REPORTABLE

THE SUPREME COURT OF APPEAL OF SOUTH AFRICA

CASE NO: 620/98

In the matter between

SYFRETS PARTICIPATION BOND MANAGERS LTD **Appellant**

and

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

CORAM: SMALBERGER, NIENABER, MARAIS, PLEWMAN JJA *et* MTHIYANE AJA

DATE HEARD: 6 November 2000

DATE DELIVERED: 30 November 2000

Income Tax - whether participations by manager of participation bond scheme in scheme are "trading stock" - whether any diminution in value by reason of payment of interest in advance - s 11 (a) and 22 of Income Tax Act 58 of 1962 - Participation Bonds Act 55 of 1987.

JUDGMENT

MARAIS JA

MARAIS JA:

[1] The first and central issue in this appeal is whether the participations in participation bonds brought into existence by appellant and offered by it to the public are "trading stock" within the meaning of that expression in the Income Tax Act 58 of 1962 (the "Income Tax Act"). The question arises in this way.

[2] The Participation Bonds Act 55 of 1981 ("the Act") consolidates the laws relating to the securing of the rights of holders of participations in participation mortgage bonds, the definition of the rights of such participants, and matters incidental thereto. In broad, the Act is designed, *inter alia*, to enable financial institutions to offer to investors, many of whom may wish to invest relatively small amounts of money, an opportunity of participating with other investors in an investment secured by a registered mortgage bond over immovable property and yielding a competitive rate of interest. Each participant who holds such a participation in a participation bond becomes a creditor of the mortgagor to the extent of the participation. The debt so created is owed by the mortgagor

to the participant and not to the nominee company in whose name the bond is registered and the rights conferred by the bond are deemed to be held by the participants (s 6 (1)).

[3] The various situations envisaged by the Act are, typically, these. A financial institution (the "manager") will set up a nominee company as defined in s 1 with a view to the registration of participation bonds in its name in terms of s 2. The manager will set about finding a borrower and a number of investors who are prepared to advance sums of money which will match collectively the sum which the borrower needs. It may succeed in achieving such a perfect match but it may not. It may find that it has accepted money from would-be investors in a participation bond but that it has no borrower in need of that money. The Act obliges it to return the money if a participation is not granted within 60 days (s 3 (1) (a)). It may also find that it has a borrower but not enough would-be participants to fund the loan fully. The manager may then take up a participation

to cover the shortfall (s 3 (2)).

[4] In cases in which the required loan is made to the borrower, an appropriate participation mortgage bond is registered in the deeds registry. The names of the participants are not required to be set forth in the bond but the manager is obliged to keep a register in which must be recorded, *inter alia*, "the names of the participants --- and the extent of their participations from time to time as well as all amounts repaid to participants in respect of their participations" (s 5 (1) (c)).

[5] Appellant, Syfrets Participation Bond Managers Limited, is such a manager. In practice, it is seldom able to achieve perfect matches in point of time between the needs of borrowers and the needs of would-be investors in participation bonds. Business expediency prompts it to frequently put its own money into the participation bonds which it arranges, until such time as other participants can be found to take its place. The need to do so might arise at the

very inception of a particular participation bond or it might arise during the currency of the bond as a consequence of a participant withdrawing. At the end of each of appellant's tax years there is a very considerable sum of its own money in the bonds. That money represents its own provisional or temporary participations. It is the true character of those participations for the purposes of the Income Tax Act which must be determined.

[6] If the participations so held by appellant are indeed "trading stock" within the meaning of the definition of that expression in s 1 of the Income Tax Act as appellant contends, it may be (I express no opinion at this stage) that tax consequences favourable to it might ensue and those consequences would have to be considered. If they are not trading stock, the appeal must fail on that ground alone.

[7] The concept is currently defined as follows:

> "**'trading stock'** includes -
>
> (a) anything -

(i) produced, manufactured, purchased or in any other manner acquired by a taxpayer for purposes of manufacture, *sale or exchange* by him or on his behalf; or

(ii) the proceeds from the disposal of which forms or will form part of his gross income; or

(b) any consumable stores and spare parts acquired by him to be used or consumed in the course of his trade,

but does not include a foreign currency option contract and a forward exchange contract as defined in section 24I (1)."

(The emphasis in this and all other provisions quoted in this judgment has been supplied by me.)

