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**THE FORMULATION OF A COHERENT SOUTH AFRICAN APPROACH TO
THE CLASSIFICATION OF INCOME AND THE TAXATION OF
INTERNATIONAL CROSS-BORDER PARTNERSHIPS**

by

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APPAFT001

SUBMITTED TO THE UNIVERSITY OF CAPE TOWN

in partial fulfilment of the requirements for the degree MCom (Taxation)

Faculty of Commerce

UNIVERSITY OF CAPE TOWN

Date of submission: 13 August 2010

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TABLE OF CONTENTS
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1	INTRODUCTION	3
2	TAXATION OF DOMESTIC PARTNERSHIPS.....	7
2.1	Introduction	7
2.2	Legal Requirements for Formation.....	8
2.3	Different Types of Partnerships	9
2.4	Legal Nature of Partnerships.....	10
2.5	Taxation of Partnerships.....	13
2.6	Case Law on Partnerships	16
2.7	Conclusion.....	19
3	INTERNATIONAL TAXATION OF CROSS-BORDER PARTNERSHIPS	19
3.1	Introduction	19
3.2	The OECD Partnership Report.....	21
3.3	International Solutions Proposed to Classification of Income Difficulties	23
3.4	International Case Law	27
3.5	Conclusion.....	31
4	SOUTH AFRICAN TAXATION OF CROSS-BORDER PARTNERSHIPS.....	32
4.1	Introduction	32
4.2	Consideration of CIR v Epstein.....	33
4.3	Consideration of CIR v Lever Brothers and Unilever Ltd.....	36
4.4	Consideration of Grundlingh v CIR	39
4.5	Proposed Reconciliation of Case Law	44
4.6	Section 6quat and Cross-Border Partnerships.....	48
4.7	Conclusion.....	50
5	PRACTICAL EXAMPLE OF THE SOUTH AFRICAN APPROACH.....	51
5.1	Circumstances of the Practical Example	51
5.2	OECD Approach	52
5.3	South African Approach	53
6	CONCLUSION	54

1 INTRODUCTION

The use of partnerships as a business vehicle has many advantages. It is easy to establish, requires very little in the way of documentation and registration, and is relatively simple in the manner of its administration. These factors contribute to the longevity of the institution since the days of the Roman conquerors to the current age of digital graphics and bandwidth. Yet, for all of its simplicity in a domestic context it becomes greatly complicated in its participation in international markets. Notwithstanding such difficulties, one finds that in an increasingly inter-active and globalised world it is the flexibility of partnerships which makes it a favoured business vehicle for international traders.

As a legal concept, partnerships can be categorized as a group of persons united in their aim to achieve a particular business goal – whether such goal is the generation of profits generally or the more specific goal of completing a project. The pivotal characteristic of a partnership is that usually all of the partners are jointly and severally liable for the debts of the partnership. The greatest complexity attached to cross-border partnerships is that they are taxed differently across countries, with some jurisdictions taxing partnerships as separate legal entities (known as "opaque entities") while others do not tax the partnership itself and instead tax the partners (known as "fiscally transparent entities"). For instance, Belgium taxes partnerships as a separate legal entity subject to corporate income tax while in France partnerships occupy a curious legal position in that they are deemed to be taxpayers separate from its partners, yet the partnership itself is not directly liable to tax (Schaffner, 2000:218). The United States of America meanwhile, has adopted a unique approach in that an entity in that country may elect to be taxed either as a partnership or a corporate taxpayer in certain circumstances (Schaffner, 2000:218).

Further difficulties arise in that there are degrees of transparency which may apply to a particular fiscally transparent partnership. In his analysis of the issue, Baker (2002:22) mentions that there are four types of transparency which may be identified: complete transparency where the partnership has no legal existence at all or is completely ignored from a tax perspective; where the ultimate tax liability for the income rests with partners but where the income or gains of the partnership is reported as though it were a separate entity; where the partnership or the partners may elect for the partnership to be transparent and where the ultimate tax liability for certain income rests with the partners while the

liability for the other income rests with the partnership. Given these difficulties, Daniels (1991:1) comments that most tax professionals regard the taxation of cross-border partnerships as a 'trap for the unwary'.

