

Is an en-commandite partnership a tax-efficient vehicle in the current private equity regime with the focus on Investments in South Africa?

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Abstract

Private equity (PE) firms often use different investment vehicles to attract high-net-worth individuals and institutional investors to invest with them, as after-tax returns are generally higher than the formal investment sector. A question that arose during a discussion with the head of tax of a large insurance company was: Is an *en commandite* partnership a tax-efficient vehicle in the current private equity regime? The purpose of this dissertation is to determine whether the benefits of *en commandite* partnership outweighed other forms of investment vehicles with regard to flow-through of income. It also dealt with the elimination of entity-level tax, while protecting investors from personal liability for the debts and obligations of the fund.

This paper firstly investigated the characteristics of the most common investment vehicles, and the legislative requirements that they are subjected to.

Secondly, the tax regime that applies to these investment vehicles was investigated. It included the financial instruments used by PE firms and how different applications of these instruments are treated by the tax authorities. This was done to determine if, when, and how these instruments were taxed as income or capital, and in whose hands they were taxed. This also covered the potential pitfalls PE firms had to be aware of when structuring investment transactions. This was followed by a conclusion to the question: Is an *en commandite* partnership a tax-efficient vehicle in the current private equity regime with the focus on investments in South Africa?

The study includes a comparative analysis of the legislative and tax consequences of the investment vehicles as well as the benefits that could be derived from each.

High-net-worth individuals and institutional investors often seek investment opportunities where they are prepared to take a higher investment risk with the objective to achieve a higher return on their investments. They can either invest in ventures and manage the investments themselves, or they can use PE firms to take up shares in private or unlisted companies to manage investments on their behalf. Confidentiality of financial affairs of individuals in particular, favour PE firms that use trusts and partnerships as investment

vehicles, as legislative disclosure requirements are very limited. In an *en commandite* partnership, the identity of limited partners is not disclosed. The most important considerations for investors are to maximise the after-tax return on their investments and to limit their potential liability and exposure to debts.

With the current structure of PE firms and their professional oversight in the management of the underlying investments under their control, it is submitted that an *en commandite* partnership is the most tax-efficient vehicle in the current private equity regime. This is primarily due to the conduit principle, where taxation at fund level is averted, and the tax liability passes through to investors with differing tax structures. The Capital Gains Tax (CGT) inclusion rate is also the lowest for individuals when utilising an *en commandite* partnership. PE firms focus on maximising investment returns within the constraints of tax legislation and investors take care of their own tax affairs.

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The high standards set by the University of Cape Town, their lecturers, and the journey I experienced I will remember for the rest of my life. It was a positive experience and it is a privilege to be part of this great institution.

Plagiarism declaration

I, Francois Retief Ueckermann, hereby declare that this dissertation is my own work. Where other people's work has been used (either from a printed source, the internet or any other source), this was properly acknowledged and referenced in accordance with the requirements of the University's plagiarism prevention policy.

FR Ueckermann

List of abbreviations

BPR	-	Binding Private Ruling
CIPC	-	Companies and Intellectual Property Commission
CGT	-	Capital Gains Tax
CTC	-	Contributed Tax Capital
IPO	-	Initial Public Offer
ITA	-	Income Tax Act No. 58 of 1962
MOI	-	Memorandum of Incorporation
OECD	-	Organization for Economic Co-operation and Development
PE	-	Private Equity
SARS	-	South African Revenue Service
STT	-	Securities Transfer Tax Act No. 25 of 2007
TAA	-	Tax Administration Act No. 28 of 2011
USA	-	United States of America
VAT	-	Value-Added Tax
vs	-	versus

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CHAPTER 1 BACKGROUND AND FRAMEWORK

1.1 Introduction

People and organisations who want to invest funds, have a number of options available to them. Banks, pension funds, insurance companies, financial institutions and high-net-worth individuals are continuously seeking new investment opportunities that achieve a trade-off between maximizing return on investment (after tax) and limiting liability. Some of these entities are highly regulated in terms of where and how they can invest their funds, whereas other entities and private individuals have freedom of choice.

Some of the key considerations investors need to take note of are specialised skills, experience and time to make the right choices regarding investment opportunities. Therefore, they must manage and monitor the performance of their investments continually.

Investors can decide to invest directly in tradeable securities and/or assets, or they can use indirect investment vehicles that are managed by professionals to manage their investments on their behalf.

The goal of this paper is to focus on the private equity industry and to investigate the various investment structures available to it, by analysing the legislative requirements applicable to investment vehicles, and then to determine the timing, nature and impact of the multiple taxation implications on these vehicles.

1.2 Background

In the investment community investors are continuously searching for high returns after tax that have the lowest possible liability. This is often a function of the investment vehicle that is utilised. On 28 February 2019, PSG traded below net asset value (NAV) of R 67 958m versus Market cap of R 60 297m¹. This is by no means a sign of poor performance. The shares traded at a discount at date of

¹ PSG Annual Report 2019, p 26. Available: <https://www.psggroup.co.za/Annual-Report-2019.pdf>

publication, which is not unusual for public trading companies. The intrinsic value might have been more than the market cap during the same period. There are multiple reasons why shares may trade below net asset value, which is a topic on its own and beyond the scope of this paper. The market value of a PE firm is not available, as their shares (where a company is used as investment vehicle) are not trading on a stock exchange. A question that arises is: To what extent do tax layers in the investment vehicle (company in the case of PSG), contribute to this phenomenon?

1.3 Rationale for topic

The aim is to determine whether benefits of *en commandite* partnership outweigh other forms of investment vehicles with regard to flow-through of income and losses that eliminate entity-level tax, while protecting investors from personal liability for the debts and obligations of the fund.

1.4 Research Question

Is an *en commandite* partnership a tax-efficient vehicle in the current private equity regime with the focus on investments in South Africa?

1.5 Subquestions

- What private equity investment vehicles are available in the South African market?
- What are the statutory requirements, advantages and disadvantages?
- What taxation issues should be considered when comparing different types of investment vehicles?
- How do these investment vehicles and the factors that have a direct impact on them, weigh up against one another?

1.6 Research method

The doctrinal research method is used in this paper. Doctrinal research is described as research in law, which is a systematic process to identify, analyse,

organise and synthesise statutes, case law and authoritative sources.² The methodology deals with the application of logic to arrive at a conclusion. Inductive and deductive reasoning is applied to law and legal rules, with a thorough analysis and application of the principles that apply to the research question under consideration.³ The doctrinal method is applied as follows:

- The characteristics and qualities of the selected investment vehicles will be researched.
- Data will be collected by utilising legislation, case law, formal publications and professional journals.
- Context, observations and interpretations will be investigated to determine the impact that they may have on the liability for tax.
- Critical and systematic analysis and synthesis of statutory provisions, legal principles, and taxation requirements will be conducted to determine legal propositions and optimal post tax results for investors.
- Results will be interpreted with reasoning to arrive at a conclusion that will address the research question.

1.7 Limitations and scope

It is beyond the scope of this thesis to discuss the features of the various financing instruments used by private equity firms. However, the tax implications of using equity-based financing instruments will be dealt with in detail. International taxation will not be considered. Non-profit and state-owned companies also fall outside the scope of this thesis.

1.8 Structure of the Report

This dissertation is structured into 6 chapters:

² McKerchar, 2008. *Philosophical Paradigms, Inquiry Strategies and Knowledge Claims: Applying the Principles of Research Design and Conduct to Taxation*. eJournal of Tax Research (2008) vol. 6, no. 1, p 18. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1464141.

³ West & Roeleveld, 2018. FTX4036F Research Methods In Tax. p 27.

Chapter 1 Background and framework

Chapter 2 Private Equity

Chapter 3 Company

Chapter 4 Trusts

Chapter 5 Partnerships

Chapter 6 Conclusion and implications

CHAPTER 2 PRIVATE EQUITY

2.1 Introduction

A private equity fund can apply a multitude of investment vehicles to accommodate the various types of investors that approach them with their funds. For clarity it is important to understand the nature of a private equity fund and its role in the market. However, a basic explanation will be provided as the topic entails so much more. It is important to understand the legal requirements imposed on different types of investors within the private equity framework, as it may limit and restrict where and how they can invest. Each succeeding chapter will review the different types of investment vehicles at the disposal of private equity funds, as well as the tax implications of each vehicle.

2.2 What is a private equity fund?

Private equity (PE) refers to capital investment (equity and debt) in companies that are not trading on a public exchange.⁴ These can be private or public companies of which the latter are not listed on a stock exchange.

In terms of regulation 28(1)⁵, a private equity fund is defined as a managed pool of capital

⁴ Baker, et al *Private Equity : Opportunities and Risks*. Oxford University Press USA (2015) p 3.

⁵ Pension Funds Act No. 24 of 1956, Regulations made under s 36.

- where the investors are primarily engaged in the making of equity, equity-oriented or equity-related investments in unlisted companies, to earn income and capital gains.
- where investments are private – it is not offered to the public as it is for public companies.
- managed by a person licensed as a discretionary financial services provider, as defined in the Code of Conduct for Administrative and Discretionary Financial Service Providers, 2003.
- subject to prescribed conditions.

PE firms who act as investment managers, will raise capital from various investors and will then pool it in a fund with a specific mandate. Such a fund will then invest in companies that meet the requirements of the fund's mandate. A mandate is a set of rules that governs how and where funds are allocated and invested, how assets should be managed, how investor capital that is not yet fully invested will be preserved, the fee structure, and the expected returns. Funds that offer very high growth will invest in high-risk, high-return ventures. In exchange for the management of these investments on behalf of the investors, the private equity firm will receive a fixed management fee, as well as sharing in profits above a certain threshold, generally known as carried interest.

Investment terms in private equity generally range from an investment horizon of 3 to 10+ years (long term) with longer terms more the norm, but with the view to exit (sell) at a later date. Pooled funds may be invested in start-up or operating companies. The PE firm will exit (liquidate) their investments in a venture by selling it back to the original vendors of the company or to another PE firm, or through an Initial Public Offer (IPO) if it is a large company. Investor returns are therefore measured over the term of the investment to which investor funds are committed. This means that investors will have a capital gain in addition to their initial capital invested. The taxation impact will be dealt with below. Investments are relatively

illiquid. However, investors may receive distributions (dividends) during the investment term.⁶

The significance of PE as a vehicle to raise venture capital for start-ups and smaller companies who require development and expansion capital, is supported by research conducted by Bernstein et al. (2018). It suggests that private equity-backed companies were more resilient in facing the financial crisis than a similar set of non-PE-backed ones, which contradicts the claim that PE firms increase financial fragility.

The financial crisis refers to the 2007–2008 sub-prime mortgage crisis that originated in the USA, where loans were granted to applicants with poor credit records (higher-risk borrowers) during a booming housing market. The Central Bank of the USA (the Fed) increased interest rates which led to defaults from sub-prime borrowers. With the bursting of the bubble in the booming housing market in the USA in 2007, troubled borrowers found it difficult to sell their homes to pay off their mortgages. Mortgage-backed securities plunged in value and financial institutions suffered huge losses as a result. The housing crisis was one of the major causes of a recession which hurt the economy in four major ways: Construction was lowered, wealth was reduced, which in turn reduced consumer spending, lending by financial institutions declined, and securities markets became less accessible.⁷ The crisis in the USA spread to Europe and the rest of the world.⁸

The following three chapters will focus on a general discussion of the entities that can be utilised as PE investment vehicles, as well as the tax consequences of each vehicle.

⁶ Yates, D. 2010. *A Practical Guide to Private Equity Transactions*. Cambridge University Press. DOI: 10.1017/CBO9780511676147.

⁷ Duca JV (2013), Subprime Mortgage Crisis 2007–2010 [Online]. Federal Reserve Bank of Dallas, Available from: <https://www.federalreservehistory.org/essays/subprime-mortgage-crisis> [Accessed 26 November 2021].

⁸ Bernstein, et al (2018), *Private Equity and Financial Fragility during the Crisis*. Oxford University Press.

