REPORTABLE

IN THE TAX COURT, CAPE TOWN

Case No. 11337

In the matter between

….. **Appellant**

and

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

Heard in Cape Town 18/11/2004 – 19/11/2004

JUDGMENT: 16 March 2005

DAVIS J

Respondent disallowed certain partnership losses claimed by appellant in respect of his share of losses arising from a participation in a venture between himself and X ('X') in respect of assessments for the tax years 1998 to 2001 inclusive. In addition, respondent included in appellant's gross income the proceeds of a sale of unit trusts acquired by appellant for the year of assessment ending 28 February 2001. Appellant has appealed against these assessments.

The factual background

In terms of the minutes of the pre-trial conference held under Rule 16 of the Rules applicable to the Tax Court in terms of section 107A of the Income Tax Act 58 of 1962 ('the Act') a number of facts are common cause. I turn first to the partnership losses.

The partnership transactions

Y (Pty) Ltd ('Y') was the owner of a property known as Z. Appellant confirmed in Court that he had been approached by an employee of the property division of A Bank Ltd ('A') about the possibility of the development of X. Pursuant to this meeting, he met Mr B who owned the shares in Y. An agreement was concluded between X and Y on 19 December 1997 with the object of developing the property. In terms of this agreement, X agreed to bind itself as co-principal and debtor on behalf of Y to A to an extent of 51% for the due fulfilment by Y of its obligations to A. The profit sharing in the venture would be 51% to X and 49% to Y.

The development at Z was to be known as the 'C Club'. On 26 February 1999 X and Y entered into an addendum to the agreement in terms of which X would take over the development of Z with effect from 1 March 1999 and that 'the parties hereto acknowledge that any profits and losses arising from the development of Z shall as from 1 March 1999 be borne by X and Y in the proportion of 10% and 90%'. On 19 December 1997 appellant and X entered into an agreement in terms of which 'their respective participation in the joint venture (with Y) will be X 10% and (appellant) 90% and consequently all profits or losses flowing from the aforementioned joint venture to X shall be divided between X and (appellant) in the aforementioned proportions'.

I turn now to the second issue for determination, being the sale of unit trusts pursuant to appellant's involvement in a container scheme.

The container scheme

Towards the beginning of 1999 appellant was informed that he would no longer be able to effect payment towards the acquisition of annuities and that he was obliged to accept payment of sums to which he was entitled in respect of these annuities from various insurance companies. In aggregate the amount involved was approximately R2m. A presented appellant with a proposal to the effect that it would advance the appellant a sum of R2,5m which would enable A to acquire approximately 22 tank containers on behalf of appellant.

On 22 August 1995 appellant entered into a number of agreements with A. He first entered into a loan agreement in terms of which A lent him an amount of R1 203 769,00 to finance the initial container lease rental of R1 203 415. This loan in addition to finance charges of R113 349,80 were repayable in 60 instalments, being one instalment of R1 221 976,73 and 59 instalments of R18 561,73 each. The first instalment of R18 561,73 was due on 14 September 1995 and the final instalment of R1 221 976,73 was due on 14 August 2000. In terms of the agreement appellant was required to pledge unit trust payments of the minimum of R581 978,00 for the first year, R586 616,00 for the second year, R162 765,00 for the third year, R155 476,00 for the fourth year and R147 751,00 for the final year.

It was anticipated from the outset that these unit trusts would not be held indefinitely but that they would inevitably be sold in order to settle the existing indebtedness of the appellant to A. There is however an important qualification to the pre-trial minute. In respondent's minute of the pre-trial conference, the words 'it was intended from the outset' were employed. However, appellant sought to correct this phrase. In a letter of

19 October 2004 he suggested that what had been agreed was as follows: 'It was anticipated from the outset that the unit trusts would not be held indefinitely'. The appellant's version of the pre-trial minute accords with the testimony of appellant. It was not effectively shaken during cross examination.

A lease agreement in terms of which the appellant leased 22 x 24 000 litered tank containers from A with effect from 14 August 1995 was also concluded. The first lease payment in the amount of R1 203 415,00 was due on 14 August 1995, and the second instalment of R1 203 415,00 was due on 31 December 1996. Thereafter four instalments of R186 128,81 were to be made on the last day of 1997, 1998, 1999 and 2000. The final instalment was due on 14 August 2001.

On 18 August 1995 appellant ceded all his rights to the containers as security to A, ceded all his rights in the unit trust as security to A and entered into an investment management agreement with A Container Investments (Pty) Ltd in terms of which he appointed this company to manage the containers on his behalf.