Added to this is the fact that cross-border trading carries with it the inherent risk of international double taxation (Olivier & Honiball, 2008:4). In the international arena, there are two forms of international double taxation: economic and juridical double taxation. Economic double taxation arises when the same income is taxed in two different taxpayers' hands (Olivier & Honiball, 2008:4). This would occur when profits would be taxed in the hands of the company; while once those same profits are distributed to the shareholders in the form of dividends, such dividends would be taxed in the hands of the shareholders. Juridical double taxation arises when the income is taxed in one taxpayer's hands in two different countries (Olivier & Honiball, 2008:4). This would occur when one country would tax its residents on their worldwide income while the other country would tax the same income on the basis that it was generated within its borders. In an attempt to avoid juridical double taxation, countries enter into double taxation agreements ("DTA's") which set out which country would be entitled to tax which type of income in which set of circumstances. DTA's are designed to set out the tax treatment of specific types of income. However, DTA's do not set down any general rules which would link such income to specific taxpayers (Ault, 2002:263). As a result, double taxation and double non-taxation remains a possibility where the two countries interpret the DTA in different ways (Ault, 2002:263).

In this work, the terms 'DTA', 'treaty' and 'tax treaty' are used interchangeably.

International organisations, such as the Organisation for Economic Co-operation and Development ("OECD"), have published model tax conventions in an attempt to ensure a measure of standardization of the contents of DTA's between its members (Olivier & Honiball, 2008:7). The OECD currently has thirty members (Olivier & Honiball, 2008:9). South Africa is not a member state, but has what is known as 'observer' status (Olivier & Honiball, 2008:9). In order for amendments to be made to the model conventions, it is necessary for the unanimous consent of all the member countries to be obtained (Olivier & Honiball, 2008:9). Given the inherent difficulty of this, amendments and proposed interpretations of the contents of the model conventions are made in the Commentary to

the provisions of the model conventions. In the international arena, most tax treaties are based on the OECD model conventions (Olivier & Honiball, 2008:10). Moreover, most of South Africa's tax treaties are based on the OECD model conventions.

OECD member states adopt varied approaches when it comes to the taxation of cross-border partnerships (Schaffner, 2000:218). The areas of disagreement were summarized by Schaffner (2000:218) as follows:

- i) Whether the protection of the DTA should be provided to the partnership itself or the partners – Schaffner further notes that some OECD member states adopt the view that the treaty benefits should be afforded to the partnership given that the taxable base is determined at the level of the partnership and not the partners;
- ii) Whether the tax credit should be available to the partnership or the partners when double taxation relief is to be provided in terms of the DTA; and
- iii) The manner in which foreign entities should be classified for tax purposes – Jones (2002:288) notes that categorization is important for both states. Categorization is important for the source state in determining whether it is the entity or the members which are to be taxed; which rate of tax would be applicable; how the taxable income should be calculated; and for purposes of applying the relevant DTA, whether it is the entity or the members who are the residents of the state (Jones, 2002:288). For the residence state, the importance of categorization lies in determining what type of income is to be taxed; when such income is to be taxed – either at distribution to the members or at the time that it is earned; and whether the tax credit should be made available at the level of the entity or the members (Jones, 2002:288).

As a result of these important differences, the greater majority of tax treaties ignore partnerships altogether (Schaffner, 2000:218). Schaffner comments that there are some treaties which do address the taxation of partnerships. Unfortunately, no consistent

approach can be discerned from these treaties (Schaffner, 2000:218). In his analysis of these treaties, Schaffner (2000:219) notes that some treaties would make even the transparent partnership the subject of treaty protection while others would specifically state that the treaty is not to apply to partnerships or the income derived from the partnership. Yet other treaties would specifically address the manner in which partnerships are to be taxed so as to avoid double taxation (Schaffner, 2000:219).