CHAPTER 3 COMPANY

3.1 Characteristics of a Company

A company is a collection of members or just one member, formed for a common purpose – usually for commercial purposes – to derive financial gain from the process of conducting business. In terms of section 1 of the Companies Act no. 71 of 2008 (Companies Act), a ‘company’ means a juristic person that is incorporated in terms of this Act and that adopts a Memorandum of Incorporation (MOI) that sets out rights, duties and responsibilities of shareholders, directors and others, within and in relation to a company. A company is a juristic person and can trade from the date and time that the company is registered, as stated in its registration certificate.⁹ As a juristic person it has all of the legal powers and capacity of an individual,¹⁰ which means it can sue and be sued. Mohamed J stated the following: Among the most important characteristics of a company are its existence as an entity separate from its members, its ability to own property apart from its members, and its continuity in perpetuity.¹¹ Hoexter, JA¹² stated that in a limited liability company, the shareholders and directors are separate legal persons. Shareholders are not liable for any liabilities or obligations of the company¹³ and therefore they are personally protected from legal actions taken by third parties against the company. Hoexter, JA¹⁴ also stated in another case that a shareholder is intitled to the distribution of the surplus assets when the company is wound up. This proves that a shareholder is financially interested in the success or failure of the company, but not that he has any right or title to any assets of the company. In short, a shareholder has a proprietary interest in the company, but not in the business and assets of the company. Shareholders only share in profits when dividends are declared by resolution and authorised by the Board.¹⁵ Any losses will

⁹ Companies Act s 19(1).

¹⁰ Companies Act s 19.

¹¹ Vitamax (Pty) Ltd v Executive Catering Equipment CC And Others [1993] 3 All SA 830 (W) (P 831)

¹² Francis George Hill Family Trust v South African Reserve Bank And Others [1992] 2 All SA 137 (A)

¹³ Companies Act S 19(2).

¹⁴ Stellenbosch Farmers’ Winery Ltd v Distillers Corporation (SA) Ltd And Another [1962] 1 All SA 485 .

¹⁵ Companies Act s 46.

be retained in the company until such time that the company can declare and distribute dividends, after the Board of Directors are assured that the company will satisfy the solvency and liquidity test.¹⁶

PE is by its nature an investment strategy that involves acquiring shares in operating companies to dispose of those shares sometime later at a greater value, thereby offering higher returns to their investors.

An analogy can be made between the relationship among partners and the relationship among members, both requiring *uberrima fides* (unwavering good faith). Such a relationship obliges the members of a company to conduct themselves with respect regarding company matters, in a way that would permit them to rely on one another's good faith and have mutual confidence in their honesty. If the company was a partnership, a member would be justified to terminate a partnership agreement in the event that another member acted in a way that would destroy the trust and mutual confidence that is inherent in the partnership. It would be a member of the company's right to pursue the winding up of the company on the grounds that it was just and equitable.¹⁷ Members (shareholders) of the company are in substance partners, or quasi-partners¹⁸. This was also confirmed by Coetzee J¹⁹: 'it is in substance a partnership in corporate form'.

One of the many purposes of the Companies Act no 71 of 2008 as set out in Section 7, is to achieve optimum conditions for the aggregation of capital, investment in enterprises, and spreading of risks in an economic system.

The affairs of a company are managed by a board of directors,²⁰ and each director has a fiduciary duty towards the company. Directors that are not ineligible or disqualified, can be elected as first directors of the company.²¹ No distinction is

¹⁶ Companies Act S 4.

¹⁷ Tjospomie Boerdery (Pty) Ltd v Drakensberg Botteliers (Pty) Ltd And Another [1989] 4 All SA 228 (T) p 242.

¹⁸ Ebrahimi v Westbourne Galleries Ltd and others [1972] 2 All ER 492.

¹⁹ Rand Air (Pty) Ltd v Ray Bester Investments (Pty) Ltd 1985 2 SA 345 (W) p 350.

²⁰ Companies Act s 66.

²¹ Companies Act s 69(7) + s (69)(8).

made between an executive and non-executive director. Every director must perform their functions as director in good faith and with the degree of care, skill and diligence that may reasonably be expected of a director.²² Should a director breach this duty, they can be held liable for any loss, damages or costs sustained by the company as a consequence of any breach²³. A shareholder will have a claim for damages against a person who intentionally commits fraud or gross negligence.²⁴ The rights of investors are well protected via the MOI of the company – the requirements laid down in the Companies Act and shareholders agreement. However, shareholders are exposed to fraud and negligence by the board of directors who runs the affairs of the company. A director may be held liable in the event of a breach of fiduciary duty, for any loss, damages or costs sustained by the company because of a breach.²⁵ The governance of a company is therefore well regulated and controlled by the Companies Act. In terms of S 180 of the Tax Administration Act no. 28 of 2011²⁶, a person who controls the financial affairs of a taxpayer – which can be a company – can be held personally liable for any outstanding tax debt of the taxpayer. Shareholders are jointly and severally liable to pay the tax debt of a private company within one year prior to its winding up of the company.

To register a company is a simple and inexpensive process. A company exists from the date that it is registered with the Companies and Intellectual Property Commission (CIPC), until its name is removed from the companies register²⁷.

A company must have shares,²⁸ and it can create different classes of shares. However, a company's Memorandum of Incorporation must set out the classes of shares as well as the preferences, rights, limitations and other terms associated with that class, which must be determined by the Board of the company²⁹.

²² Companies Act s 76(3).

²³ Companies Act s 77(2).

²⁴ Companies Act s 20(6).

²⁵ Companies Act S 77(2) and 77(3).

²⁶ Tax Administration Act no. 28 of 2011 s181.

²⁷ Companies Act s 19(1).

²⁸ Companies Act s 35.

²⁹ Companies Act s 36(1).

There are two types of companies: profit companies and non-profit companies. The latter falls outside the scope of this paper.

There are 4 categories of profit companies:

- a state-owned company (not in the scope of this paper);
- a private company where the MOI prohibits it from offering any of its securities to the public, and restricts the transferability of its securities³⁰;
- a personal liability company if it meets the criteria for a private company, and if its Memorandum of Incorporation states that it is a personal liability company³¹;
- a public company in any other case.

Section 8 of the Companies Act defines a profit company as a private company. The Memorandum of Incorporation of a company that is not owned by the state, prohibits it from offering its securities to the public, and limits the transferability of those securities.

A company may only transfer money or property of the company to the holders of a beneficial interest in shares of the company. 'Beneficial interest' extends to nominee entities, assets managers, or similar persons who have the power to dispose of securities for the benefit of their owners.³²

A nominee is a person who holds securities that are registered in their name on behalf of another person. A nominee is therefore the registered legal owner who holds shares on behalf of the beneficial owner. Whenever beneficial interest is used in relation to securities of a company, it refers to the right of a person, alone or jointly, through ownership, agreement, relationship, or otherwise, to receive or share in distributions made by the company.³³

A person who holds a security of a company *nomine officii* (in his official capacity) on behalf of another person, or who acts in accordance with an agreement with

³⁰ Companies Act s 8(2)(b)(ii).

³¹ Companies Act s 8(2)(c).

³² Companies Act s 82(1).

³³ Companies Act s 1.

another person, will have a beneficial interest in that security. In the agreement, the parties will cooperate on matters relating to the acquisition, disposition, or any other matter involving a beneficial interest in that security.³⁴

Any benefit derived by virtue of a beneficial interest in shares therefore accrues to the beneficial owner and not to the legal owner (nominee). A nominee is merely an agent of the beneficial owner. A nominee can be an individual (person), company or a partnership who hold shares in trust on behalf of the beneficial owner. This relationship is governed by an agreement between the nominee and the beneficial owner, which outlines the terms (rights and obligations of the nominee).

The requirements regarding transparency, accountability and integrity of company directors, are well defined by the Companies Act.

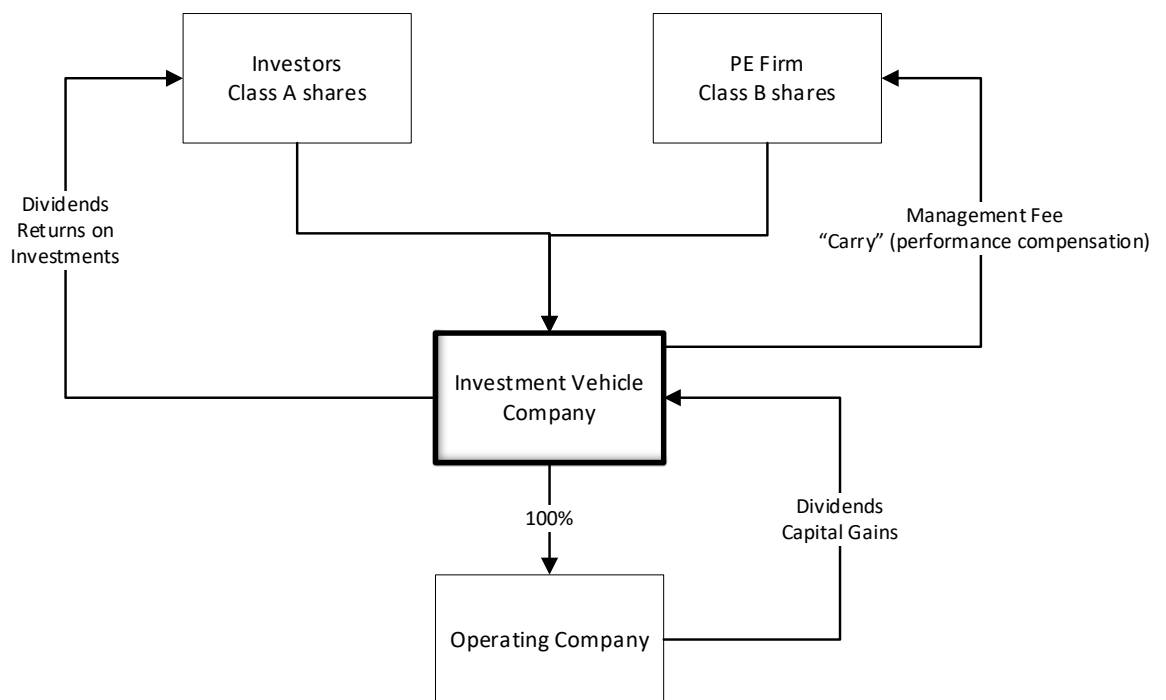


Figure 1 - Company Structure

3.1.1 Dissolution of a company

A company may be dissolved in different ways:

³⁴ Companies Act s 56(2).

- In a solvent company, the company itself or the creditors may apply for voluntary winding-up, following the adoption of a special resolution.³⁵
- If the company is insolvent, a court must issue an order for the company to be wound up.³⁶
- A solvent company may also be wound up by a court order under specified conditions as set out in s 81 of the Companies Act. The following parties may apply for winding-up under s 81 namely, the company, a shareholder, a creditor, a business rescue practitioner, the Companies and Intellectual Property Commission.

Once a company has been wound up completely, the Master of the High Court will file a certificate for winding up with the Companies and Intellectual Property Commission, who will then remove the company's name from the companies register.³⁷

3.1.2 Advantages of a company

- A company is a legal entity and exists separate from the shareholders.
- A company owns the underlying assets, which are protected from creditors.
- Changes in shareholders do not affect the trading of the company.
- Different classes of shares with different terms, rights and limitations can be set up.³⁸
- The business can be sold as a going concern by selling all the shares.
- Retained earnings can be retained and re-invested back into the business, after payment of corporate income tax on profits of 28%.

3.1.3 Disadvantages of a company

- A company is more complex and expensive to set up.

³⁵ Companies Act ss 79 + 80.

³⁶ Companies Act s 79(3).

³⁷ Companies Act s 82.

³⁸ Companies Act s 36(2).

- The governance formalities of companies are extensive and more costly to administer.
- Taxation of income is focused on entity level, with limited pass-through opportunities to shareholders.
- Income can only be distributed via dividends, which attract withholding tax on dividends.

3.2 Taxation of Companies

3.2.1 Introduction

Should a PE firm opt to utilise a company as investment vehicle, there are specific tax implications to be considered. A company is a legal entity and is taxed in its own right,³⁹ separate from the owners. A company is therefore subject to corporate income tax. Any distribution of after-tax income may be subject to withholding tax on dividends, that will be discussed in paragraph 3.2.4. A further tax applicable to companies, is Security Transfer Tax that will be discussed in paragraph 3.2.3. The ultimate goal of a PE firm and their investors is to maximise the return after tax. With this goal in mind, the different taxes imposed on companies are therefore a challenge.

