**J Ltd v Income Tax**

**Division:** High Court of Kenya at Nairobi

**Date of judgment:** 5 March 1974

**Case Number:** 4/1972 (42/74)

**Before:** Muli J

**Sourced by:** LawAfrica

*[1] Income Tax – Capital or income receipt – Profit on sale of investments of cash reserves of insurance*

*company – Income receipt – Business of investment carried on.*

**JUDGMENT**

**Muli J:** In these consolidated appeals, the appellant appeals against the decision of the Commissioner-General of Income Tax confirming additional assessments for the years of income, 1964 and 1965 pursuant to the provisions of the East African Income Tax Management Act 1958 (hereinafter referred to as “the Act”). In both appeals the grounds of appeal and the statements of facts are substantially similar with the exception of the figures. The parties agreed that the court should concern itself with the general issue, and the figures would be adjusted in the light of the decision. The main issue was whether the subject matter of the assessments was capital gains or income derived from the appellant’s business. I will therefore state the facts as contained in Appeal No. 4 of 1972. The appellant company was incorporated in Kenya under the Companies Act (Cap. 486) to carry on all kinds of insurance business including, *inter alia*, fire and accident; indemnity, motor, workman’s compensation, third party risks and life insurance. Under its Memorandum of Association, the appellant company was in addition authorised by sub-clause (*q*) of the main clause 3 as follows: “(*q*) to invest and deal with the moneys of the company not immediately required upon such securities and in such manner as may from time to time be determined.” The appellant maintained surplus cash reserves which they did not require to meet their day to day possible liabilities and even unprecedented claims. Prior to the relevant years, they had invested these surplus cash reserves in equities and Government stock. Thus in 1964 the appellant owned as a part of equity investment some 3,650 Shs. 10/- shares in Cooper Motor Corporation Ltd. of Nairobi. Similarly in 1965, the appellant had Government stock purchased at various dates prior to this year at different percentages and which were redeemed by the Government of Kenya paying therefore some £2,091 to the appellant and this sum is the subject matter of the additional assessment for year of income 1965. With respect to the 3,650 Shs. 10/- shares the appellant had in Cooper Motor Corporation, the latter issued a bonus of one Shs. 10/- share in another company known as A.R.V. Holdings Ltd. of England for every share in Cooper Motor Corporation. Thus the appellant acquired 3,650 Shs. 10/- bonus shares in the said A.R.V. Holdings Ltd. A.R.V. Holdings being a foreign company and according to the appellant, contrary to the policy of the appellant company to invest its surplus in England, it sold the shares receiving therefore some Shs. 35,946/-, the subject matter of the additional assessment for the year of income 1964. The Commissioner thus charged to tax the profits of the sale of the shares in A.R.V. Holdings. It was contended on behalf of the appellant that this was an isolated transaction of the sale of the shares issues on bonus in the A.R.V. Holdings and that the proceeds were in the nature of capital gains not liable to tax. In 1965 the Government redeemed the stock and paid to the appellant Shs. 3,558/45 being the profit on the stocks bought at Shs. 81,441/55. In the same year the Government redeemed a further stock bought earlier at Shs. 972,213/50 and paid to the appellant profit thereon of Shs. 37,768/50. Thus the appellants were charged to tax on £2,091 in respect of the difference between the purchase price and the redemption value of the Government Stock. The tax charged on this sum is the subject matter of Additional Assessment for the year of income 1965. The appellant contended that the proceeds from the Government Stocks were capital gains and therefore not liable to tax. It was maintained on behalf of the appellant company that it merely invested its surplus capital in equity and Government Stocks which are safe securities and that occasionally due to special circumstances such capital investments are realised yielding the capital gains which are not taxable under the Act. It says that the stock market in East Africa is insufficiently expansive to make it worthwhile to deal in stocks and shares with a view to making profits. In short, as I understood it the appellant’s portfolio of investment business of surplus moneys not immediately required for its insurance business was not operative at the material time. That the transactions were isolated transactions of capital investments in stocks and shares with the result that realisation of these by way of sale of equity shares and redemption of Government stocks resulted in accretion of their capital and therefore capital gains. It was contended on behalf of the respondent that the sale of the shares and redemption of government stock was a normal business transaction by the appellant as an insurance company carrying on the business of insurance and investment of their surplus funds and therefore the proceeds of the said sale and redemption of the government