Between 19 December 2001 and 9 July 2002 the containers were disposed of in the amount of R1 760 000. Appellant deducted the interest payments on the loan from A in terms of section 11*(a)* of the Act. The unit trusts were repurchased by A on 28 March 2000 for an amount of R2 226 824. Respondent subjected the profits of R593 238 realised by appellant on the sale of unit trusts to A to tax in the 2001 year of assessment.

Appellant's evidence

As noted, appellant testified before the Court. He was the only witness. Much of his evidence confirmed the record of the pre-trial conference. A significant portion of additional evidence of appellant related to the dispute between the parties as to whether section 103(1) of the Act was applicable to the present dispute. After the hearing Mr Stevens, who appeared on behalf of respondent, informed the Court that respondent no longer relied on section 103(1) of the Act to justify the assessments made by respondent. Accordingly this evidence is of no further relevance to the case.

Of particular importance to the present dispute was the nature of the agreement between appellant and X as well as the agreement between X and Y.

In this regard appellant was cross examined extensively on the meaning of paragraph 2 of the agreement between Y and X which read: 'The parties hereto acknowledge that any losses (sic) arising from the contemplated development of Z shall be borne by Y and X in the proportion of 49% to 51%.' Appellant conceded that this was an omission, but testified that when the agreement had been concluded there had been no losses incurred. The intention had not merely been to share in losses. Pursuant to the projections prepared by A, appellant envisaged that a significant profit would be earned from the development of Z.

Appellant testified that his personal exposure to the project was approximately R5m whereas X's was approximately R500 000. He was then asked why he had entered into an agreement between himself and X which read as follows:

> 'X and (appellant) hereby agree that their respective participation in the joint venture reflected in Annexure X2 will be X 10% (ten percent) and (appellant) 90% (ninety percent) and consequently all profits or losses flowing from the afore-mentioned joint venture to X shall be divided between X and (appellant) in the aforementioned proportions.'

Appellant testified that, on the anticipated projections, X would earn R500 000 and thus recoup its exposure whereas he considered that, as 75% of the shares of X were held through trusts in which appellant's children were the beneficiaries, he had already made them 'very rich'. He now wanted to benefit his wife. This could be best achieved by ensuring that the profits from the property project would be earned in the ratio of 10% X: 90% appellant. In this way his estate would increase to the benefit of his wife who stood to so inherit.

Mr Stevens questioned appellant as to why there was no tripartite agreement between the appellant X and Y. Appellant testified that the arrangements between himself and X were none of B's business and all that B was required to know was that appellant had come to the deal through the medium of X. Furthermore, A was not particularly concerned with this arrangement regarding appellant's family, provided that the bank was adequately covered for the loans which had been made. Accordingly, A was satisfied that appellant had signed as surety and co-principal debtor. Insofar as A was concerned, appellant was the critical person in the entire set of transactions. Regarding the approval of the children of appellant whose trusts owned 75% shareholding in X, appellant testified that he was the sole director of X, was entitled to enter into an agreement between X and himself, he had made his children extremely wealthy and he

was now concerned to look after his wife. There was thus no need to consult the children with regard to the agreement entered into on 19 December 1997.

Appellant also testified on the issue regarding the unit trusts. He testified that he intended to acquire the containers from A by utilising funds borrowed from the bank and that simultaneously he invested in A unit trusts which would be ceded to the bank in **securitatem debiti**. He testified it was contemplated by A that the unit trusts would grow in value over the five year investment period. At the end of the five years the unit trusts might have a value sufficient to repay his indebtedness to A in terms of the loan which had been utilised to finance the rental of the containers.

He testified that the investment in the containers proved to be very disappointing and that he had eventually acquired the containers in his own name. He then divested himself of the tanks which he had bought for approximately R120 000 per tank and sold for approximately R80 000. The unit trusts were for a five year duration, being the duration of the container scheme. At the end of the five year period appellant had the option of holding the unit trusts or realising them. He emphasised that he was not a share speculator and held shares only for long term investment. However, unit trusts were ‘not my game’ and at the end of the five year period he chose to realise these investments.

The partnership dispute

Mr Emslie, who appeared on behalf of appellant, submitted that, on the facts, a valid partnership had existed between appellant and X. He submitted that there could be no doubt that the partnership should be carried on for the benefit of both parties; that is X

and appellant. The object was to make a profit and the agreement concluded was valid and binding on the parties. Not only did appellant bind himself personally as surety for the indebtedness of the joint venture in which he had an interest by way of his partnership agreement with X but he personally was the driving force in the affairs of both the partnership and the joint venture. In this way, he contributed his labour and skills and services to the partnership.