3.2.2 Normal Income tax

The current corporate income tax rate is 28%.⁴⁰ The Minister of Finance proposed a reduction in the corporate income tax rate to 27%, commencing on or after 1 April 2022.⁴¹

3.2.3 Securities Transfer Tax

Securities Transfer Tax is levied at the rate of 0.25% of the taxable amount – on the transfer, sale or disposal of shares in a company (securities), whenever there

³⁹ Income Tax Act No 58 of 1962 ('ITA') s5(1)(d).

⁴⁰ Rates and Monetary Amounts and Amendment of Revenue Laws Act No 22 of 2020, Schedule 1 para 3(a).

⁴¹ Mboweni TT, *Budget speech 2021* (2021) p 9.

is a change in beneficial ownership of the shares.⁴² Section 1 of the repealed Uncertificated Securities Tax Act No 31 of 1998, defined beneficial ownership as entitlement to dividends and voting rights. The provisions of this act in respect of any change in beneficial ownership, still apply as if the act had not been repealed.⁴³

The taxable amount is the market value of the consideration given for the unlisted security. The company that issued the unlisted securities is liable for the payment of transfer tax.⁴⁴ However, the company can recover the tax from the person to whom the security was transferred.⁴⁵

3.2.4 Dividends General

Distributions made by a resident company to shareholders for their benefit, are defined as dividends, and with certain exceptions they are subject to dividends withholding tax of 20%.⁴⁶ Tax that is so levied, should be withheld by the company that declares and pays a dividend,⁴⁷ although the beneficial owner of the dividend is liable for the tax of that dividend. The consequence is an effective tax rate of 42.4% on net income distributed to investors (individuals), subject to dividends tax, irrespective of the marginal tax rate of the individual. The effective tax rate of 42.4% equals 28% corporate income tax on profits, plus a further 20% withholding tax on dividends, applicable to the after-tax income from which dividends were declared. Withholding tax on dividends therefore creates a flat tax rate that applies to all shareholders, irrespective of their marginal tax rates. A shareholder with a low marginal tax rate therefore does not receive the benefit of their low rate, as the tax is levied in the company, and it is not in the hands of the individual.

The beneficial owner of a dividend is liable for the tax on the dividend. A beneficial owner is the person entitled to the benefit of the dividend attached to a share⁴⁸.

⁴² Securities Transfer Tax Act no 25 of 2007 ('STT') s 2.

⁴³ STT s 11(2).

⁴⁴ STT s 6.

⁴⁵ STT s 7(2).

⁴⁶ ITA s 64E(1)(a)(i).

⁴⁷ ITA s 64G(1).

⁴⁸ ITA s 64D.

The OECD Model Tax Convention on Income and on Capital (2017) takes it a step further. In paragraph 12.6 on the commentary on article 10 that deals with taxation on dividends, it states that the term 'beneficial ownership' refers to ultimate beneficial ownership or interest by a natural person. The person with ultimate beneficial ownership is considered to be the person entitled to use and enjoy the dividends in any way that they desire without restriction.

In the Federal Court of Appeal in Canada, Décarry J.A.⁴⁹ confirmed the ruling by Justice Rip in the Canadian Tax Court, that the 'beneficial owner' of dividends is the person who receives the dividends for their own use and enjoyment, and assumes the risk and control of the dividend they receive. He also confirmed that when it comes to corporations, one does not pierce the veil, unless the corporation acts as an avenue for another person and does not have any discretion regarding how the funds it receives will be used or applied. Furthermore, the principle also applies if a person agrees to perform actions on someone else's behalf on their instructions, and they have no right to do anything other than what they were instructed to do.

Dividends are exempt from normal tax,⁵⁰ which means it will not be subjected to double taxation.

There are several exemptions⁵¹ from dividends tax, where the beneficial owner of the shares is :

- A company which is resident. Whenever this company declares and pays a dividend to a person as shareholder, that dividend will be subjected to dividends tax.
- A pension fund, pension preservation fund, provident fund, provident preservation fund or retirement annuity fund or a beneficiary fund,⁵² i.e. an

⁴⁹ Her Majesty the Queen v Prévost Car Inc [2009] (FCA 57) p13.

⁵⁰ ITA s 10(1)(k)(i).

⁵¹ ITA s 64F(1).

⁵² ITA s 10(1)(d)(i).

association/business that manages death benefits payable to members of a pension fund.⁵³

A nominee (regulated intermediary)⁵⁴ who holds the registered shares on behalf of a shareholder and who may be the registered owner of the shares, merely acts as an agent for a shareholder on their instructions.⁵⁵ A nominee is not the beneficial owner of shares and hence the dividends will not be taxed in their name. Article 10 para 12.4 of the OECD Model Tax Convention on Income and on Capital (2017), states that (agent, nominee, conduit company acting as a fiduciary or administrator), direct recipients of dividends are not "beneficial owners," because their right to use and enjoy the dividend is limited by contractual or legal obligations to pass on the payment received to another person. A legal obligation of this type is usually derived from relevant legal documents. It can also be established, based on facts and circumstances that clearly show that in substance, the recipient does not have an unconstrained right to use and enjoy the dividend. The payment received must then be passed on to another person.

Where a company pays a dividend to a nominee, the company should not withhold dividends tax.⁵⁶ The nominee must withhold tax on the dividends when it is paid over to the beneficial owner.⁵⁷

3.2.5 Dividends on Preference Shares

General

PE firms often invest in operating companies to provide expansion capital, as they consider the business to provide good returns in line with their mandate.

One way to provide funding to an operating company, is for the operating company to issue preference shares, with a predefined dividend rate that is often

⁵³ Pension Funds Act No. 24 of 1956 s 1.

⁵⁴ ITA s 64D - regulated intermediary para (d).

⁵⁵ Oakland Nominees (Pty) Ltd v Gelria Mining & Investment Co (Pty) Ltd 1976 SA 441 (A) p453.

⁵⁶ ITA s 64G(2)(c).

⁵⁷ ITA s 64H(2).

linked to an interest rate. These dividends have preferential rights to ordinary dividends.

Should preference shares be interest-bearing (preference shares secured by a financial arrangement), dividends paid from these shares are deemed to be income. The company paying the dividend will not be allowed to deduct the dividend as an interest expense, because it is deemed to be income and not interest.⁵⁸ However, an exception to this condition is where preference shares were issued for a qualifying purpose,⁵⁹ in which event s 8E will not apply. Qualifying purpose means 'funds derived from the issue of a preference share' that were utilised to acquire equity shares (directly or indirectly) 'in an operating company [at the time] of the receipt or accrual of any dividend or foreign dividend in respect of that preference share.'⁶⁰ Operating company in turn is defined as any company that conducts continuous business and provides goods or services for consideration in the course or furtherance of business.⁶¹ The term [at the time] is important, as the implications will now be dealt with. The timing (date) of investment in an operating company is therefore important.

There is an apparent inconsistency between an operating company within the definition of qualifying purpose,⁶² and a general understanding within the definition of an operating company. Does this mean that the operating company must have been an operating company (as defined) [at the time] of the receipt or accrual of any dividend in respect of that preference share? One can argue it is obvious as a non-operating company cannot declare dividends. Or must it be an operating company [at the time] when the proceeds from the issue of the preference shares were utilised to acquire the equity shares?

In Binding Private Ruling 228 (lapsed 31 October 2018) that deals with the definition of 'Operating Company' and 'Qualifying Purpose' and whether a newly established company will be regarded as an 'operating company', SARS stated that

⁵⁸ ITA s 8E(1)(c)(i) of hybrid equity instrument.

⁵⁹ ITA s 8E(c) of hybrid equity instrument.

⁶⁰ ITA s 8EA(1) .

⁶¹ ITA s 8EA(1)(a) of operating company.

⁶² ITA s 8EA(1) qualifying purpose.

'[At the time] of the investment in the Project company (timing of investment), the Project company will not be operating and will not be providing the goods or services it intends to provide for consideration.' It was therefore ruled that the Project company will not be an 'operating company' as defined, with the legal consequence that preference shares issued, fall within the definition of a hybrid equity instrument.

Centlivres JA⁶³ stated that the Court is concerned with the deductions which are permissible according to the language of the Act. This principle was confirmed by Wallis JA in the Endumeni case,⁶⁴ which is regarded in South African law as the *locus classicus* of interpretation, where the following principles were laid down:

- consideration must be given to the language used considering the ordinary rules of grammar and syntax;
- the context in which the provision appears (context and language must be considered together);
- the apparent purpose to which it is directed; and
- the material known to those responsible for its production (intention of the legislature).

Any dividends derived from equity instruments, funded with the proceeds from preference shares which were not issued for a qualifying purpose, are deemed to be income and not dividends, in relation to recipients thereof.⁶⁵ A BPR is issued in favour of an applicant(s) and cannot be applied in general by other taxpayers, as it does not constitute a practice generally prevailing⁶⁶. This ruling can be cited in a case and may have persuasive authority. However, following the approach adopted in the Endumeni case with regard to the interpretation of 'qualifying purpose' in S8EA(1), it is submitted that qualifying purpose means that the operating company, must be an operating company [at the time] when the dividend in respect of that preference share is received or accrued to the holder

⁶³ Sub-Nigel Ltd v CIR 15 SATC 381 (1948) (SCA – 3 judges) p 389 .

⁶⁴ Natal Joint Municipal Pension Fund v Endumeni Municipality [2012] JOL 28621 (SCA – 5 judges) para 18 p15.

⁶⁵ ITA s8E.

⁶⁶ Tax Administration Act ('TAA') no. 28 of 2011 s 82(4).

thereof, and not [at the time] when an investment is made in an operating company.

Where a PE firm utilises a company as an investment vehicle, caution must be exercised when issuing preference shares to fund the acquisition of equity shares in a newly established business (operating company). At the outset the operating company may be in a construction phase and not yet 'carrying on business continually' and in the course of that business, provide goods or services for consideration. From a taxation point of view, the period from date of registration of a company until the date the company starts to produce goods and services for consideration, will not be regarded as an operating company within the definition of ITA s 8EA(1).

To date this matter has not yet been tested in a court of law.

It is thus important for PE firms to avoid issuing preference shares as a means of funding a start-up operating company.

3.2.6 Dividends on hybrid equity instruments

General

S 8E of the ITA is an anti-avoidance provision that classifies the distribution of income from a hybrid equity instrument as income, as opposed to a dividend. Where dividends are paid on a hybrid equity instrument, the dividend will be deemed as income in the hands of the recipient,⁶⁷ and the interest exemption⁶⁸ is not available, as the amount is deemed to be income.

Definitions

A hybrid equity instrument is any share where

- the issuer must redeem the share, or the holder of the share has an option for the share to be redeemed within three years from date of issue of the share.⁶⁹

⁶⁷ ITA s 8E(2).

⁶⁸ ITA s 10(1)(i).

⁶⁹ ITA s 8E(1)(a)(i) hybrid equity instrument.

- the issuer must redeem those shares within three years, or holders of those shares have the option of redeeming them within three years, or the company issuing those shares is dissolved within three years and those shares do not rank equally in the distribution of dividends of equity shares.
- the preference share is secured by a financial instrument, unless it was issued for a qualifying purpose.⁷⁰

From the above conditions it is evident that these shares do not have the characteristics of equity shares, but rather of debt instruments. The ITA therefore tax distributions of income in terms of its substance and not the legal form.

Exceptions

Should the redemption or conversion date be more than three years after the date of issue of the shares, the shares will not be constituted as a hybrid equity instrument.

Before issuing preference shares to raise capital, PE firms should consider whether they intend to keep the shares for three years before they convert or redeem them.

3.2.7 Extraordinary dividends

Dividends are exempt from normal tax, however there is an exception when shares are disposed.

When a PE firm disposes of shares in an operating company while they have a **qualifying interest** (50% or more) in the company, and they received **extraordinary dividends** in the 18 months prior to disposal, those extraordinary dividends will be included in the proceeds upon disposal of those shares.⁷¹ These extraordinary dividends are therefore not exempt from tax. Dividends on preference shares are defined as 'extraordinary dividends', where dividends

⁷⁰ ITA s 8E(1)(c)(i) hybrid equity instrument.

⁷¹ ITA 8th schedule para 43A(2).

received on these shares exceed 15% per annum of the consideration for which those shares were issued⁷².

A PE firm is deemed to have a **qualifying interest** in an operating company, if that firm has 50% of the equity shares or voting rights, or 20% of the equity shares or voting rights, where no other person has a majority share in the company.