[8] In *De Beers Holdings (Pty) Ltd v Commissioner for Inland Revenue* 1986 (1) SA 8 (A) at 32 E - F this court considered that the definition as it then stood fell into two parts -

"(1) anything produced, manufactured, purchased or in any other manner acquired by a taxpayer for purposes of manufacture, sale or exchange by him or on his behalf, or

(2) anything the proceeds from the disposal of which forms or will form part of his gross income."

As will have been noticed, the definition has been expanded since by amendments the effect of which is to add yet a third part, but the third part is of no relevance

given the facts of this particular case and appellant did not contend otherwise.

[9] In the Cape Income Tax Special Court from which the appeal emanates it was contended by appellant that its own participations should be regarded as falling within the first part of the definition of trading stock. In this court, without abandoning that contention, counsel for appellant preferred to contend that they fell within the second part. In my view, they fall within neither and even if, contrary to what was said in the case of *De Beers Holdings (Pty) Ltd* at 33 C, the definition is not exhaustive and other examples of what would in ordinary parlance be regarded as trading stock could be conceived of, the participations which appellant holds cannot be so regarded.

[10] In appellant's written heads of argument the case sought to be made was that the participations held by it were trading stock; that the cost to appellant of those participations was deductible in terms of s 11 (a) of the Income Tax Act; that the value of the participations still held and not disposed of by appellant at the

end of each tax year fell to be added back in terms of s 22 (1) (a) of the same Act; and that, in terms of the latter sub-section, that value consisted of the cost price to appellant of the participations less the amount which the Commissioner might think just and reasonable as representing the amount by which the value of the participations had been diminished by a decrease in their market value. The consequence, so it was submitted, was that appellant was entitled to a substantial deduction in terms of s 11 (a) because the cost price of the participations exceeded by far the diminished value of the undisposed of participations which had to be added back. Whether there was in fact any such diminution in value is yet another question which would have to be answered affirmatively before appellant could enjoy any success in this appeal. To that question I shall return.

[11] The rationale which underlies s 22 was explained in *Richards Bay Iron and Titanium (Pty) Ltd and Another v Commissioner for Inland Revenue* 1996 (1) SA 311 (A) at 316 F - 318 C. It is unnecessary to repeat the explanation. It is

critical to appellant's case that it be shown at the outset that the participations which it holds are held to be sold or exchanged or, if they are not, that a "disposal" of them takes place "the proceeds ..... of which forms or will form part of (its) gross income". In my opinion, appellant has failed to do so.

[12] In order to forge a link to the word "sale" in the definition of "trading stock", appellant has attempted to characterise as sales transactions which are not capable in law of being so characterised. The transaction which a participant in a participation bond scheme enters into can by no stretch of imagination be regarded as a sale. The participant lends to the mortgagor a sum of money in return for which the mortgagor will pay interest until the loan is repaid to the participant. Appellant, as manager of the scheme, will be rewarded for its efforts by a commission which it deducts from the interest payable by the mortgagor. It is the earning of that commission for the rendering of its management services which is appellant's principal object. It is not intended to operate primarily as a

moneylender and, to the extent that it does in fact lend its own money to a mortgagor, it does so only because it is expedient to do so for the reasons I have explained. Those loans by it are bridging loans made only because another participant cannot be found at a time when money is required either to make up, or to maintain, the full amount required by the mortgagor. As soon as another participant can be found appellant's participation will cease *pro tanto* or altogether as the case may be.

[13] Attempts to classify the acquisition of these participations (whether participations by third parties or participations by appellant) as sales are confronted, in my view, by insuperable obstacles. It is of the essence of a sale that there be an identifiable *merx* and *pretium*. What could conceivably qualify as the *merx*? Nothing other than a secured right to be repaid at a future date the same sum of money which the participant has paid and to be paid interest in the meantime. That is hardly a *merx* in the ordinary sense of that word. If that is to

be regarded as a *merx* then hundreds of thousands of South Africans are unwittingly "buying" daily from the post office, banks, and other financial institutions the right to be repaid the money they deposit with such institutions in savings accounts, short, medium and long term deposits, and the right to receive interest in the interim. The sum of money deposited would have to be regarded as the *pretium* even although it has to be repaid in due course to the "purchaser". That cannot be right. Transactions such as those are quite unlike, say, factoring transactions in which debts are sold at a discount to their face value. The latter are plainly sales. There is an identifiable *merx* (a debt due to the seller by a third party) and an identifiable *pretium* (the discounted face value of the debt) which is the product of negotiation.