Appellant's case was that the business of the partnership was constituted as a participation in the joint venture with Y. The income of the partners, that is appellant and X, accrued to them in common as partners in a partnership, being 90% of the income pursuant to the joint venture with Y. For this reason, section 24H of the Act was applicable to the agreement entered into between appellant and X.

Mr Stevens submitted that appellant and X did not carry on any business for their joint benefit. He submitted that a separation should be made between the business of the joint venture between Y and X from 'the partnership' between appellant and X. The 'business' between appellant and X, amounted to no more than a sharing of the profits and losses of the joint venture to which X had become entitled. There was no 'business activity' between appellant and X. Their venture had no outward manifestation that could be associated with a partnership. All that was shared were the fruits of X's capital contribution to the joint venture between Y and X.

Mr Stevens also submitted that X's contribution to the 'partnership' with appellant was suspect in that any contribution which X had made was that of a suretyship in respect of a joint venture with Y and not in respect of a partnership with appellant. Mr Stevens also drew attention to the rather skeletal document which had been prepared to

establish the partnership between X and appellant. He submitted that appellant was an experienced professional person and it could have been expected of him to make sure that the documentation relating to the partnership would have been precisely drafted. Thus, it would have been expected that the relationship between X and Y be called a partnership and not a joint venture. Similarly, the relationship between X and appellant did not include a standard heading 'A partnership agreement'. Mr Stevens therefore contended that appellant should be bound to the wording of the agreement; it was an agreement to share in the profits and losses to which X had become entitled.

Mr Stevens also submitted that the parties who shared in the expenditure and losses in the development of the Z property were X and Y. They made losses because the expenditure incurred was higher than the income. This expenditure or losses were allowed to be deducted by X and Y in terms of section 11*(a)* of the Act, being expenditure or losses actually incurred in the production of their income from the development. He submitted that it would be totally artificial to allow appellant to share in the losses in question, without having incurred any expenditure himself in the production of income from the joint venture.

Analysis

In essence, respondent's case is that the partnership between X and appellant was not a valid partnership and, even if it were a partnership, section 24H(5)*(a)* and *(b)* applied so that the profits and losses (in particular the losses) could not be deducted by appellant because they were incurred in a different partnership.

It is trite law that the **essentialia** of an agreement of partnership are:

1. Each of the partners must bring something into the partnership or bind themselves to bring something into it whether it be money, labour or skills;

2. the partnership business must be carried on for the joint benefit of the partners;

3. the object of the partnership must be to make a profit; and

4. the contract between the parties must be a legitimate contract. See **Joubert v Tarry and Company** 1915 TPD 277; LAWSA Vol. 19 paras 269 ff.

In determining whether a particular contract gives rise to a partnership, regard must be had both to the **essentialia** of the partnership as evidenced in the agreement and the intention of the parties. The fact that a contract does contain the **essentialia** of a partnership does not necessarily mean that the legal relationship created by the contract is that of a partnership. Upon a proper construction of the relationship, the true intention of the parties may well be that, notwithstanding the existence of the **essentialia** of a partnership agreement, a contract other than a partnership has been created. See LAWSA Vol. 19 at para 274.

In the present case appellant testified that the written contract reflected its contents; that is that appellant had concluded a family transaction. In principle, it cannot be denied that it is possible for a person in the position of the appellant to enter into a valid partnership between himself and a company controlled by a family trust. According to appellant's evidence, which was not disturbed under cross-examination, the partnership

between appellant and X was carried out for the joint benefit of the partners, in that the intention was to earn a profit from the property development. This profit would ensure the joint benefit of the two partners, being X and appellant. Mr Stevens submitted that X's contribution to the partnership with appellant was suspect. During his evidence appellant had indicated that X's contribution was a suretyship to A. However, Mr Stevens submitted that X's alleged contribution of suretyship had been given in respect of its joint venture with Y and not as a partner with appellant. According to Mr Stevens the agreement between appellant and X was merely an agreement whereby the parties agreed that, in view of the fact that appellant was to be the surety and co-principal debtor in respect of X's indebtedness to A, X was prepared to surrender 90% of its share in the profits and losses in that joint venture to appellant.

Appellant made a contribution to the profits which X might have earned pursuant to its joint venture with Y. There was uncontested evidence that appellant had bound himself as surety for the indebtedness of the joint venture, that he was a driving force in the affairs of the joint venture in that he contributed his labour and skills to that joint venture. It was common cause that X was a co-principal debtor to A in respect of a mortgage bond loan in the amount of R36 450 000 which was procured for the development of the property into sectional title and individual units. Both appellant and X contributed money, labour and skill (particularly in the case of appellant) to ensure that a profit in a joint venture would be enjoyed and in turn thus would ensure that a profit would accrue to the partnership between X and appellant.