Extraordinary dividends in relation to equity shares, are dividends received within a period of 18 months prior to the disposal of those shares, where the dividends so received or accrued, are more than 15% of the market value at the beginning of 18 months, or 15% of the market value at date of disposal, whichever is higher. Dividends up to 15% of market value will be exempt.

Where the PE firm does not have a qualifying interest with regard to either preference shares or equity shares, paragraph 43A will not apply, and dividends received prior to disposal will be treated as exempt dividends.⁷³

Although PE firms can own majority stakes in operating companies, they need to exercise caution in relation to dividends received during the 18 months preceding the sale of the shares.

3.2.8 Capital Gains Tax – disposal of shares

Equity shares held for less than three years, may attract income tax on the profit made, should the shareholder be unsuccessful to prove that the shares were held as an investment. The primary intention⁷⁴ and dominant purpose⁷⁵ with which a shareholder acquired and held equity shares, are key factors that will be considered by SARS to determine whether the disposal of shares is income or capital. Two factors which are always of great importance in deciding whether the proceeds of the sale of property are of a revenue or of capital nature are:

- the intention with which the taxpayer acquired the property (shares), and

⁷² ITA 8th schedule para 43A(1) extraordinary dividends.

⁷³ ITA 8th schedule para 43A(1) exempt dividend.

⁷⁴ CIR v Stott 3 SATC 253 (1928) (SCA) p 254.

⁷⁵ Bloch v Secretary for Inland Revenue 42 SATC 7 (Cape Provincial) p 14.

- the circumstances in which the property (shares) were sold⁷⁶.

In terms of S9C(2) of the ITA, amounts received with regard to the disposal of equity shares that were held for a period of at least three years, are deemed to be of a capital nature. Any capital gain or loss in respect of a disposal of these shares, will be subject to Capital Gains Tax (CGT).⁷⁷

To qualify as capital on date of disposal, the three year period⁷⁸ will apply, from date of issue of the capitalisation shares when the shareholders became unconditionally entitled to the shares.

This is a key reason why PE companies remain shareholders in an operating company for at least three years – to ensure that a gain on disposal will be deemed to be of a capital nature.

3.2.9 Capital Gains Tax – S12J Venture Capital

Amounts received with regard to disposal of Venture Capital shares acquired in terms of s 12J of the ITA, are deemed to be of a capital nature, provided that the shares were held for longer than five years, and the disposal amount is not greater than the expenditure allowed in respect of that share in terms of section 12J(2).⁷⁹

This requirement remains applicable, despite the fact that S12J has been repealed from 30 June 2021. Should these shares be disposed of before a period of five years, it will be included in taxable income.⁸⁰

3.2.10 Capital Gains Tax - Capitalisation shares

When a company issues capitalization shares to shareholders, it merely converts retained income (undistributed profits) to shares. No distribution takes place. CTC includes capitalisation shares as the company has not received any consideration for the issue of these shares⁸¹.

⁷⁶ Commissioner for South African Revenue Service v Wyner [2003] 4 All SA 541 (SCA) p 4.

⁷⁷ ITA 8th Sch para 11.

⁷⁸ ITA s 9C(2).

⁷⁹ ITA s 9C(2A).

⁸⁰ ITA s 12J(9).

⁸¹ ITA S 40C.

3.2.11 Capital Gains Tax – Share buy-back

Capital gain or loss in respect of shares that meet the criteria of contributed tax capital (CTC), will be of a capital nature and subject to Capital Gains Tax (CGT).

Furthermore, dividends exclude shares in a company.⁸² Should a company repay any share capital to shareholders (share buy-back), any part of that repayment that does not constitute CTC, will therefore be a dividend and subject to dividends tax. Should a PE firm have an investment period that goes back prior to 1 January 2011, and they decide to repay CTC to shareholders, the same principle applies, irrespective of into which class of shares capitalisation shares were converted. The ITA introduced the concept of contributed tax capital with effect from 1 January 2011.

The CGT inclusion rate where a company is a shareholder is 80%.⁸³ With a statutory income tax of 28%, the effective rate is 22.4% (80% x 28%).

3.3 Conclusion

The governance of a company is well codified in the companies act.⁸⁴ It includes the legal duties and responsibilities of the Board and its directors. The results of actions taken by a board are open and transparent to shareholders and provide a great deal of comfort to shareholders regarding the way their investments in a company are managed.

As a legal entity, companies are subject to corporate income taxes, which is the first layer of tax on income. With a few exceptions, a second layer of tax is dividends withholding tax levied on beneficial owners, when profits in a company are distributed. Therefore income does not flow through to the ultimate beneficial owner without being taxed. With corporate income tax of 28% and a further 20% withholding tax on dividends of 20% (with a few exceptions), the after tax income to the ultimate beneficial investor may be 57.6% of the initial income. This is a challenge for PE firms, to decide on the best investment vehicle to secure

⁸² ITA s 1(1) dividend para b(ii).

⁸³ ITA 8th schedule para 10(c).

⁸⁴ Companies Act part F.

the highest possible returns after tax to the initial investors. Transparency from a fiscal point of view is low, as entity level tax is high. The conduit principle does therefore not apply where the PE investment vehicle is a company.

The disposal of equity shares held for at least three years, are deemed to be of a capital nature. Should it be held for less than three years, it may attract normal income tax on the profits made, provided the shareholder can prove that the shares were held as an investment. The anti-avoidance provisions apply within the first three years of investment, not thereafter. A key reason why PE firms invest in operating companies for at least three years, is to stay clear of anti-avoidance provisions, and to ensure that disposal of equity shares will be a capital gain and not an income.

Another investment vehicle used by PE firms are trusts that will be discussed in the following chapter – Chapter 4.

CHAPTER 4 TRUSTS

4.1 Characteristics of a Trust

In terms of S1 of the Trust Property Control Act No. 57 of 1988, a Trust is an arrangement in which ownership (dominium) in property of one person is entrusted to a trustee,

- only to be administered or disposed of, or
- to hold trust property under their control and to administer and dispose it.

This is in accordance with the provisions of the trust instrument for the benefit of the beneficiaries, or for the accomplishment of the trust's specified objectives. A trust deed (trust instrument) must be carefully drafted, and it includes inter alia the objective of the trust, nomination of beneficiaries, rights, powers and obligations of trustees and administrative powers such as trustee meetings, voting powers, dispute resolution and veto rights. The only powers available to trustees are defined in the trust deed. The trust instrument must then be lodged with the

Master of the Supreme Court to be authorised.⁸⁵ Trust property must also be registered with the Master.⁸⁶ Once a bank account has been opened⁸⁷ and all legal formalities have been complied with, a trust can commence business.

Section 1 of the Companies Act 71 of 2008 states that a 'juristic person' includes a trust. This does not impose a legal personality on a trust, but rather controls the relationships among juristic persons⁸⁸. Nugent JA⁸⁹ stated that a trust, established by a trust deed, is not a legal person. As defined by the authors of Honoré's South African Law of Trusts, it is a special kind of legal relationship where an individual, known as a trustee, holds or administers property in the name of another individual or group separately from their own. It may also be for charitable reasons or to benefit another individual or group.

The fact that a trust is not a legal person, was also confirmed by Mayat AJ,⁹⁰ who stated that while a trust is not a legal person in the same manner as juristic entities such as companies, beneficiaries of trust assets have notionally different rights from trustees in such trusts. A trust can therefore not sue or be sued.

Role of Trustees

Trustees act as custodians of the trust property on behalf of the beneficiaries, and are appointed in terms of a trust instrument (deed) that must be authorised by the Master of the Supreme Court to act as trustees.⁹¹ Cameron JA⁹² stated that no objection can be made to business trusts as long as trustee functions are distinct from beneficial interests. Trustees have a fiduciary duty to the fund, its members and other beneficiaries.⁹³ Although a trust cannot be sued, trustees can be sued in their official capacity as trustees. Trustees are jointly and severally liable for damages, and they can be sued by beneficiaries or third parties if they act

⁸⁵ Trust Property Control Act s 4.

⁸⁶ Trust Property Control Act s 11.

⁸⁷ Trust Property Control Act s 10.

⁸⁸ Companies Act s 2(1)(c).

⁸⁹ *Lupacchini NO and another v Minister of Safety and Security* [2011] 2 All SA 138 (SCA).

⁹⁰ *WT and others v KT* [2015] JOL 32977 (SCA) p 10.

⁹¹ Trust Property Control Act s 6.

⁹² *Land and Agricultural Bank of South Africa V Parker and Others* 2005 (2)SA 77 (SCA).

⁹³ *PPWAWU National Provident Fund v CEPPWAWU* [2007] JOL 20463 (W) p9.

negligently in breach of due care, diligence and skill. Any provision in a trust instrument that exempts or indemnifies a trustee against liability for breach of trust where they fail to show the degree of care, diligence and skill, shall be void.⁹⁴

Financial institutions or nominee companies do not own trust properties as part of their assets or funds which they manage, control or administer⁹⁵. Furthermore, trust property must be kept separate from assets belonging to trustees, and it must clearly indicate in their books of account that these assets belong to a specified principal.⁹⁶ Scott JA⁹⁷ stated that a trustee must avoid as far as possible a conflict between their personal interests and those of the beneficiaries.

Joubert, JA⁹⁸ stated that although the trustee owns the trust property for purposes of administration, he does not have a beneficial interest in it as trustee. Therefore, if the trust fails or come to an end, he does not acquire personal ownership of it.

Vested Trust

Assets and income of the trust vest in beneficiaries. Here the beneficiary's right to income and capital is certain. Watermeyer J.A.⁹⁹ defined vesting as a right vested in a person, which means that he has all the rights of ownership in that right, including the right to enjoy it. As long as the word vested is always used in that sense, then saying a man owns a vested right, merely means that he owns a right. Moreover, it is used in another sense to distinguish what is certain from what is contingent – a vested right as opposed to a contingent or conditional right.

Ownership (*dominium*) of trust assets may vest in beneficiaries, but it may still be controlled by the trustees.

⁹⁴ Trust Property Control Act s 9(2).

⁹⁵ Financial Institutions (Protection of Funds) Act no. 28 of 2001 s 4(5).

⁹⁶ Financial Institutions (Protection of Funds) Act no. 28 of 2001 s 4(4).

⁹⁷ *Jowell v Bramwell-Jones and others* [2000] 2 All SA 161 (A) p 167 para 16.

⁹⁸ *Braun v Blann and Botha* NNO 1984 2 SA 850 (A).

⁹⁹ *Jewish Colonial Trust Ltd Appellant v Estate Nathan Respondents* 1940 AD 163 p 175.

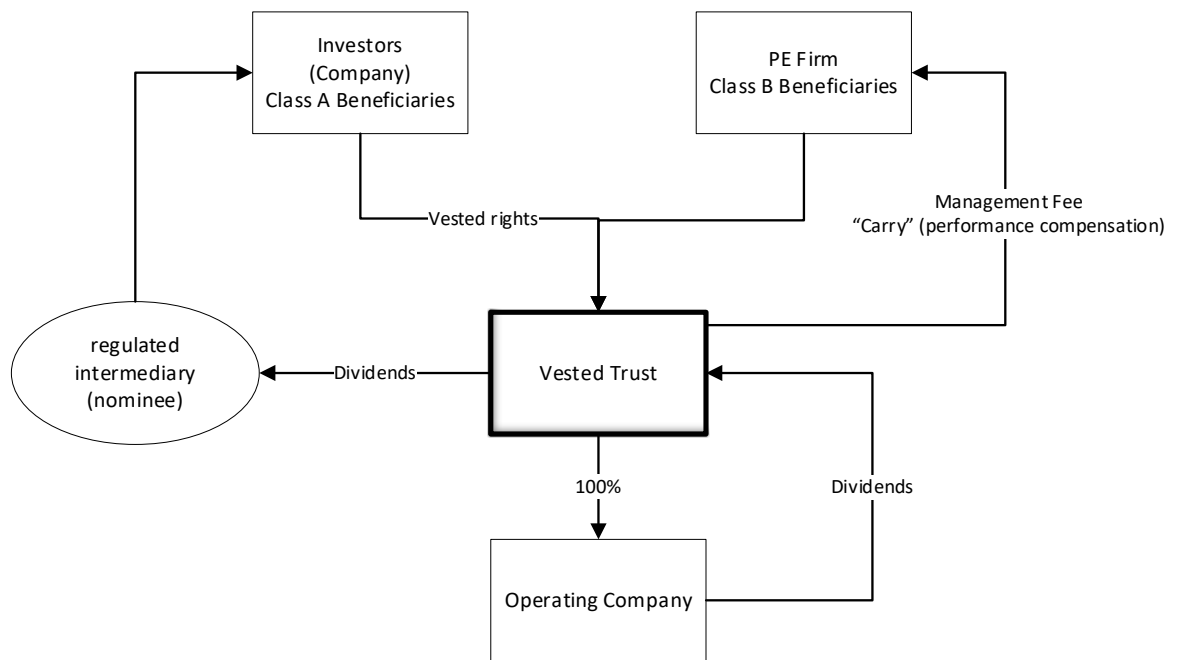


Figure 2 - Vested Trust

4.1.1 Bewind Trust

In a *bewind* trust, ownership of the assets (income and capital) vests in the beneficiary, and trustees only administer the assets.¹⁰⁰ When a PE firm utilises a *bewind* trust as an investment vehicle, the trust assets are owned by the beneficiaries (investors). PE firms only act as trustees who administer and control the trust assets.