The taxation of international partnerships has particular relevance for South Africa. Zaaiman (2008:5) remarks that South African investors often have limited choice in the legal form of the entity in which they invest. Their lack of choice largely stems from the fact that the type of legal structure implemented internationally is shaped by the tax and commercial concerns relevant to the foreign jurisdiction in which such structure is established (Zaaiman, 2008:5).

In South Africa, the taxation of partnerships has received very little attention. There is also no legislation in place dealing with this business vehicle. However, many South Africans are investing in offshore partnerships. There is accordingly a need to develop a comprehensive work on the taxation of cross-border partnerships. Furthermore, on a domestic level, the recent judgment delivered in *Grundlingh v CSARS*¹ raised several issues regarding the taxation of cross-border partnerships. Of particular relevance to the common law of South Africa, is the yet unresolved tension which now seems to exist between the *Grundlingh* case and the well-established principles of the taxation of international partnerships as laid down by the then Appellate Division in the *CIR v Epstein*² judgment. The comments made regarding partnerships in the *CIR v Lever Bros*³ judgment also seems to conflict with the *Grundlingh* case. Bearing in mind the principle of *stare decisis* and the constitutional obligation to develop South African common law in line with international law, it is necessary that a body of work be developed to begin the process of reconciling South African sources of law into one coherent approach, to the taxation of cross-border partnerships.

¹ *Grundlingh v CSARS* [2009] 72 SATC 1 (*Grundlingh*)

² *CIR v Epstein* [1954] 19 SATC 221 (*Epstein*)

³ *CIR v Lever Brothers and Unilever Ltd* [1946] 14 SATC 1 (*Lever Bros*)

This study seeks to determine the South African approach to the taxation of international partnerships. The different sources of law dealing with this issue will be considered and analysed. In determining this stance, the approaches adopted internationally will be considered. The interaction between South African domestic law and DTA's will also be investigated. The OECD issued a Partnership Report⁴ in 1999 which sought to address the tax issues arising from the taxation of cross-border partnerships. Jones (2002:288) hailed this report as a "significant contribution" to the development of a coherent international approach to the taxation of partnerships across countries. The Partnership Report, which espouses certain proposed solutions to particular cross-border partnership situations, will be analysed to determine whether the South African approach is in keeping with international tax law. This work will seek to address the distinct lack in any substantive research work on the issue of cross-border partnership taxation in South Africa.

The manner in which this work will address the issue of the taxation of cross-border partnerships is to provide an overview of the legal nature of a domestic partnership in South Africa, as found in chapter 1, which will be followed by an account of the relevant case law on the issues in chapter 2. Chapter 3 provides an account of the international views and approaches adopted in the tax treatment of cross-border partnerships. Chapter 4 proposes a reconciliation of the relevant case law with a view to provide a coherent South African approach to the issue. A practical example is considered in Chapter 5. The conclusion in chapter 6 sets out the salient elements which characterizes the South African approach, and which are in keeping with that found in international law.

2 TAXATION OF DOMESTIC PARTNERSHIPS

2.1 Introduction

Partnerships have been around for centuries. In his consideration of the ancient origin of partnerships, Henning (2006:178) notes that the most rudimentary form of a partnership can be traced back to our earliest understandings of family and clan arrangements. However, the Romans provided the most significant influences to the shaping of the modern principles of partnership law that we are familiar with today (Henning, 2006:178).

⁴ The Application of the OECD Model Tax Convention to Partnerships, as incorporated into the April 2000 update of the OECD Model Tax Convention and Commentary

Partnerships have a very particular seating in South African law. They are not governed and regulated by legislation as with companies and close corporations which are governed by the Companies Act and Close Corporations Act respectively. Instead, the principles and rules governing the formation, management, and dissolution of partnerships are to be found in South African common law. Over the years, a number of principles have evolved regarding the legal treatment in general and the tax treatment specifically of partnerships. In instances where the principles emerging from our courts have taken a turn not agreeable to the South African Revenue Services ("SARS"), the Income Tax Act⁵ (ITA) would be changed to correct it. This is illustrated by the introduction of section 24H into the ITA which regulates partnerships specifically. This section, introduced to apply to years of assessment ending after 1 January 1989, was inserted in the wake of the *Sacks v CIR*⁶ judgment.