As appellant informed the Court, the intention was that X and appellant would share 10:90 in respect of the profits of the joint venture. The intention of both parties was to make a profit. The fact that the source of such profits was a joint venture entered into

between X and Y was not destructive of the intention to create a valid partnership between X and appellant and for these two parties to enjoy a profit.

Mr Stevens made much of the fact that there was no outward manifestation of the partnership of X and appellant. Thus neither Y nor A was aware of the agreement between X and appellant. Appellant testified that there was no need for either Y or A to know about the partnership between himself and X, in that both parties had looked to him (appellant) for delivery in terms of the contract which had been entered into between themselves and X.

Respondent's submissions can be tested on the basis of the assumed existence of a silent or anonymous partnership. Assume that this was the nature of the partnership concluded between X and appellant. A silent partnership is one where parties agree to share the profits of the business which has to be carried on by one or some of the partners in his or her name alone while the partners whose names are not disclosed remain the silent or anonymous partners sometimes also referred to as 'sleeping' or 'dominant' partners. See LAWSA Vol. 19 para 267.

The essence of the silent partnership is that the silent partner shares the risk of the undertaking with his co-partners, is liable to them for a **pro rata** share of the partnership losses, but his or her name is not disclosed to outside parties. If Mr Stevens' submission is correct, then a legally recognised silent partner would equally be susceptible to attack by Revenue on the grounds of an absence of knowledge by Y or A.

Section 24H

Section 24H(5)*(a)* provides as follows:

> 'Where any income has in common been received by or accrued to the member of any partnership, a portion (determined in accordance with any agreement between such members as to the ratio in which the profits or losses of the partnership are to be shared) of such income shall, notwithstanding anything to the contrary contained in any law or the relevant agreement of partnership, be deemed to have been received by or to have accrued to each such member individually on the date upon which such income was received by or accrued to them in common.'

As **Meyerowitz on Income Tax** at para 16.74 notes:

> 'The effect of these provisions is that there accrues to each partner for his tax year a proportionate share of the partnership accruals during his tax year and against such accruals he can claim as a deduction his proportionate share of allowable expenditure incurred by the partnership during the year and his share of any allowances which may be made available in respect of the trade, assets etc of the partnership.'

Mr Stevens submitted that the income that would have accrued to X and Y in common from their partnership would have accrued to them individually in the ratio in which the profits and losses of their partnership were to be shared; that is 51%:49% and later 90%:10%. Because X's share of the partnership would have been deemed to have

accrued to X itself, the income could not be held to accrue to X and the appellant in common. Accordingly, section 24H(5)*(a)* could not deem any income to have accrued to the appellant individually since no income was received by or accrued to X and appellant in common in terms of the agreement between X and Y.

This submission however misconstrues the meaning of section 24H(2). Once it is accepted that X and appellant were in partnership, then each member of that partnership is deemed to be carrying on the trade or business of that partnership. The business of the partnership between X and appellant was its participation in the joint venture with Y. The income of the partners, being appellant and X, accrued to them in common as partners while X's share of the income from the partnership with Y would have accrued to X itself. That was not the end of the enquiry. The enquiry needed to be extended to the consequences for the partnership between appellant and X. That partnership was involved in a venture with Y pursuant to which partnership profits or losses which flowed from the joint venture to X would be divided between X and appellant in defined proportions. To that extent therefore, section 24H(2) applied to the taxation of income or losses which accrued to or were incurred by that partnership in the proportions specified in the agreement between appellant and X.

If appellant had been a silent partner as contemplated in section 24H, that is an undisclosed partner, section 24H(1) and (2) expressly provide for this situation. In this case, income earned by X from the joint venture with Y would require distribution pursuant to the partnership agreement between appellant and X. The taxation of the income would stand to be dealt with in terms of section 24H(2).

The unit trusts

Mr Stevens contended that appellant had embarked on an investment in unit trusts knowing well, at the time of making the investment, that this investment would be inevitably realised, hopefully at a profit. His intention differs totally from that of an investor in unit trusts who invests his or her money with the intention to hold such unit trusts as a capital asset. It had never been the intention of appellant to hold these unit trusts as a permanent asset. Appellant has accepted that he would do far better by investing his money other than in unit trusts. As he had told the court unit trusts 'were not his game'.