stock were normal business profits. The profits realised were of revenue nature subject to income tax. The charging section is s. 3 of the East African Income Tax (Management) Act 1958 which charges tax upon the income accrued on or derived from E.A. in respect of gains or profits from any business. S. 18 of the Act provides the machinery for computing gains or profits of insurance companies from insurance business and provides in sub-s. (3) thereof as follows: “(3) The gains or profits for any year of income from the insurance business other than life insurance business shall be the amount arrived at after– ( *a*) t aking, for the year of income the sum of– (i) . . . ( ii) t he amount of other income from such business, including any commission or expense allowance received or receivable from re-insurers and any income derived from investments held in connection with such business.” Mr. Deverell argued that “income derived from investments” is not appropriate to cover profits from sale of investments because these are from sale of investments and not income derived from investments held in connection with the business of the appellant’s insurance company. He said that the profits made on the sale of the shares and from redemption of the stock was mere enhancement of their security. In other words accretion of the appellant’s investments of surplus funds. This being so any accretion of investment of surplus funds was not liable to tax. The real issue is whether the appellant’s investment of these shares and stocks was in connection with the appellant’s insurance business and whether the gains or profits made on the sale of the equity and the redemption of Government stock was a capital gain or a gain of a revenue nature. Mr. A. G. Hussein Nanji, the appellant company’s director, gave evidence that he had been on the board of directors of the company since 1965 and that the main object of the appellant company was to carry on insurance business; that one of its subsidiary businesses was set out in paragraph (*q*) of the Memorandum of Association; that reserve funds of the appellant company are held from time to time in cash, in equity investments and in Government stock. He went on: “Any given time the surplus cash was in the region between £400,000 and £500,000. We are not able to invest in everything we would wish to invest in. The stock exchange is too small in this country. If we started buying shares the prices will unnecessarily go up. Whenever Government stocks are offered we take whatever we are offered. There are no other securities for instance gilt-edged securities. These factors make us have so much money in our hands. No outlet to invest in. Whenever we acquire share investment we never sell them. If we started selling shares the prices will go down because stock market is very small. The liquidity will increase and our income will be less. Selling shares will aggravate liquidity and reduce income from dividends.” He went on to say that whenever the appellant’s company buys government stocks the motive is to earn interest: the policy being to help the government in its development policies. In their books of accounts the sale of the shares in A.R.V. Holdings and the redemption of government stocks for the relevant years were shown as profit on sale of investments. In the face of this Mr. Khaminwa sought to show that the appellant’s profits on sale of these shares and stocks was in the nature of revenue but not capital gains derived from the appellant’s investments. The appellant had a committee to determine whether or not surplus funds should be invested. In answer to the court Mr. Nanji said: “The investment committee was formed after I had joined the insurance company to carry out the objects of clause (3) (*p*) and (*q*). . . . It is the business of investment committee to investigate acquisition of Government stocks and shares in companies. We would invest in stocks and shares if possible.” So that there was an investment committee of the appellant company to investigate the viability or otherwise of carrying on the business of investments. If this was so then was the appellant’s business included that of investment in stocks and shares, though stock exchange market in Kenya was unfavourable, a business of investment connected with the appellant’s insurance business? The company says that it did not operate its investment portfolio and that investment of surplus funds was capital investment with a view to earning interest thereon. Yet there was an investment committee formed in the years under review. It is true that the appellants had little say with respect to the government stocks as the terms and conditions were pre-determined under a statute. The appellants could not deal with them as they wished. On the other hand they could sell their equity investments if they so wished should the stock exchange market become favourable. At least I understood them to infer that far. The pattern of their investments in stocks and shares for the relevant and subsequent years appears to me to be regular and properly designed. The regularity of investments in stocks and equity appears to be the result of well-planned policy of investments in stocks and shares. Though this is the only limited viable