[14] When, and if, appellant succeeds in arranging a perfect match at the outset and has no need to advance any part of the loan itself, it has not "sold" any participations. It may loosely, but inaccurately, be said have "sold" its managerial

services, the "price" to be its commission on the interest paid, but it is not that which is contended to be the trading stock; it is the participations themselves. When a participant subsequently withdraws and is replaced by a new participant found by appellant what is happening in law? There is no sale by the outgoing participant of his participation to the incoming participant. The former will not even know who the latter is. The incoming participant makes a payment to the manager in his representative capacity; the sum so paid is employed by the manager to reduce *pro tanto* the debt of the mortgagor; a new debt is thereupon created in the same amount which the mortgagor then owes the new participant. The outgoing participant is repaid the sum which he lent the mortgagor. The mortgagor's debt to that participant is discharged and the register is amended to reflect that. There is nothing left to "sell" to the incoming participant and there is no identifiable *pretium*.

[15] The fact that the incoming participant's payment to appellant in its

capacity as manager of the scheme may be used to fund payment of the debt due to the outgoing participant does not make it a payment by the incoming participant to the outgoing participant. The incoming participant's payment remains what it was intended to be: a direct investment by the incoming participant in the scheme - in legal parlance a secured interest-bearing loan by the incoming participant to the mortgagor. If that be so where the outgoing participant is a third party, why should it be any different when the outgoing participant is appellant? No good reason suggests itself. On the contrary, all the same considerations apply *mutatis mutandis*.

[16] The provisions of the Act are, as one would expect, entirely consistent with the classification of participations as secured interest-bearing loans by the participant to the mortgagor, and inconsistent with their classification as the intended subject of sales by the managers of participation bond schemes.

[17] A "participant" is defined as "a person who holds a participation in a

participation bond"; a "participation" as "a share of, or all, the rights secured under a participation bond". Such a bond must be registered in the name of a "nominee company" to fall within the definition of "participation bond". A nominee company is also defined and *inter alia*, must have "as its principal object to act as nominee for or representative of any person or persons in the holding of property in trust for such person or persons". These definitions are all to be found in s 1 of the Act.

[18] S 2 requires a participation bond clearly described as such to be registered as such in a deeds registry in the name of a nominee company "as nominee for or representative of the participants" in the bond. The names of the participants do not have to be set forth in the bond (s 2 (2)). They are deemed to hold their participations subject to the provisions of the Act (s 2 (3)). Whenever a participation in a bond is "granted", the participant must be notified in writing of the particulars of the bond, the extent of the participation granted, and the

conditions upon which the participant may transfer, cede or encumber his rights (s 4).

[19] A register must be kept in which must be recorded, *inter alia*, the particulars of each participation bond; the amount owing from time to time by the mortgagor; and "the names of the participants in such bond and the extent of their participations from time to time *as well as all amounts repaid to participants* in respect of their participations (s 5 (1)). The rights of a participant are spelt out in s 6:

> "(1) The debt secured by a participation bond *shall to the extent of the participation granted to any participant be a debt owing by the mortgagor to such participant and not to the nominee company,* and the rights conferred by the registration of any such bond shall, notwithstanding the registration of the bond in the name of the nominee company, be deemed to be held by the participants."

[20] The circumstances in which a participant may enforce his rights against the mortgagor are set forth in s 6 (2). Where the nominee company itself takes action to recover money from the mortgagor any money recovered "shall be the

property of the participants proportionately to the extent of their participations" (s 6 (4)). Money received from would-be participants in a participation bond, or money paid in reduction of the principal debt owing under a participation bond, must be deposited "in the name of the nominee company *on behalf of the investor*" with a registered banking institution and must "remain so deposited until the investor is granted a participation --- or *until the money is repaid to the investor*" (s 10 (5)).

[21] Provision is made in the Act for the appointment by the nominee company of a manager in terms of an "irrevocable agreement --- in terms of which [the manager] has undertaken to pay all the expenses of and incidental to [the nominee company's] formation, operations, management and liquidation". (See the definitions in s 1 of "manager" and "nominee company".) A manager may also hold a participation in a participation bond (s 3 (2)).

[22] What all these provisions show, to my mind, is that the legislature set

out to create for the public at large opportunities for the making of even relatively modest interest-bearing loans secured by a mortgage bond over immovable property. (A minimum amount of R1000,00 is all that s 3 (1) (b) of the Act requires.) For someone with only a modest amount available for investment the expense of registering a mortgage bond to secure so modest an investment would be prohibitive if a separate bond reflecting the investor as the mortgagee would have to be registered. There is not the slightest indication anywhere in the legislation that the granting of these participations by the manager of a participation bond scheme is, or is to be regarded as, the entering into of sales or exchanges.