Beneficiaries who hold trust assets in a *bewind* trust, lose the protection provided by a trust if these assets are held by the trust. Should a beneficiary pledge these assets as security on debt, the full liability will be borne by the beneficiary. Any security held against these assets, will be a liability against the beneficiaries. Where the assets are held by the trustees on behalf of the beneficiaries, the assets of the beneficiaries are protected from legal disputes and creditors.

¹⁰⁰ Bafokeng Tribe v Impala Platinum Ltd [1998] JOL 3619 (B) p 47.

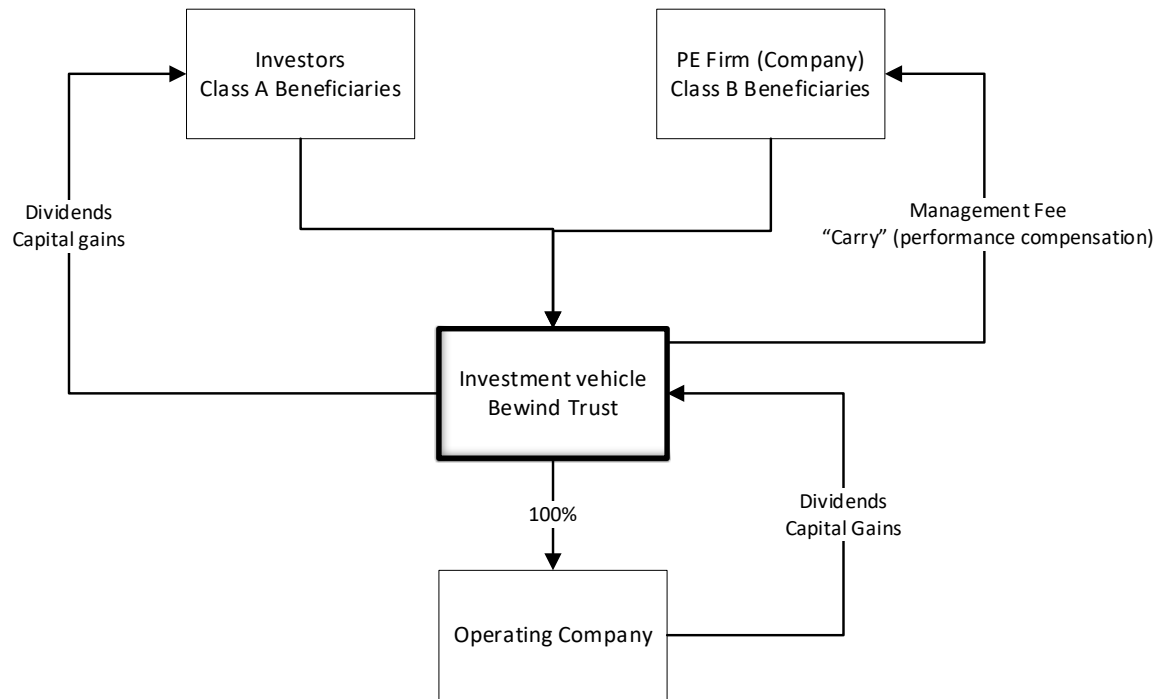


Figure 3 - Bewind Trust

4.1.2 Discretionary Trust

In a discretionary trust ownership of the assets vests in the trustees, and the trustees also have discretion with regard to the distribution of income and capital. A beneficiary's right to income and capital is therefore conditional upon a decision by the trustees. The moment (date) that a beneficiary acquires a personal right (*des cedit*) in income, is the date that the income vests in the beneficiary.

Where the trust is set up as a discretionary trust, with no explicit rules in the trust deed about income distribution, the trustees are generally free to make income distributions to certain beneficiaries, with no obligation to benefit all the beneficiaries. It is highly unlikely that this will happen in a PE firm, as investors will not agree to such conditions, but it is a risk. From a practical point of view it is important that trustees draft a resolution prior to the financial year end, whereby they distribute the income in the trust to beneficiaries. It is important that the wording of the resolution should be done in such a way that beneficiaries receive a vested right in income, prior to financial year-end, to avoid any potential tax implications.

4.1.3 Dissolution of a Trust

There are no legal requirements applicable to the termination of a trust. The following general principles will apply:

- Conditions defined in a trust deed may specify when a trust should be dissolved.
- If there are provisions in the trust deed that prevents the trustee from accomplishing the objectives of the trust, is detrimental to the beneficiary's interests, or is in conflict with the public interest, then the trustee or an individual holding an interest in the trust, may apply to a court to terminate the trust.¹⁰¹

4.1.4 Advantages of a Trust

- The rights and responsibilities of trustees can be well defined in a trust instrument (deed).
- Trust income and capital vested in beneficiaries will be taxable in their names and not in the trust.
- Trust property vested in a trust are protected from creditors.
- The rights of beneficiaries can be clearly outlined in a trust deed.

4.1.5 Disadvantages of a Trust

- Beneficiaries with vested rights in assets do not have the protection of a trust.
- The entire trust is governed by a trust deed. Insufficiently drafted trust deeds may expose beneficiaries to potential risk.
- Trust income is taxed at a flat rate of 45%.

¹⁰¹ Trust Property Control Act no 57 of 1988 s 13.

4.2 Taxation of Trusts

4.2.1 Introduction

A trust is not a legal person, however, in terms of section 1¹⁰², the definition of a person includes a trust. The ITA has therefore given legal personality to a trust for tax purposes.

ITA s 1 also defines the term resident to include a 'person (other than a natural person) which is incorporated, established or formed in the Republic or which has its place of effective management in the Republic.' The fact that a trust (person) has a trust deed that is registered and approved by the Master of the High Court in the Republic, confirms that a trust thus registered, is resident in South Africa and subject to income tax and CGT in South Africa.

Any amount received by or accrued to any person during any year of assessment in the person's capacity as the trustee of a trust (other than a capital amount or a lump sum recoverable from a pension fund or insurer) will, subject to the provisions of section 7 of the ITA, be dealt with in two ways. Should the amount be derived for the immediate or future benefit of any ascertained beneficiary who has a vested right to that amount during that year, it will be deemed to be an amount which has accrued to that beneficiary. However, should the amount not be derived for the benefit of a beneficiary, it will be deemed to be an amount which has accrued to the trust.¹⁰³

4.2.2 Vested Right

The term vested right means a right that is vested completely and unconditionally in a specific individual as a property interest. A vested right cannot be impaired or revoked by retroactive legislation without the explicit consent of that individual.

In the Ochberg case,¹⁰⁴ it was found that when a right to payment is unconditional and has a money value, the right accrues to the payee as they are legally entitled

¹⁰² ITA s 1.

¹⁰³ ITA s 25B(1).

¹⁰⁴ Ochberg v CIR 6 SATC 1 (1933)(Cape Provincial) .

to payment, and the amount is regarded as part of their 'gross income'. The principle of vested right was also confirmed to be a legal right to claim payment, even if it is in the future.¹⁰⁵

Where a beneficiary acquired a vested right in income as a result of the discretion exercised by a trustee, the amount will be deemed to have been derived for the benefit of that beneficiary.¹⁰⁶ It is therefore evident that a beneficiary's right to the trust's income will determine whether the income is taxed in the beneficiary's hands, or in the hands of the trust. Vesting takes place on the date that the trustees exercise their discretion and income accrues to the beneficiary.¹⁰⁷

Income retained in a trust (excluding special trust) is taxed at a flat rate of 45%.¹⁰⁸ With the objective of a PE firm to maximise after tax returns for investors, it will be counterproductive to retain any income in the trust, as it will be taxed at 45%.

4.2.3 *Bewind* trust from tax perspective

Ownership of assets and resultant income from those assets, vest in the beneficiary. This means that a beneficiary in a *bewind* trust will be taxed on the income from those assets and will be subject to CGT should the assets be disposed. All income tax payable will be in the hands of the beneficiaries. A PE firm will only administer the assets, and the trust will therefore not attract any income tax or CGT.

4.2.4 Conduit (flow-through) Principle in a trust

Income that passes through a trust, retains its identity and the trust acts merely as a conduit pipe through which the income flows.¹⁰⁹ The principle is that income retains its character in the hands of the beneficiary. If the trust receives dividends, the beneficiary receives dividends too.

¹⁰⁵ Commissioner for Inland Revenue v People's Stores (Walvis Bay) (Pty) Ltd 52 Satc 9 (SCA)

¹⁰⁶ ITA s 25B(2).

¹⁰⁷ Merriam-Webster.com Legal Dictionary, Merriam-Webster, <https://www.merriam-webster.com/legal>.

¹⁰⁸ Rates and Monetary Amounts and Amendment of Revenue Laws Act No 22 of 2020, Schedule 1 para 2.

¹⁰⁹ Armstrong v CIR 10 SATC 1 (1938)(SCA – Full bench) p6.

Trollip JA¹¹⁰ made a comment in the case and said that he expresses no firm view, that a trustee may use his discretionary right not to pass on dividend receipts to a beneficiary, but rather retain and accumulate it in the trust. When dividends are subsequently paid to the beneficiary, their identity and character as dividends may change. It may not be dividends in the beneficiary's hands, because the conduit-pipe had turned off at the relevant time. The consequence is that these "dividends" may then be taxed as income at a rate of 45%, as opposed to the flow-through to the beneficiary where it will be subject to withholding tax only. To date the continuation of the conduit-pipe has not yet been tested by the courts where dividends are received in one year, but only paid out to beneficiaries in a subsequent year.

4.2.5 Exemptions, deductions and allowances

Interest received by a non-resident is exempt from normal tax¹¹¹. Dividends received or accrued by any person, are exempt from normal tax¹¹², however, should these amounts be paid out in the form of an annuity to beneficiaries, the exemption with regard to these deductions will not apply.¹¹³

Tax deductions or allowances must be apportioned between the trust and the beneficiary in the same ratio as the corresponding income is deemed to have been received by the trust and beneficiary.¹¹⁴ Deductions and allowances attributable to a beneficiary, are limited to the income received by or accrued to the beneficiary from the trust¹¹⁵. Any excess of these deductions and allowances can be set off against income attributable to the trust, provided it does not create an assessed loss in the trust.¹¹⁶ Should there still be an excess left of these deductions and allowances in the trust (up to the point where it does not create an assessed loss) the remainder will be deemed to be deductions and allowances to be set off

¹¹⁰ CIR v Rosen 32 SATC 249 (1970)(SCA – Full bench) p 270.

¹¹¹ ITA s 10(1)h.

¹¹² ITA s 10(1)(k).

¹¹³ ITA s 10(2)(b).

¹¹⁴ ITA s 25B(3).

¹¹⁵ ITA s 25B(4).

¹¹⁶ ITA s25B(5).

against taxable income of the beneficiary in the immediate succeeding year of assessment.¹¹⁷

Neither the trust nor the beneficiary can therefore create a loss from income derived from the trust. In the early years of an investment by a PE firm in a new venture, this is likely to be the scenario, as income only starts to flow to the trust in later years.

4.2.6 Dividends received

PE firms generally invest in operating companies and may receive dividends as a result. PE firms often have companies that invest in the PE's ventures. Where a trust is utilised as an investment vehicle, companies invested in the venture will be beneficiaries in the trust.