This chapter will set out the South African position on the legal treatment of partnerships in general, together with a consideration of the taxation of partnerships on a domestic level. In doing so, the legal principles relating to the formation, management and dissolution of a partnership enterprise will be considered from a legal perspective. This will be followed by an outline of the legislative landscape relevant to the taxation of partnerships. Regard will also be given to the tax case law which has developed in the area.

2.2 *Legal Requirements for Formation*

Henning (2006:177) defines a partnership as "a legal relationship arising from a contract between two or more persons, usually not exceeding twenty, each contributing to a business or undertaking carried on in common, with the object of making and sharing profits". Watermeyr J in *Hoheisen v CIR*⁷ remarked that:

"[p]artnership does not consist merely of a contract; it is a relationship between parties which arises from a contract, and if the contract is not carried out, then the relationship of partnership does not come into existence."⁸

⁵ Act 58 of 1962

⁶ *Sacks v CIR* [1946] 13 SATC 343

⁷ *Hoheisen v CIR* [1931] 5 SATC 207

⁸ *Hoheisen* op cit at 210

The judgment of *Joubert v Tarry and Co*⁹ established the following elements which must be present in order for a partnership relationship to be formed: 1) each partner is to contribute either money, labour or skills to the partnership; 2) the partnership business must be carried on for the joint benefit of the partners; 3) the object of the partnership must be to make a profit; and 4) the partnership agreement or contract between the partners must be valid.

The simplicity involved in the formation of a partnership is one of the advantages of its use as a business vehicle. There are no formal requirements for the conclusion of a partnership agreement, and the agreement may be oral, tacit or reduced to writing. It is important to note, however, that should the partnership agreement be reduced to writing, in terms of section 83(8)(a)(iv) of the Attorneys Act¹⁰ only an attorney, notary or conveyancer may draw up any agreement, deed or writing relating to the creation, variation of terms or dissolution of any partnership where such work is to be rewarded by a fee. It is advisable for the partnership agreement to be reduced to writing, as the existence of the agreement would greatly reduce the burden of having to prove the partnership's existence. On the other hand, it would behove prospective partners to remember that the drawing up of a partnership agreement alone without the implementation of its terms would not ensure that a partnership was in fact established - as the cases below will illustrate. Furthermore, no registration is required before a partnership may be formed. There is also no requirement that the partnership's annual financial statements are to be audited as is the case with companies. However, most creditors would insist on such an audit before advancing any credit to the partnership.

The partnership is therefore easy to establish and manage as compared to other business vehicles in South Africa.

2.3 *Different Types of Partnerships*

There are two types of partnerships in South Africa: ordinary and extraordinary partnerships. Extraordinary partnerships comprise the partnership *en commandite* and the silent or anonymous partnership.

⁹ *Joubert v Tarry and Co* [1915] TPD 277

¹⁰ Act 53 of 1979

Partners of an ordinary partnership are jointly and severally liable for the debts of the partnership. On the other hand, the common factor of extraordinary partnerships is that not all of the partners are liable for the debts of the partnership vis-à-vis outsiders (Henning, 2006:192). A further commonality is that both the partner *en commandite* and silent partner's identity is not disclosed to persons outside of the partnership (Henning, 2006:193). Such undisclosed partners do not participate in the business of the partnership (Henning, 2006:193). The difference lies in the extent of the partner *en commandite* and the silent partner's liability for the losses of the partnership. The partner *en commandite* is only liable for the loss to the extent of his contribution made to the partnership *en commandite*. The silent partner on the other hand is liable to his co-partners for his pro rata share of the partnership's total debts.

Should there be any uncertainty as to whether an extraordinary or ordinary partnership has been established, it was noted by the court in *ITC 248*¹¹ that the presumption exists in favour of an ordinary partnership having been formed by the parties.