[23] The evidence adduced by appellant in the court *a quo* to bolster its contentions fell far short of doing so. If anything, it reinforces the conclusions I have reached. I see no need to review it in any detail. What emerges clearly from it is this. These participations were referred to by appellant in its promotional literature as "investments". Its own role was that of a facilitator and manager of

the scheme. It referred to participants as "investment clients". It took from would-be participants what amounted to a power of attorney to make participation bond investments and reinvestments "on his behalf". Interest paid by the mortgagor to it was received by it as agent for the participant. Nothing in the contractual documentation existing between it and a participant suggested that anything was being sold. The period of time for which a client would be a participant was (subject to a prescribed minimum period) potentially open-ended. Its own financial statements were difficult to reconcile with its own participations being regarded as trading stock in that no sales thereof were reflected, and in those statements the existence of any "turnover in the generally accepted sense" was specifically disclaimed.

[24] The terms "bond stock", "stock on hand", and "office pool" which were used internally by appellant to describe the participations held by itself count for little in the face of all that. They are equivocal expressions which do not

necessarily connote that they were being used as the equivalent of trading stock within the meaning of s 1 of the Income Tax Act or indeed within the ordinary meaning of trading stock. But even if they were being so used, if their use was inaccurate and not a true reflection of the real nature of the participations, that usage cannot advance appellant's case.

[25] The Court *a quo* seems to have regarded instances of appellant being succeeded as a participant by a third party as cessions by appellant to the third parties of its rights against the mortgagor. While such transactions are notionally conceivable (subject to the limitations to be found in the Act), it was not appellant's case that any such cessions occurred. A cessionary's right against a debtor is a derived right which he acquires by virtue of the contract of cession. It would be inherent in such a cession that the mortgagor's debt to the cedent has not been discharged.

[26] There is no provision made in the Act for the registration of a

cessionary as a participant in lieu of the cedent. A cedent will therefore remain registered as a participant and the debt due to him, her or it by the mortgagor will continue to be reflected as owing. When appellant replaces itself as a participant by admitting a new participant to the scheme it reflects itself in the register as having been repaid and enrols the new investor as a participant. The new investor's rights are the original rights of a new investor; they are not rights acquired from appellant. If they were, and if it is so that appellant had the right to withdraw from participation at any stage as it asserts it had (a question upon which I refrain from expressing any opinion), it would follow that a cessionary would have the same right. If the rights acquired are not those of a cessionary, but those of a new investor, all the restrictions upon withdrawal from the scheme applicable to a new investor would apply. Appellant's entire case was predicated upon the latter being the position. There is no basis in fact for any finding that appellant is ceding its rights against the mortgagor when it replaces itself with a new investor.

[27] Neither in the written heads of argument nor during oral argument was it argued that any such substitution of a new participant for appellant's participation amounted to an "exchange" within the meaning of the definition of "trading stock". Nor could it have been for, even if it could be said that such a transaction involves an exchange, the exchange takes place between participant and mortgagor and not between participant and appellant. In exchange for the participant's loan to the mortgagor, the mortgagor makes a commitment to the participant to repay the loan in due course and to pay interest on it in the interim.

[28] As I have said, during oral argument in this court counsel for appellant sought to bring such transactions within the second part of the definition. In order to do that it must show that there have been "disposals" of something, that there were demonstrable "proceeds" of those disposals, and that those proceeds formed part of its "gross income". The concept of "gross income" is also defined in s 1 of the Income Tax Act. The definition is extensive. It is not

necessary to quote it in full. It is sufficient to say that while it excludes in general "receipts or accruals of a capital nature", it contains a list of particular receipts or accruals which are to be included irrespective of whether or not they are of a capital nature. None of the receipts or accruals so listed would comprehend the sums of money invested by participants in appellant's participation bond scheme. That is so irrespective of whether any such sum is or is not a sum which has enabled appellant to withdraw either wholly or partially from participations in its own scheme.

[29] If such sums are to be classified as gross income, they will have to fall within the general rubric of receipts or accruals which are not of a capital nature. Here again appellant faces an insuperable hurdle. Such sums are not received by appellant in its own right, nor are they sums accruing to appellant in its own right. They are sums received by appellant and held by it on behalf of would-be participants preparatory to the investment of those sums in participation bonds by

appellant in its capacity as agent for the participants. They do not constitute income received by or accruing to appellant at all. On this view of the matter it is irrelevant whether or not those sums are of a capital nature.