As Mr Emslie contended, appellant would have been free to repay the loan using other funds at his disposal. At no time did he intend to speculate using the unit trusts as stock in trade. He always intended that, at the very least, the unit trusts would be held for a period of five years. Appellant had testified that, had the unit trusts performed better than other investments, he would have held on to such unit trusts. He submitted that appellant invested his capital for a period of five years, that he was entitled to realise this investment after a period of five years without tainting the capital nature of this investment.

In support of his contentions, Mr Stevens cited a **dictum** of **Conradie AJ** (as he then was) in ITC 1418 49 SATC 42 at 45:

> 'The taxpayer may have several motives for purchasing a property. His intention, however, is something which has to be inferred from his acts and from his dealings with the property. If his intention was to use the property as floating

capital, not to hold it and to derive an income from it, then I do not believe that his motive for the acquisition of that asset can, in an income tax context, play any role at all. As in the criminal law, I believe that in this context a person must be taken to intend the reasonable and natural consequences of his acts, and if the reasonable and natural consequences of the acts of the taxpayer are that he will acquire a property and very shortly thereafter dispose of it, without deriving any income from it, then it seems to me that it can only be a transaction on revenue account.'

This **dictum** has now to be read within the context of the majority judgment of **Smalberger JA** in **CIR v Pick 'n Pay Employees Share Purchase Trust** 1992(4) SA 39(A) at 58B, particularly the following passage:

'Receipts of a revenue nature (in the form of profits) accrue to a trader who acquires and disposes of shares as part of a scheme of profit making … **Nicholas AJA** accepts, in my view, correctly, that the purpose of this scheme was not one of profit-making. If that is so, it seems impossible to conclude, as a matter of logic, that any business conducted in pursuance of this scheme, and according to the strict letter thereof (which is essentially the case here), could be part of a scheme of profit-making. But apart from this the trustees never intended or designedly set out to make a profit – it was not their purpose to do so … Contemplation is not to be confused with intention in the above sense. But a tax case will have not concerned with what possibilities, apart from his actual purpose, the taxpayer foresaw and with what he reconciled himself. One is solely concerned with his object, his aim, his actual purpose. While they might have contemplated the possibility of profits, it was not the purpose of either the

> Company … in founding the Trust, or the trustees in conducting the affairs of the Trust, to carry on a profit-making scheme. The sole purpose of acquiring, holding and selling the shares was to place them in the hands of eligible employees. The forfeiture provision was not intended to yield a profit. Its purpose was to deter unwanted resignations.'

This **dictum** of **Smalberger JA** clearly refuses the invitation of **Conradie AJ** (as he then was) to employ the criminal law in the determination of the intention of a taxpayer in the determination of whether proceeds should for tax purposes be treated as being on revenue or capital account. The test turns on the taxpayer's actual purpose; in short did the taxpayer intend to initiate a scheme of profit making?

It is common cause that the unit trusts were acquired by appellant as security for a loan utilised to finance the rental of 22 containers hired by him from A. It was clearly in the contemplation of appellant that the unit trusts would grow in value over a five year investment period and that they would realise (hopefully) sufficient value to repay any indebtedness of the appellant to A pursuant to the loan which had been utilised to finance the rental of the containers.

Applying the **Pick 'n Pay** test, this was not a scheme of profit making. Appellant was at pains to emphasise in his evidence (without any contestation by respondent) that he was not a share dealer. The acquisition of the unit trusts was not part of a scheme of profit making. The unit trusts were acquired as security for a loan which was essential to the acquisition of the containers. In my view, therefore, it cannot be said that the disposal of the unit trusts after a period of five years was implemented in pursuance of a scheme of profit making. What the appellant might have contemplated should not be

confused with his intention as that concept is employed by **Smalberger JA** in **Pick 'n Pay Employee Share Purchase Trust, supra** at 58B-F. Accordingly, the proceeds received on the disposal of unit trusts were of a capital nature.

For the reasons set out, the appeal succeeds and the assessments of the respondent are set aside. Respondent is directed accordingly to make revised assessments for the years of assessment ending the last day of February 1998 to 2001.

___________________ (Sgd)
D M DAVIS: PRESIDENT

FOR THE APPELLANT:	ADV TS EMSLIE (SC)
INSTRUCTED BY:	….
FOR THE RESPONDENT:	ADV G STEVENS
INSTRUCTED BY:	COMMISSIONER FOR SARS

The Honourable Mr Justice D Davis	–	President
Mr RJT de Beer	–	Accountant Member/Rekenmeester
Mr TM Pasiwe	–	Commercial Member/Kommersiële Lid