market in their investment portfolio it does not necessarily follow that the appellants are not engaged in the business of investment connected with their business of insurance by the fact that they do not sell shares on day to day basis or that the government stocks are not redeemable at the instance of the appellant. It is possible for someone to deal in investment of surplus funds even though one has no power to call for redemption of stocks which are pre-regulated by statute. It is also possible for someone to invest in equity shares with a view to making profits of a revenue nature. It appears to me that the yardstick to measure what may be regarded as business and what is not depends on the totality of the whole surrounding circumstances of a particular case. I venture to say that an isolated transaction of any investment, whether in stocks or in shares may perhaps more readily fall in the category of capital investment while the systematic pattern of such transactions does not. Mr. Deverell sought to differentiate business investment and realisation of those investments or securities stating that the former may exist but what matters is the latter. I am unable to share this view. The Act uses the phrase “and any income derived from investments held in connection with such [insurance] business”. There was no doubt that the appellant’s surplus funds were held in connection with their business of insurance. He says that the phrase is not appropriate to cover profits from isolated sale of shares. I am unable to see this. If the appellants were engaged in the business of investing in equity, the proceeds of the sale of those equity shares to a third party is income derived from the equity investment. It matters not whether the sale of the shares is frequent or not for once there is the element of investment the sale of the shares may take place at the instance of the holder. This argument goes in respect of the stock investments for once there is the investment, the redemption of the stock is determined at the time of such investment with the result that redemption of the investment stock at the predetermined time is income from the stock investment. If the appellants were engaged in the systematic pattern of investment of their surplus funds in equity shares or in Government stock it becomes inescapable that the realisation of such investments whether by way of an isolated sale of shares or predetermined redemption of the stock at a profit would be income derived from such investment held in connection with their business of insurance. If on the other hand the investment in equity shares or in Government stock was once for all, i.e. an isolated transaction of investment of surplus funds the realisation of such securities at a gain would be realisation of capital investment with its accretion. I say once for all meaning that initial investments remained wholly unchanged by systematic additions. I am fortified in this by the decision in *N. Ltd. v. Income Tax*, [1974] E.A. 120 in which Trevelyan, J. said at p. 124: “I do not doubt that an isolated transaction such as we have here may be taxable but this can be so only if the venture – call it what you will – is in the nature of trade.” Lord Clyde in *Commissioners of Inland Revenue v. Livingston*, 11 T.C. 538 at p. 542 said: “I think the profits of an isolated venture, . . . may be taxable . . . provided the venture is ‘in the nature of trade’. I say ‘may be’ because in my view regard must be had to the character and circumstances of a particular venture. If the venture was one consisting simply in an isolated purchase of some articles against an expected rise in price and a subsequent sale, it might be possible to say that the venture was ‘in the nature of trade’ because the only trade in the nature of which it could be participated would be the trade of a dealer in such article, and a single transaction falls far short of constituting a dealer’s trade. . . . The trade of a dealer necessarily consists of a course of dealing. . . . But this principle is difficult to apply to ventures of a more complex character. . . . I think the test, which must be used to determine whether a venture such as we are now considering is, or is not, ‘in the nature of trade’, is whether the operations involved in it are of the same kind, and carried on in the same way, as those which are characteristic of ordinary trading in the line of business in which the venture was made.” In the instance case, the characteristics of the transaction are of a systematic kind and carried on the same way, that is to say the venture was merely investments in equities and Government stocks and this in my opinion was a well-calculated venture in the nature of trade. Looking at the scheme as a whole the question of realisation of the securities whether by means of an isolated transaction or not does not affect the venture. Let us see whether the appellant falls in one or the other of these two categories. In the statement of facts in both appeals the appellant stated that it held cash balances ranging from £325,479 to £536,097 for the years from 1964 to 1970. That during these years they had investment in equities ranging from £207,318 to £751,380 and also in Government stock ranging