A resident company is defined as a person within the context of deemed beneficial owners of dividends¹¹⁸. In terms of s 10(1)(k) of the ITA, dividends received or accrued to a person are exempt from normal tax. There is a specific exception with regard to the s 10(1)(k) exemption that relates to trusts. Where a trust holds shares in an operating company and other companies are beneficiaries of the trust, the s 10(1)(k) exemption does not apply to any dividend received by a company 'in consequence of the exercise of a discretionary power by any trustee of a trust'. The exception is where a cession or exercise results in that company holding all of the rights attached to a share'(vested right).¹¹⁹ This measure prevents PE firms who invested in a high-growth operating company by means of a trust, from 'stripping' cash via a tax exempt dividend, and transferring 'cash' tax free to a specific beneficiary company. If the exercise of discretionary power by trustees does not result in holding of all of the rights attached to a share by the beneficiary company, the beneficiary company will lose its s 10(1)(k) exemption with regard to income tax on dividends, and they will be taxed on their dividends as income.

¹¹⁷ ITA s25B(6).

¹¹⁸ ITA s 64EB(2)(a)(i).

¹¹⁹ ITA s 10(1)(k)(i)(ee)(B).

An operating company that pays dividends to a trust, (that has resident companies as beneficiaries which have vested rights to the income of the trust) who then pays over the dividends to a regulated intermediary (nominee), must withhold dividend tax on those dividends paid to the trust. A trust is not a regulated intermediary as defined in S 64D and therefore subject to the exemption afforded by s 64G(2)(c) of the ITA. If the regulated intermediary (nominee) submits a declaration on behalf of the beneficial owner (company) to the operating company (before the dividend is paid), stating that the dividend is exempt from dividends tax in terms of section 64F(1)(a), the operating company must not withhold any dividends tax.

If the operating company withheld dividends tax in terms of S64G(1) because the declaration was not received in time, the trust can claim back a refund of dividends tax withheld,¹²⁰ if it provides

- a declaration to the operating company (on behalf of the beneficial owner of the dividend – a company) that the dividend would have been exempted in terms of s 64F(1)(a), and
- a written undertaking that it will inform SARS if there is any change in the beneficial ownership of the shares.¹²¹ The trust will then pay over that refund of dividends tax to the regulated intermediary (nominee).

Where the right to a dividend has not vested in a beneficiary, or the trustees have not exercised their discretion to vest a dividend in a beneficiary, the trust will be regarded as the beneficial owner.

Should dividends be received by a trust, but paid over to beneficiaries in the form of an annuity, the exemption from tax provided by s 10(1)(k) of ITA will be lost¹²². Annuity has not been defined in the ITA. The *locus classicus* on the meaning of annuity has been established by Price J¹²³, where the main characteristics of an annuity were defined that

¹²⁰ ITA 64L(1).

¹²¹ ITA s 64G(2).

¹²² ITA s 10(2)(b).

¹²³ Income Tax Case No 761 (1952) 19 SATC 103(T) p106.

- (1) 'it is an annual payment (this would probably not be defeated if it were divided into instalments);
- (2) it is repetitive payable from year to year for, at any rate, some period;
- (3) it is chargeable against some person.'

These characteristics were confirmed by Holmes JA¹²⁴ in the Appellate Division as well as by Joubert Wn HR¹²⁵.

It is evident that a beneficiary must have vested rights in the underlying shares of an operating company to ensure that the taxation will flow through to the investor (beneficial owner), and will not remain in the trust. PE firms should also be cautious that dividends from operating companies should not be paid annually, as it may be deemed as an annuity, with the result that the exemption from income tax will be lost.

4.2.7 Tax Rebates

A trust is included in the ITA definition of a person, however, a trust is not a natural person. The consequence of this is that the normal tax rebates¹²⁶ available to a natural person are not available to a trust.

4.2.8 Value Added Tax

Every person (which includes a trust fund)¹²⁷ that carries on an enterprise and where the taxable supplies reach R1m in any month, must be registered for VAT¹²⁸. A trust fund 'means any fund consisting of cash or other assets the administration and control of which is entrusted to any person acting in a fiduciary capacity by any person, whether under a deed of trust or by agreement'¹²⁹. The PE firm as trustees, act in a fiduciary capacity and is responsible for the administration and payment of VAT.

¹²⁴ Secretary for Inland Revenue v Watermeyer 27 SATC 117 (SCA) p 122.

¹²⁵ Kommissaris Van Binnelandse Inkomste en 'n Ander v Hogan [1993] 2 All SA 469 (A) p 472.

¹²⁶ ITA s 6(1) and (2).

¹²⁷ Value-added Tax Act No. 89 of 1991 s 1(1) sv 'person'.

¹²⁸ VAT Act s 23(1)(a).

¹²⁹ VAT Act s 1(1) 'trust fund'.

4.2.9 Capital Gains Tax

A connected person (within the context of a trust) means any beneficiary of such a trust¹³⁰. The relevance of a connected person is the following: When a beneficiary (seller) of a trust disposes of an asset at a capital loss to another beneficiary (buyer) of the same trust, that capital loss is ring-fenced and cannot be offset against any other capital gain¹³¹, provided it is a capital gain incurred between the same seller and buyer.¹³²

The nature of PE is that the PE firm will receive 'carried interest' – a percentage of the difference between the amounts invested in a venture and the amount received, at exit. Any amount received regarding the disposal of an equity share that was held for at least three years, is deemed to be of a capital nature¹³³. If the 'carried interest' is for payment of services rendered 'by virtue of his or her employment or office of director of any company (operating company),¹³⁴ the gain on disposal of shares will be taxed as income in the hands of the PE firm'. The wording of the trust deed is therefore of utmost importance to ensure that any payment relating to 'carried interest' bears no relevance to a service the PE firm provided to the company.

The moment an interest in an asset vests in a beneficiary, it constitutes a disposal.¹³⁵ A disposal of an asset is deemed to have taken place on the date that an interest in an asset vests in a beneficiary.¹³⁶ When a trust disposes of shares held in an operating company that realises a capital gain and distributes the cash to beneficiaries in the same year of assessment, or where the beneficiaries had a vested right,¹³⁷ or acquired a vested right by virtue of the exercise of discretionary power by the trustees,¹³⁸ the capital gain in those shares will be taxable in the

¹³⁰ ITA s 1(1)(b)(i) connected person.

¹³¹ ITA para 39(1) of 8th sch.

¹³² ITA para 39(2) of 8th sch.

¹³³ ITA s 9C(2).

¹³⁴ ITA s 8C(1)(a)(i).

¹³⁵ ITA para 11(1)(d) of 8th sch.

¹³⁶ ITA para 13(1)(a)(iiA) of 8th sch.

¹³⁷ ITA para 80(1) of 8th sch.

¹³⁸ ITA para 80(2) of 8th sch.

hands of the beneficiary and not the trust. Any capital loss will remain in the trust as para 80 does not deal with a loss.

Should the beneficiary be a natural person, they will be entitled to an annual exclusion of R40 000 with regard to determination of taxable capital gains in their hands for a year of assessment¹³⁹.

Any capital gain taxable in the trust will be subject to an inclusion rate of 80% of gains. This 80% will be taxed at 45%, i.e. effective tax rate of 36% on capital gains, with no annual exclusion available.

4.3 Conclusion

From a tax perspective trusts have cumbersome requirements, since a beneficiary can have a vested right as distinguished from a contingent or conditional right, which determines when income accrues to a trust or a beneficiary. Here a PE firm's management will be affected by the taxation issues in determining who is ultimately liable for the payment of tax.

When a trust is used as an investment vehicle, a *Bewind* trust (vested trust) is the preferred trust to be set up, where the beneficiaries own the trust assets, and the trustees merely control the administration of the trust and its underlying assets. Income flows through to the beneficiaries, who are then responsible for their own tax affairs. Here the conduit principle applies where the income vests in the beneficiaries. Taxation of income in a trust is the highest – at a flat statutory rate of 45% – which must be avoided.

Where the rights that are attached to equity shares vest in a beneficiary, the legal *persona* of the beneficiary will determine the effective tax rate, as the capital gain will be taxed in the name of the beneficiary.

A third investment vehicle used by PE firms are partnerships, which will be discussed in the following chapter.

¹³⁹ TIA para 5(1) of 8th sch.

CHAPTER 5 PARTNERSHIPS

5.1 Characteristics of a Partnership

The 4 *essentialia of a Partnership* were first defined by Pothier:¹⁴⁰

- Each partner should bring or be obligated to bring a contribution to the partnership, whether it is in the form of money or other effects, or his or her labour or industry;
- A partnership should be established for the benefit of the parties;
- Each of the contracting parties expects to make and share in the profits or gains, proportionate to what they brought into the partnership;
- A condition of the partnership agreement is that the business which the parties intend to pursue and which they intend to draw profit from must be lawful. The profit that they intend to derive must also be lawful.

A partnership only requires a partnership agreement to come into existence. There is no SA legislation that regulates the establishment, registration and control of partnerships. One of the *essentialia* of a partnership is a lawful and valid partnership agreement, where the intention of all the parties is defined. Such an agreement will define *inter alia* the rights and duties of partners, and the relationship between the partners.

Smalberger JA¹⁴¹ confirmed that Pothier's formulation of such *essentialia* has been accepted by our courts as a valid statement of the law. Therefore, as long as these four criteria are present, it will be regarded by law as a partnership. 'In order to be valid, a partnership can be formed orally, in writing, or by conduct. . . "¹⁴²

A partnership is a collection of members who can be natural persons or companies. A partnership falls within the scope of an 'association of persons'.¹⁴³

¹⁴⁰ Pothier (1854) *A Treatise on the Contract of Partnership*, p5-7, London: Butterworths.

¹⁴¹ Pezzutto v Dreyer And Others [1992] 2 All SA 81 (A) p 90.

¹⁴² Bamford (1982) *The law of partnership and voluntary association in South Africa*, p16, Juta & Co Ltd.

¹⁴³ Rex v Milne And Erleigh (7) [1951] 2 All SA 113 (A) p 140.

Scott JA¹⁴⁴ stated that ‘a partnership, like a trust, is not a legal persona.’ This means that a partner cannot enforce his rights against the partnership – it has to be done against the co-partners. The individual partners therefore own assets and liabilities utilised in the partnership.

5.1.1 Types of Partnerships

There are two main categories of partnership, general (*en nom collectif*) and extraordinary. The latter can be grouped into two categories: anonymous or *en commandite*.

5.1.2 General Partnership

In an ordinary partnership the partners are bound *in solidum*, i.e. jointly and severally by the debts of the partnership. The anonymous partners are not liable for the debts of the partnership to the creditors with whom the principal or known partner has contracted.¹⁴⁵

5.1.3 Anonymous partnership

The term ‘anonymous partnership’ refers to a contract in which two or more parties agree to share in the profits derived from a particular trade or business, under the sole control of one of the partners, while the undisclosed partners’ names remain anonymous.¹⁴⁶ Munnik, A.J¹⁴⁷ referred to the case of *Sabatelli v St. Andrew's Building Society and Others 1933 WLD 55*, when he said that an anonymous partner may not participate actively in the business of the partnership. This principle also applies equally to an *en commandite* partnership.

5.1.4 *En commandite* partnership

‘A partnership *en commandite* must have at least one managing or general partner. Furthermore, all of the partners, managing or commanditarian, must be

¹⁴⁴ BE Thorpe, S Thorpe & AER Dixon (in their capacities as Trustees of the Brian Edward Thorpe Trust) & another v Trittenwein & another [2006] JOL 17053 (SCA) p 5.

¹⁴⁵ Pothier (1854) *A Treatise on the Contract of Partnership*, p70-71,77. London: Butterworths.

¹⁴⁶ Lamb Bros. v Brenner & Co (18851887) 5 EDC 152.

¹⁴⁷ Eaton & Louw v Arcade Properties (Pty), Ltd [1961] 4 All SA 182 (T).

entitled to share in the profits'¹⁴⁸. The general partners are liable *singuli in solidum* for the debts of the partnership. In an *en commandite* partnership, the undisclosed partners (partner *en commandite*) are only liable for the debts of the partnership, limited to the amount of capital which they have put into the partnership¹⁴⁹. This was also confirmed by Munnik A.J when he said that in an *en commandite* partnership the undisclosed partner 'is not liable for losses in excess of the fixed sum contributed by him to the partnership as capital'. This principle applies in all circumstances, even in the event of insolvency. Although a partnership is not a juristic person, s 13 of the Insolvency Act no 24 of 1936, makes specific provision for the sequestration of a partnership estate, as it may be indebted to other parties. The word 'debtor', in relation to the sequestration of the debtor's estate, refers to any individual or partnership.¹⁵⁰ If the court serves a sequestration order on the estate of a partnership (provisionally, permanently, or upon the court's acceptance of surrender), it will also serve a sequestration order on the estates of all partners, except the *en commandite* partners.¹⁵¹ This principle corresponds to the taxation of partners, as they own assets and liabilities of the partnership.

