, embrace their intellectual origins, ie their derivation from a creative mind, their potential for commercial exploitation, the fact that the law regards such exploitation as creating a justifiable monopoly which is available only to the creator of the property or persons to whom the creator transfers his rights according to law and that the law accords the rights and protection of

ownership to such property. (That the recognition is accorded by statute rather than by common law does not seem to me to be of importance. Nor does it detract from the monopolistic character of a right that its owner may, if so minded, choose to license more than one person to use it.)

[19] By the test of the statute the licence acquired by the respondent does not qualify for the allowance under s 11 (gA): it is not 'property similar in nature' to a trade mark. The licence is not intellectual property. It is merely the grant of a temporary right of use, conferring no monopoly in the hands of the licensee and neither proprietary interest nor the protection accorded by law to such an interest. The limited duration, absence of a power in the respondent to dispose of its interest in the licence, the inability of the respondent to restrict the use of the marks by Dow Corning or others or to defend itself or act against infringers are such material deviations from the essential natures of the identified properties that the limited power of exploitation of the marks which the licence confers is quite insufficient to justify the description of the licence as 'similar in nature'. The learned Judge *a quo*

said:

‘For commercial purposes the protected trading operations of the licensee in the permitted territory in dealing under the banner of the trademark are for all practical purposes identical to that of the holder in the areas where the holder trades.’

Even if that is a correct statement (which I would question having regard *inter alia* to the non-exclusive nature of the licence and the limitation on the use of the trade marks to specified products), it does not address similarity or dissimilarity in the *nature* of the properties (the licence and the trade marks) but only the consequences of possessing the right to use each of them.

[20] Inherent in what I have said is a recognition that the acquisition of intellectual property which s 11 (gA) requires as the first step towards the right to claim the allowance is an acquisition of a proprietary interest in such property. In this regard the comparison of s 11(f)(iii) and 11 (gA) illustrates that the former provides tax relief appropriate to a right of use of intellectual property. See in this regard the reasoning in ITC 353 (1936) 9 SATC 82 at 83-4 and ITC 613 (1945) 14 SATC 389 at

392. As the trade mark licence conferred only a right of use and did not transfer a proprietary interest, the respondent's reliance on s 11 (gA) was misplaced for this reason also.

[21] The submission that the customer connection formed part of the substance of the trade mark rights for which the respondent paid R14,5 million is untenable. The customer connection relating to the trade mark rights was, as I have concluded earlier, not an asset in the hands of DBS which it had the right to dispose of. That, of course, does not mean that DBS could not have purported to sell it nor prevent the respondent, believing that DBS was selling the customer connection, from acquiring it: *Frye's (Pty) Ltd v Ries* 1957 (3) SA 575 (A) at 581A-E. That, however, is an unusual situation which would require clear evidence to sustain a finding that that is what occurred in this case. The evidence is to the contrary. The Sale of Business agreement contains no reference to the customer connection as a specific item of the business for which payment was made. However, the sale was of a business as a going concern and it is logical that the customer connection went with it. There were

two possible sources for such a connection, - derived from the use of the trademark or built up independently of the trademark. In the latter regard it is significant that the respondent paid separately for the goodwill and the trade mark rights. The usual meaning of 'goodwill' is 'the possession of a ready-formed connection of customers considered as a separate element in the saleable value of a business' (Shorter OED 871). The trade mark licence agreement excludes the possibility of the transfer of goodwill in the trade marks. Such indications as there are in the Sale of Business agreement, therefore, point unequivocally to an intention from the side of both parties that the goodwill payment was to be made for the customer connection which did not derive from the trade marks. Indeed the respondent did not lead evidence of a contrary intention held by any representative of the respondent who was privy to the conclusion of the sale. Instead it relied on an inference to be drawn from the fact that the sale was concluded after advice had been taken from Momberg in which he treated the customer connection as an asset which the buyer would acquire by virtue of the sale linked to the subsequently acquired right to use the trade marks. For the reasons given earlier it

appears that Momberg's advice was more honoured in the breach than in the observance. The best evidence of the respondent's intention remains the terms of the agreement which it concluded. It is true that more than three months after the sale of the business, in the deed of assignment of the trade mark rights, DBS and respondent purported to 'confirm and agree that the assignment as aforesaid includes an assignment of the whole of the goodwill of the business of the assignor in relation to the said agreement', and stipulated that 'In pursuance of the said agreement [presumably the trade mark licence agreement referred to in the preamble] and for a consideration of R14 500 000,00' DBS ceded, assigned and transferred all of its rights under the trade mark licence agreement. I do not consider that much weight can be given to this document as a statement of the parties' intentions on 20 February 1995 when the agreement of sale was concluded. The obligation to pay the R14,5 million had already been incurred as an element of the purchase price of the business. The 'confirmation' that the assignment included the whole of the business in relation to the trade mark licence agreement was only necessary because that intention was