from £344,180 to £394,626 for the same period. They did in fact invest in equities and stocks every year and the figures tend to show an upward trend more or less corresponding with the upward trend of the cash balances they held at the end of each year. This period of course relates to subsequent years but it is relevant as far as the pattern and system is concerned. For this subsequent period it is clear that the appellant had a systematic system of investing their surplus funds in equities and stocks every year. We are not told the pattern of realisation or redemption of the shares and stocks during this period. As far as the redemption of stocks was concerned this was predetermined by statute and is or was bound to come at the occurrence of the predetermined event or time. The question of being an isolated transaction does not therefore arise. With regard to the investments in equities the pattern is systematic but the question of realisation by way of sale whether in an isolated transaction or not does not affect the issue. The appellant invested in some 26 companies with total individual shares held of about 465,000 and I find it difficult to come to any other conclusion than their investment portfolio was operative for these subsequent years. With regard to the previous period culminating in the years of income the appellant says that it held shares in Cooper Motor Corporation as part of its equity investment, which it “held for many years”. Similarly they had purchased twice in 1961 Government stocks which matured in 1965. In addition, there was evidence that the investment committee was formed after 1965, that the gains or profits realised from the investments in equities and in stock were shown as profits in the appellant’s profit and loss accounts; the pattern of investment prior and subsequent to the years of income show a systematic pattern of investment business. Taking these facts in their totality, I can come to no other conclusion than that the appellant’s portfolio of investment was also operative prior to the years of income in question. I was referred to the case of the *Commissioners of Inland Revenue v. The Scottish Automobile*, 16 T.C. 381 in which it was held that the net profit arising from realisations of investments was not a trading profit. I appreciate that the question as to whether a person is or is not engaged in a trade is a question of fact and each case must be viewed on its own facts. In the *Scottish* case, the taxpayer had reserve funds from its incorporation and these were invested exclusively in Government securities. There was increase through successive purchases of additional securities but the securities remained wholly unchanged. Lord President Clyde held that there was evidence that the taxpayer was not engaging in a trade of investment in securities. The *Scottish* case is clearly distinguishable on facts from the present case. A glance at the facts tends to show that the case is similar to the present one but on close analysis it is not. In the *Scottish* case, the taxpayer company was not authorised by its Memorandum of Association to engage in investments. The power to invest the surpluses was subsidiary and in normal course of business. The investments themselves right from incorporation of the company remained wholly unchanged over the years and the treatment of the realisation of the investments in their books of accounts indicated that the company was not engaged in a trade of investment of surplus funds. This is not so in the present case. The appellant was authorised by its Memorandum of Association to invest surplus funds, there was an investment committee which regulated the policy of investments, the appellant invested in equities in various companies as well as in Government stocks whose realisation was predetermined, the sale of bonus shares issues in A.R.V. Holdings was not without their sanction and the accounting of the profits realised from the sale of their equities and the redemption of their stock, all these factors taken in their totality point to the conclusion that the appellants were engaged in investment business, though limited by the nature of stock market in East Africa. There was evidence that if the stock market was favourable they would actively participate in that business. So I find that the *Scottish* case does not help the appellants and in any event its decision was doubted in the *Punjab Co-operative Bank* case (below). In this case the company was from inception empowered to overrate its investment portfolio with profit-making in view. Once the appellant invoked that portfolio, the realisation of the investments at enhanced value was not merely incidental or as they say, isolated, but was the essential feature of the business, speculating only in limited fields of the stock market for making profits within the appointed means. I was also referred to the *California Copper Syndicate v. Harris*, 5 T.C. 159. The facts were that the Syndicate was formed, *inter alia*, to acquire copper and other mines, to prospect and explore etc. It was also to carry on mercantile commercial, financing and trading business . . . to acquire shares or stock of any company and to accept payment in shares for property sold or business undertaken