In an *en commandite* partnership the general partners are responsible for the management of the partnership. The mandate within which the general partners may operate, is defined in the partnership agreement. The general partners are therefore under a contractual obligation on how the affairs of the partnership should be managed. *En commandite* partners will have common law recourse against general partners, in the event of fraudulent actions or gross negligence.

Should an anonymous and/or *en commandite* partner act outside the partnership agreement and meddle in partnership activities with outside parties, Wessels J¹⁵² stated that courts will always interpret partnership agreements in favour of ordinary partnerships, as opposed to partnerships *en commandite* or anonymous partners. The consequence is that an *en commandite* partner will lose the

¹⁴⁸ Henning JJ *Perspectives on the law of partnerships in South Africa*, p99, Juta.

¹⁴⁹ Pothier (1854b).

¹⁵⁰ Insolvency Act no 24 of 1936 s 1.

¹⁵¹ Insolvency Act no 24 of 1936 s 13(1).

¹⁵² *Barker & Co. v Blore*, 1908 TS 1156 p 1158 .

protection as silent partner and will have unlimited liability with the general partners for losses and liabilities of the partnership. There are, however, two conditions that must be met before this principle will be applied: The anonymous and/or *en commandite* partner must have represented himself as a partner, or with his consent, and secondly, it must have been known to the person who benefits from this engagement. A major advantage of *en commandite* partnerships is that liability of partners are limited to the amount of capital invested by each partner. This is in line with a PE firm's goal to limit liability for its investors.

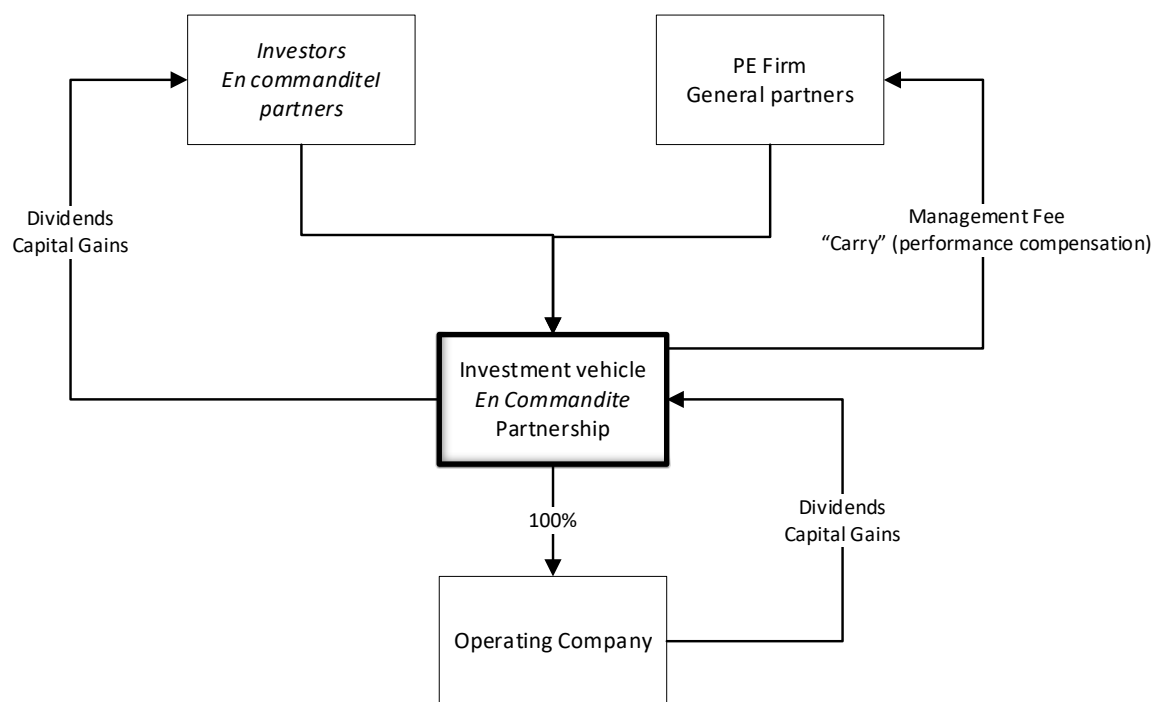


Figure 4 - *En commandite* partnership

5.1.5 Dissolution of a partnership

A partnership may be dissolved several ways:¹⁵³

- By agreement with the consent of all partners, and it must be in terms of the partnership agreement. This may 'on fulfilment of a condition expressly or impliedly agreed upon by all the partners at the time of the formation of the partnership.' When a partner retires or a new partner is admitted to the

¹⁵³ Bamford (1982) *The law of partnership and voluntary association in South Africa*, p 75-85, Juta & Co Ltd.

partnership, the 'old' partnership is dissolved. The original partnership agreement may provide for the continuation of the partnership, but a new partnership would have been created by such continuance.

- A partnership may be dissolved by an operation of law on frustration of a partnership business, or death of a partner or insolvency of partnership or any of its members, which can include liquidation of a company where the company is one of the partners.
- A partnership may be dissolved by renunciation. It may be dissolved at will by a partner, when the conduct of the partnership causes a loss of confidence or where a partner breaches an essential term of the partnership agreement. The latter needs to be proved by the aggrieved partner. The substance of a partnership is mutual trust,¹⁵⁴ which is one of the key elements when a partnership is created.
- Admission of a new partner is deemed to be a dissolution of the old partnership, even if all the 'old' partners remain in the partnership, as the ratio of profit sharing will change.

When a partnership is dissolved, the authority of a partner to bind the partnership and his co-partners terminates.

Any new transaction that a partner is engaged in that is not related to the liquidation of the partnership, or incidental to transactions that were conducted during the partnership's existence, is not binding on his ex-partners, but is for the partner's own account.¹⁵⁵

Should one or more partners commit a misconduct that irreparably damages mutual trust and goodwill between partners, it constitutes legal grounds for termination of the partnership¹⁵⁶.

In today's world trust is the most important and valuable trait in any business.

5.1.6 Advantages of partnerships

- The only legal formality is to draw up a partnership agreement.

¹⁵⁴ Fortune v Versluis [1962] 1 All SA 414 (A) p 416.

¹⁵⁵ Moosa NO and others v Akoo and others [2008] 1 All SA 585 (N) p 588.

¹⁵⁶ Fortune v Versluis [1962] 1 All SA 414 (A) p 418.

- The lack of statutory governance of partnerships means that partners are not obliged to publish information by law and can keep their partnership business confidential.
- The cost to set up a partnership agreement will be shared by the initial partners.
- A sole proprietor who joins a partnership, gains the knowledge and experience of the other partners.
- Rogers J¹⁵⁷ stated that the *Turquand rule* (as codified in s 20(7)¹⁵⁸) does not apply to solo proprietors, partnerships and associations without a public constitution. Should a third party deal with a particular partner in a matter, the onus is on the third party to prove that the partnership traded within its mandate (limits).
- The exposure of sleeping and/or *en commandite* partners is limited to the amount of the capital that they invested in a partnership¹⁵⁹.
- There are tax benefits discussed in Chapter 3.

5.1.7 Disadvantages of partnerships

- A partnership does not have a statutory governance structure like a company, which is controlled by the Companies Act no 71 of 2008.
- Partners with majority decision rights may take decisions at the disadvantage of other partners.
- In a general partnership all partners share in the losses and debts of the partnership.

¹⁵⁷ One Stop Financial Services (Pty) Ltd v Neffensaam Ontwikkelings (Pty) Ltd (The CRL Trust as intervening creditor) [2015] 4 All SA 88 (WCC).

¹⁵⁸ Companies Act.

¹⁵⁹ S. Butcher & Sons v Baranov Bros. (1905) 26 NLR 589.

5.2 Taxation of partnerships

5.2.1 Introduction

A limited partnership is any member of a partnership *en commandite*, anonymous partnership, similar partnership, or a foreign partnership whose liability towards a creditor is limited to their contributions to the partnership, or limited in any other way¹⁶⁰.

A partnership cannot have a taxable income simply because it is not a taxable entity,¹⁶¹ therefore, partners are taxed in their own hands. Income earned from the partnership will be apportioned in the ratio in which the profits or losses of the partnership are to be shared,¹⁶² and every partner is deemed to be trading in his own name in the partnership, even if it is a limited partner¹⁶³. *En commandite* partners who are sleeping partners and not involved in trading, are therefore also deemed to be carrying on a trade.

Irrespective of what the partnership agreement stipulates with regard to recognition of income in the partnership, the date that income was received or accrued in the partnership, will be deemed as the date that the partners received income¹⁶⁴. The date when a partnership completes its accounts is therefore irrelevant.

5.2.2 Deductions and allowances

The date income was received or accrued in the partnership, will be considered the date deductions and allowances were incurred in relation to that income.

The same principle applies with regard to deductions and allowances that must be apportioned to partners¹⁶⁵. The partnership therefore has no liability for income tax, and all income and expenses flow through to the individual partners.

¹⁶⁰ ITA S24H(1).

¹⁶¹ Chipkin (Natal) (Pty) Ltd v Commissioner, SARS [2005] JOL 14470 (SCA) p 9.

¹⁶² ITA s 24H(5).

¹⁶³ ITA s24H(2).

¹⁶⁴ ITA s 24H(5)(a).

¹⁶⁵ ITA s 24H(5)(b).

The timing for recognising income in the partnership is important for partners that exit, or for those that are admitted to the partnership. Should a partner be admitted to a partnership four months before the year end of the partnership? That partner will only share in profits incurred during the last four months. The same principle applies to a partner that exits the partnership.

Any allowance or deduction which may be granted to a limited partner in terms of s24H(3) of the ITA, in consequence of any trade or business carried on by him in a partnership to which he is a limited partner, is limited to the sum of

- the contribution to the partnership or liability to a creditor and
- income received or accrued from such trade.¹⁶⁶

The statutory limitation on the deduction of a tax loss by a limited partner, essentially "ringfences" the tax loss that may be claimed by the partner, regardless of what is stated elsewhere in the ITA.

Any deduction or allowance that has been disallowed pursuant to the provisions of subsection (3), shall be carried forward and is deemed to be an allowance or deduction to which the taxpayer is entitled in the following year of assessment.

5.2.3 Conduit (flow-through) Principle in a partnership

Because a partnership is not a taxable entity, income flows through a partnership to the partners who are taxed in their own hands. Depending on the statutory nature of each partner, every partner will be taxed in their own right, based on the tax legislation that entity or person is subjected to.

5.2.4 Dividends

'In an *en commandite* partnership, the shares held by the partnership in a company will generally be registered in the names of the general partners and not in the names of the *en commandite* partners. Even though the shares are registered in the names of the general partners, the *en commandite* partners will be the beneficial owners of a percentage of the shares in accordance with the

¹⁶⁶ ITA s 24H(3).

partnership agreement.¹⁶⁷ *En commandite* partners will thus receive dividends from equity shares that the partnership holds in an operating company, in the same ratio that they hold shares. The individual partners (beneficial owners) will be liable for dividends tax.¹⁶⁸

5.2.5 Value-Added Tax (VAT)

The definition of a person includes a 'body of persons (corporate or unincorporated)'¹⁶⁹. A body of persons includes a partnership.¹⁷⁰ This definition also corresponds with the definition of a person as defined in s 2 of the Interpretation Act No. 33 of 1957, which includes 'any body of persons (corporate or unincorporate)'.

It is mandatory for a person carrying on a trade to register for VAT, where cumulative taxable goods and services over the last 12 months exceed R1m.¹⁷¹

This means that a partnership must levy VAT on every product or service that it supplies. Although a partnership is not a taxable entity, a partnership is deemed to carry on an enterprise separate from the members of the partnership.¹⁷²

In an *en commandite* partnership, one of the general partner's staff members (natural person) 'who is the treasurer of that body or whose functions are similar to those of a treasurer of that body', must act in a representative capacity to take responsibility for VAT in the partnership.¹⁷³

Where a partnership is dissolved (see para 5.1.5), but still continues to conduct business with at least one of the previous partners in the new partnership, the new partnership will be deemed the same partnership as before and is not required to register for VAT again.¹⁷⁴

¹⁶⁷ Legal council, *Comprehensive Guide To Dividends Tax (issue 4)*, p 50, SARS.