not apparent from the Sale of Business agreement. If the respondent intended to acquire rights not already covered by the sale agreement it had no intention to pay anything extra for those rights. But the respondent must at all relevant times been aware of the content of the licence agreement. Consequently the purported assignment was, at worst, a charade which added nothing to the sale agreement, or, at best, a *bona fide* purported rectification of the agreement which was objectively ineffective in law to transform the agreement into something other than what it originally was.

[22] The consequence is that the Court *a quo* erred in concluding that any part of the expenditure of R14,5 million was devoted to the acquisition of property which fell within the purview of s 11(gA). It follows that the deduction claimed by the respondent was correctly disallowed by the appellant.

[23] The appellant submitted that the apportionment of R14,5 million to the trade mark rights in the Sale of Business agreement was a sham because

- (a) a trade mark licence was unnecessary for the business of purchase,

repacking and resale carried on by DBS and the respondent;

- (b) the licence agreement was only concluded seven years after DBS commenced selling Dow Corning products and at a time when DBS was negotiating with respondent for the purchase of its business;
- (c) DBS paid nothing for the licence yet the parties thought R14,5 million an appropriate price for its rights three months later;
- (d) the really valuable asset of the DBS business was the distribution agreement with Dow Corning, to which no part of the purchase price was attributed.

This is an attractive submission but because of my earlier conclusions it is unnecessary to decide it.

[24] The appeal is upheld with the costs of two counsel. The judgment of the Special Court is set aside and the assessment is restored.

J A HEHER
JUDGE OF APPEAL

HOWIE P)**Concur**
MARAIS JA)
ZULMAN JA)

CLOETE JA:

[25] I have had the benefit of reading the judgment of my brother Heher. I agree with the order proposed, but I consider that this result can be achieved by a consideration of the facts alone. In my respectful view it is unnecessary to embark on an interpretation of s 11(gA)(iii) of the Income Tax Act and I would prefer not to do so.

[26] Two fundamental submissions were made on behalf of the respondent in this Court. One was that information relating to the customer network of the seller, DB Silicones CC, was an asset sold in terms of the sale of business agreement to the respondent taxpayer; and that the amount of R14,5 million paid to the seller by the

respondent, or part of that amount, fell under the section as it was paid in respect of property covered by the phrase ‘any other property of a similar nature’. I shall assume, without deciding, that both of these propositions are correct. But the problem which faces the respondent is that the amount of R14,5 million in respect of which the respondent claims an allowance in terms of the section, was not, to use the words of the section, ‘expenditure... actually incurred by the taxpayer... in acquiring’ the information relating to the customer network of the seller. The amount of R14,5 million was paid for the rights of the seller in terms of the agreement between the seller and a third party, Dow Corning; and as counsel representing the respondent was obliged to concede, that agreement did not include information relating to the customer network of the seller. There is accordingly no factual foundation for the respondent’s reliance on the section so far as the customer network is concerned.

[27] The other submission made on behalf of the respondent was that the amount of R14,5 million, or part of that amount, was paid for the licence D B Silicones CC had from Dow Corning to use the Dow Corning trade mark when repackaging products supplied by Dow Corning. But DB Silicones CC did not have the right to assign that licence to the respondent or anyone else. The agreement between the seller as licensee and Dow Corning provided in terms in Article III *inter alia* that:

‘Dow Corning hereby grants to Licensee a non-assignable ... right to use the Trademarks’

I am content to accept at face value the following evidence of Engelbrecht, the managing director of the respondent’s holding company:

‘[W]e believed we needed the licence agreement to sell these trademark — to sell the products with these trademarks in the territory.’

That means that the sale of business agreement would not fall foul of s 103 of the Income Tax Act. But *non constat* it fell under s 11(gA)(iii). The test is objective, not subjective; and unless there are facts which show that the amount in respect of which a deduction is claimed under the section was ‘expenditure ... actually incurred by the taxpayer ... in acquiring’ property etc., the section is not applicable. In the present matter, the respondent could not acquire rights the seller did not have and the subjective belief of one or both of the parties to the sale of business agreement is irrelevant.

[28] It is for these reasons that I concur in the order made by my brother Heher.

T D CLOETE
JUDGE OF APPEAL