[30] That is not the only obstacle in the way of appellant. What ranks as a "disposal" and what ranks as the "proceeds" of the disposal within the meaning of the definition of trading stock? As was explained in paragraph 12 above, appellant does not dispose of anything nor are there any proceeds of a disposal. In exiting from the scheme either partially or wholly appellant is simply receiving payment from the mortgagor of part or the whole of the debt due to it. It is not disposing of its right to be paid by the mortgagor to the incoming investor nor is what the latter lends to the mortgagor the "proceeds" of any such disposal. But even if those difficulties could be overcome, it would be far from clear that they would be receipts not of a capital nature. The appellant is not "trafficking" in participations; it is not "purchasing and selling" participations in order to generate

an income from such activity. Its own involvement in participations is temporary and incidental to its true vocation which is to administer the scheme in return for its agreed commission. As such its "holding" of participations is *prima facie* of a capital and not of a revenue nature. However that may be, in as much as the point was not addressed during argument, I refrain from expressing a more definite opinion.

[31] To the extent that there are expressions of opinion in the "Guidelines and Explanatory Notes" issued by appellant as to what is happening in law, and to the extent to which they are incompatible with what I consider to be the correct juristic analysis of what actually happened and was intended to happen, they must be taken to be erroneous.

[32] In view of these conclusions it is not really necessary to consider whether, if the participations could be classified as trading stock, there was in fact any diminution in their value within the meaning of s 22 of the Income Tax Act,

whether that was in fact so decided by the Commissioner, and if so, whether that finding is open to attack in this appeal. Had it been open to this court, and necessary, to consider the first question, I would have answered the question in the negative.

[33] An elaborate argument to the contrary was advanced in the written heads of argument by appellant and repeated during oral argument. Parallels were sought to be drawn between the well-known fluctuations in intrinsic value of traded stock and debentures carrying particular interest rates as market conditions change. In my opinion, the argument is fallacious. The intrinsic value of stock and debentures traded at any given date depends primarily upon the relationship between the fixed rate of interest payable throughout the life of the instrument and prevailing interest rates and current expectations as to how rates may move. In the case of these participation bonds there is no fixed rate of interest. It is variable and there is no "floor rate" below which it cannot fall. The intrinsic value of the

participation is therefore not under threat by virtue of it bearing a fixed interest rate. The risk of the borrower being unable to repay the loan is theoretically a factor which may adversely affect the intrinsic value of the participations but it is not suggested that any such risk existed here.

[34] The way in which appellant sought to demonstrate a depreciation in value was this. Interest is payable quarterly in advance on participations. The case was postulated of an investor who becomes a participant during a quarter and after interest for that quarter has already been paid to the outgoing investor. The incoming investor will therefore be deprived of interest for the remainder of that quarter. That will "impair the price" which he is prepared to pay for the participation. The extent to which the "price" will be diminished will depend on how long the new investor will have to endure the non-payment of interest. In practice this means, so the argument runs, that the value of such a participation is diminished by an amount equivalent to the interest which the incoming participant

will not get.

[35] The fallacy in the argument is shown by what appellant does in such a case. It does not give the incoming participant a discount representing the interest which the participant will not receive for the remainder of the relevant quarter. It accepts from the incoming participant a sum equal to what has been repaid to it (appellant). It then pays the participant a sum by way of interest on *his* investment for the remainder of the quarter. The position is plain: appellant, in its capacity as a participant, has received a quarter's interest in advance in anticipation of it remaining invested for the coming quarter. If it does not in fact remain invested for the whole of the quarter, it disgorges the interest attributable to the period for which it was not in fact invested and uses it to pay interest to the new investor who was in fact invested for that period. This is purely and simply a recognition of the facts of economic life. A lender cannot insist upon being paid interest in respect of a period during which he lent nothing and a lender at interest cannot be

expected to forego the payment of interest in respect of a period during which his money was in fact made available to the borrower. The "value" of the participation as such is unchanged. What will have to be advanced to acquire it remains constant.

[36] The appeal is dismissed with costs, such costs are to include the costs of two counsel.

R M MARAIS
JUDGE OF APPEAL

SMALBERGER JA)
NIENABER JA)
PLEWMAN JA)
MTHIYANE AJA) CONCUR