or services rendered and to hold, sell or dispose of the same. It made profit on realisation of shares and did buy copper bearing land which it later sold at fully paid up shares. It was held that the difference between the purchase price and the value of the shares for which the property was exchanged was a profit from a trade. Lord Justice Clerk had this to say in his opinion at p. 165: “It is quite a well settled principle in dealing with questions of assessment of Income Tax, that where the owner of an ordinary investment chooses to realise it, and obtains a greater price for it than he originally acquired it at, the enhanced price is not profit in the sense of Schedule D of the Income Tax Act of 1842 assessable to Income Tax. But it is equally well established that enhanced values obtained from realisation or conversion of securities may be so assessable, where what is done is not merely a realisation or change of investment, but an act done in what is truly the carrying on, or carrying out, of a business.” I adopt this yardstick whether the appellant’s gains were mere enhancement of value by realising their securities or whether the gains were made in the operation of a scheme for profit-making. The evidence before me supports the latter. The pattern of the appellant’s investment portfolio was enshrined in its Memorandum of Association followed by a systematic scheme of investments in equities and stocks. The objective cannot be said to be other than profit-making. In *Punjab Co-operative Bank v. Income Tax*, [1940] A.C. 1055 approving the decision in the *California Copper Syndicate* case and doubting *Scottish Automobile* case, it was held that the realisation by a bank of some of its securities in order to meet withdrawals by disposition is a normal step in carrying on the banking business and the amount realised on the sale of the securities over their cost price was taxable. It was contended on behalf of the appellant that, because the surplus funds invested in equities and stocks were not required to meet the appellant’s day to day claims, even unpreceded claims, the investments therefore were not an act done in carrying on the business of investment connected with their business of insurance, and that the accruals on realisation of the securities were incidental. As I have tried to show the investment portfolio was an essential feature entrenched in the company’s constitution. Once the essential feature was invoked it matters not whether the realisation was an isolated one or not. The criterion is whether the appellant engaged in a scheme of investment business of surplus funds and I find they were. The fact that they did not resort to the investments to meet day to day claims did not alter their essential feature of business of investments. If they did resort to these investments to meet their clients’ claims, it would have only provided evidence that the business was linked and connected with their insurance business and nothing more. The above decisions were followed in *General Reinsurance v. Tomlinson*, [1970] 2 All E.R. 436. I adopt in whole the reasoning in Foster, J.’s judgment at p. 439 in arriving at the conclusion as I have done on the facts of the present case. I do not think it worthwhile to refer to the other cases cited to me as the principle applicable in this case is well established as stated in the *Californian Copper Syndicate* case. I may mention in conclusion that the issue of bonus shares in A.R.V. Holdings, though no cash was received by the appellant, does not affect the question of tax liability. The sale of those shares at a profit attracted tax and the appellant cannot escape liability on the ground that it was an isolated case or that no cash was involved. The result is that the appellant was engaged in the business of investment of surplus funds connected with its business of insurance. The profits on the sale of the bonus equities issued by Cooper Motors in A.R.V. Holdings and the redemption of the Government Stock for the years of income 1964 and 1965 were in the nature of trade. The profit made on realisation of the securities was of a revenue nature and therefore liable to tax. Let me put it another way. The appellant by its memorandum could carry on certain types of business. One of them is specified in Clause 3 (*q*) above. The appellant can say: we invested the money as we did reluctantly and so are not required to treat them as revenue. But whether the particular business was or was not carried on reluctantly is not material. It was carried on. If that is agreed it matters not at all whether the shares or stock produced dividends bonus shares or a profit in their sale or redemption for it is unlike say, the sale of a supplies shop at which trade is carried on and the venture, i.e. that concerning stocks and shares within the rule in *N. Ltd. v. Income Tax* (*supra*) was “in the nature of trade”. So even isolated realisation attracts tax. The Commissioner-General’s decision on the issue was justifiable and I see no ground for disturbing it. The appeals are dismissed with costs.

*Order accordingly.*

For the appellant:

*WS Deverell* (instructed by *Kaplan & Stratton*, Nairobi)

For the respondent:

*JM Khaminwa* (Deputy Counsel to the Community)