¹⁶⁸ ITA s 64EA.

¹⁶⁹ VAT Act s 1(1) sv 'person'.

¹⁷⁰ VAT Act s 51(2).

¹⁷¹ VAT Act s 23(1)(a).

¹⁷² VAT Act s 51(1)(a).

¹⁷³ VAT Act s 46(d).

¹⁷⁴ Vat Act s 51(2).

Any change in the composition of the members of a partnership must be reported to SARS within 21 days after a change in partners has occurred.¹⁷⁵

Every member of a partnership will be jointly and severally liable for the payment of VAT. However, a partner *en commandite* who has not held himself out as an ordinary or general partner of the partnership, will not be liable.

The definition of 'taxable supply' means any supply of goods or services which is chargeable with tax under the provisions of section 7 (1)(a)¹⁷⁶. 'Any distribution of profits by a partnership to the individual partners, does not constitute a taxable supply, as it does not constitute consideration for the supply of goods and services supplied in the course of carrying on an enterprise by the individual partners.

Based on SARS's interpretation, the vesting of assets and the provision of services by partners to the partnership, constitute supplies of goods or services in the course or furtherance of an enterprise. However, since they were provided without consideration, the value of these supplies is zero.¹⁷⁷

In the event of a PE firm, the output tax that the firm levied on management fees to the partnership, can thus be claimed as input tax deductions in the partnership's VAT liability, provided the partnership is registered for VAT.

5.2.6 Capital Gains Tax

As a partnership is not a separate taxable entity, the individual partners are liable for any CGT, as they own the assets and not the partnership. If a partner's interest in an asset of the partnership is sold, the proceeds must be deemed to have accrued to that partner at the time of that sale ¹⁷⁸.

It was held by Potgieter AR¹⁷⁹ that a partnership's assets are the property of the partners in common undivided shares. SARS treats partners as having a fractional interest in an asset. As CGT relates to the disposal of rights, it is not intended that

¹⁷⁵ VAT Act 25(e).

¹⁷⁶ VAT Act S 1.

¹⁷⁷ De koker & Badenhorst, (2021) *VAT in South Africa*. para 12.6, LexisNexus.

¹⁷⁸ ITA schedule 8 para 36.

¹⁷⁹ Muller en 'n Ander v Pienaar [1968] 3 All Sa 290 (A) p294.

partners are seen to be disposing of all their interests in the partnership assets every time a new partner is admitted or an existing partner leaves. Therefore, each partner should be considered to have a fractional interest in each partnership asset. There will not be a disposal of partnership assets if a partner's fractional interest remains unchanged, following the introduction of a new partner or the withdrawal of an existing partner. A disposal of partnership assets takes place only when the partner's fractional interest decreases in value.¹⁸⁰

Whenever there is a dissolution of a partnership, there will be CGT consequences for the partners that exit the partnership, as well as for the new partners that are admitted to the partnership. In a PE firm the funds of the partners are generally committed for a fixed period and partners do not exit a venture piecemeal. This will only happen when the PE as a whole exits from an investment in an operating company.

Where partners invest in a partnership to acquire shares in an operating company, it is important to note that each class of shares that is authorised by a company, has the same preferences, rights, limitations and terms, as shares of the same class.¹⁸¹ The provisions of para 32, 8th schedule of the ITA apply to assets that form part of a holding of 'identical assets'. Shares in a company fall within this definition of identical assets. 'Identical assets' are assets that, if they are sold individually, they would realise the same value, regardless of which one was sold. Furthermore, these assets, to some extent, cannot be distinguished from each other except by their identifying numbers.¹⁸²

This tax treatment corresponds with the practise adopted in the United Kingdom¹⁸³. Should a partner exit a partnership, the partner leaving the partnership will have disposed his right in the assets (shares) of the partnership, and therefore he will attract CGT.

¹⁸⁰ SARS, Comprehensive Guide to Capital Gains Tax Issue 9, p 379.

¹⁸¹ Companies Act s 37(1).

¹⁸² ITA 8th schedule p 32(2).

¹⁸³ HM Revenue and Customs 'Statement of Practice D12: Partnerships' para 2.1.

Whenever a partner joins the partnership and contributes assets or cash to the partnership, all pre-existing partners must be treated as having disposed of a part of their share in the partnership assets, in exchange for a fractional interest in the new asset or cash contribution of the new partner.

Paragraph 36¹⁸⁴ stipulates that the proceeds derived from the disposal of a partner's interest in an asset of the partnership, should be treated as having accrued to that partner at the time of the disposal. The date of change of ownership is the event that determines the time of disposal, as defined by para 13, 8th schedule of the ITA.

The fact that a partnership is not liable for income tax, but each partner in his own right is, places the onus on every partner to determine when a disposal has taken place.

When a partner ceases to be a resident,¹⁸⁵ that person must be treated as having his rights to assets in the partnership disposed of at market value on the date immediately before the day on which that person so ceases to be a resident. 'Carried interest' is the percentage of the difference between the amounts invested in a venture and the amount received at exit. 'Carried interest' is payable to the general partners in an *en commandite* partnership on exit of a venture.

5.3 Conclusion

In PE, an *en commandite* partnership is the preferred form of partnership, as investors' liability in the partnership is limited and investors are not involved in the management of their investments, which is the responsibility of the general partners. Furthermore, income flows through to the partners, each with their own unique tax circumstances. Each partner is responsible for the taxation of their income and capital, depending on their unique tax situation. A partnership is therefore never taxed, unlike a company or trust.

¹⁸⁴ ITA 8th Schedule.

¹⁸⁵ ITA s 9H(2)(a)(i).

The disadvantage of an *en commandite* partnership is that a loss incurred by a commanditarian partner from that partnership, is ring-fenced and cannot be set-off against other sources of income of that partner. The conduit principle therefore applies to income and capital gains from such partnership, with the exception of losses.

CHAPTER 6 CONCLUSION AND IMPLICATIONS

6.1 Comparative analysis of investment vehicles

Criteria	Company	<i>Bewind</i> Trust	<i>En commandite</i> Partnership
Formation	<ul style="list-style-type: none"> Initial set-up - uncomplicated and inexpensive Reserve name, elect first directors, MOI and register with CIPC Draft shareholders agreement 	<ul style="list-style-type: none"> Initial set-up - more complicated and expensive Decide on trust type Draft trust deed Register with Master¹⁸⁶ 	<ul style="list-style-type: none"> Initial set-up - less complicated, but expensive Draw up partnership agreement
Governance	<ul style="list-style-type: none"> Highly regulated by Companies Act Managed by Board Subject to independent review/audit 	<ul style="list-style-type: none"> Regulated by Trust deed only Managed by trustees Subject to audit 	<ul style="list-style-type: none"> Regulated by partnership agreement only Managed by general partners (<i>en commandite</i> partnership)
Liability for debts	<ul style="list-style-type: none"> Company liable Directors liable for damages when in breach of fiduciary duties 	<ul style="list-style-type: none"> Beneficiary liable for debts applicable to asset owned Trustees liable for damages when in breach of trust 	<ul style="list-style-type: none"> <i>En commandite</i> partner Limited to General partners liable <i>singuli in solidum</i> for the debts of the partnership
Income distribution	<ul style="list-style-type: none"> Only via dividends 	<ul style="list-style-type: none"> Income vests in beneficiary 	<ul style="list-style-type: none"> Income vests in beneficiary
Tax on Income distribution	<ul style="list-style-type: none"> Dividends withholding tax of 20% before distribution Beneficial owner liable for dividends tax 	<ul style="list-style-type: none"> Taxed in hands of beneficiary Beneficiary liable for tax 	<ul style="list-style-type: none"> Taxed in hands of partner Partner liable for tax
Capital distribution	<ul style="list-style-type: none"> Only via dividends 	<ul style="list-style-type: none"> Capital vests in beneficiary 	<ul style="list-style-type: none"> Capital vests in partners
CGT – inclusion rate	<ul style="list-style-type: none"> 80% in company 	<ul style="list-style-type: none"> 40% in hands of beneficiary if individual 	<ul style="list-style-type: none"> 40% in hands of partner

6.2 Conclusion

With the different types of investment vehicles at the disposal of private equity funds, the following is evident:

Companies have the best legislative governance of all investment vehicles, and they provide the best protection to shareholders, but also prohibits offering any of its securities to the public. They restrict transferability of shares, should it be a private company. Due to legislative financial reporting requirements, it is transparent to shareholders, who are not involved in the management of the company, except the shareholders who serve as directors on the Board.

¹⁸⁶ Master of the High Court.

In a trust, the taxation requirements are the most intricate and delicate, primarily due to the existence of vested versus contingent rights.

A partnership is deemed to carry on with an enterprise, and apart from VAT and any disallowed allowances and deductions, it has no other tax matters to attend to. Partnerships have the least control as it is created and governed solely by internal arrangement (contract) between partners, and they are not subjected to legislative requirements. The major advantage of this arrangement is that an agreement can be drafted in a very specific manner to accommodate the requirements of the partners.

Taxation of income and/or capital gains and the distribution thereof to the ultimate beneficial owners in companies versus trusts versus partnerships, vary significantly. There are multiple factors and circumstances that play a role to determine where and when tax will be imposed and who will be liable for payment of tax. At one end of the spectrum you have a company which has the highest level of governance and that is taxable in its own right. At the other end of the spectrum you have a partnership which is subject to the least governance and is not taxable in its own right. It provides more flexibility for the (partners) recipients of revenue and capital flowing from the partnership, as the tax structures of the partners may differ significantly. The greatest advantage of a partnership from an income tax point of view, is the conduit principle where income and capital gains flow through to the partners.

The low inclusion rate for individuals on CGT, is the most attractive for partners who are individuals. This also applies to individuals who have vested rights in capital, when capital is paid or refunded to beneficiaries. With a multitude of different types of investors that invest with PE firms, a PE partnership provides the best option to investors to use, from a tax point of view, as it is solely up to the investor to decide whether he wants to use a legal entity such as a company, or a trust, or to invest in a PE firm as an individual.

PE Firms have the option to use different financial instruments to provide funding to operating companies they invest in, but they need to be careful how these

instruments are utilised and for which periods, as the South African tax legislation tends to subject repetitive streams of income to normal income tax as gross income. Substance over legal form is also important, as legal form can be deceiving. The true substance of a transaction or financial instrument will determine whether the nature of the receipt/accrual is income or capital.

It is submitted that an *en commandite* partnership is the most appropriate vehicle in the current private equity environment, and has the least stringent legislative, fiscal and regulatory requirements. In an *en commandite* partnership the PE firm that acts as general partners, can focus on the management of the underlying investments and its performance, without undue interference from *en commandite* partners, provided they meet the requirements that were set out in their mandate to investors.

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Bloch v Secretary for Inland Revenue	1980	Cape Provincial	42 SATC 7
Braun v Blann and Botha NNO	1984	Appellate Division	2 SA 850
BE Thorpe, S Thorpe & AER Dixon (in their capacities as Trustees of the Brian Edward Thorpe Trust) & another v Trittenwein & another	2006	Supreme Court of Appeal	JOL 17053
Chipkin (Natal) (Pty) Ltd v Commissioner, SARS	2005	Supreme Court of Appeal	JOL 14470
CIR v Rosen	1970	Appellate Division	32 SATC 249
CIR v Stott	1928	Appellate Division	3 SATC 253
Commissioner for Inland Revenue v People's Stores (Walvis Bay) (Pty) Ltd	1990	Appellate Division	52 SATC 9

Case	Year	Division	Reference
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Eaton & Louw v Arcade Properties (Pty), Ltd	1961	Transvaal Provincial Division	4 All SA 182
Ebrahimi v Westbourne Galleries Ltd and others	1972	House of Lords	2 All ER 492
Fortune v Versluis	1962	Appellate Division	1 All SA 414
Francis George Hill Family Trust v South African Reserve Bank And Others	1992	Appellate Division	2 All SA 137
Her Majesty the Queen v Prévost Car Inc	2009	Federal Court of Appeal (Canada)	FCA 57
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Jowell v Bramwell-Jones and others	2000	Supreme Court of Appeal	2 All SA 161
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