2.4 *Legal Nature of Partnerships*

A partnership is not a separate legal entity in South Africa. Given that the partnership is transparent, it would be reasonable to expect the assets of the partnership to vest in the partners in their individual capacities. Instead, as was confirmed in the *Sacks v CIR* judgment further discussed below, each partner holds an undivided share in the partnership assets in terms of South African law.

Further consequences flow from the transparency of the partnership. One of them is that the partner cannot be a creditor or a debtor of the partnership (Henning, 2006:249). Also, one partner cannot claim the rendering of specific performance to the partnership by another partner (Henning, 2006:250). In so far as the division of profits is concerned, partners can agree to distribute the profits in accordance with any ratio. However, in the absence of such specific agreement profits are to be distributed between the partners according to the contributions made by each to the partnership (Henning, 2006:242). Should the value of each partner's contribution not be determinable, the profits are to be

¹¹ *ITC 248* [1932] 6 SATC 382

shared equally between them (Henning, 2006:242). It is the same with the losses of the partnership. The partners are entitled to determine a ratio in their partnership agreement in accordance with which the losses of the partnership are to be shared amongst the partners (Henning, 2006:242). In the absence of such agreement, it was noted in *ITC 248* that the losses will be shared in the same ratio as the partners' profit sharing arrangement.

One of the drawbacks of a partnership as a business vehicle is that it offers a distinct lack of continuity. A partnership will be dissolved upon the happening of any one of the following events (Henning, 2006: 268):

- i) Effluxion of time – A partnership agreement may stipulate that the partnership is to exist for a specific period only, in which event after the lapsing of such specific period the partnership will cease to exist.
- ii) Completion of business or undertaking – Similarly, a partnership agreement may state that the partnership is formed for the particular purpose of achieving a particular business goal. Once such goal is achieved, the partnership is dissolved.
- iii) Agreement of dissolution – As the partnership itself is an agreement between the partners; the partners are free to enter into a subsequent agreement whereby they agree to dissolve the partnership. This is the most common means of terminating a partnership.
- iv) Change in membership – As the partnership has no legal persona of its own, the existence of the partnership is keenly attuned to the identity of the individual partners. Thus, the death; retirement; admission or resignation of a partner would dissolve the partnership. The remaining partners would have to establish a new partnership should they wish to continue the business of the old partnership. All the assets and liabilities of the old partnership are to be transferred to the new partnership.

- v) Sequestration – Should any one of the partner's personal estate or the estate of the partnership be sequestrated, it would have the effect of dissolving the partnership. In the event that it is the partnership estate which is sequestrated, each partner's private estate would also be sequestrated. This can be avoided by one or some or all of the partners undertaking to pay the debts of the partnership and providing security for this purpose. An important exception to this general rule is that the estate of a partner *en commandite* or a silent partner would not be sequestrated together with that of the partnership.
- vi) Partner declared mentally ill – Should any one of the partners be declared mentally ill by a court of law, the court would in the ordinary course dissolve the partnership in the same court order or in a subsequent order.
- vii) Partner becomes an alien enemy – A partnership would be dissolved by the breaking out of war between two countries where some of the partners are domiciled in one country and others in the other country. The partnership would also be dissolved should a *de facto* state of war exist between the countries without a formal declaration of war having been made. However, in this event, a declaratory order from the court should be obtained to dissolve the partnership.
- viii) Frustration – Once it becomes objectively impossible for the partnership to realise its commercial purpose on account of factors outside of the partners' control, the partnership is dissolved.
- ix) Notice of Dissolution – A partnership formed without the specifying of a fixed term can be dissolved by any one of the partner's serving the others with a notice notifying them that he no longer wishes to be part of the partnership. This notice cannot be served upon the partners at an unreasonable or inconvenient time, and must be given in good faith. A notice would be delivered in bad faith when the partner intends to take up an opportunity for himself after the dissolution of the partnership which would otherwise have been taken up by the partnership. The reasonableness or convenience of the

time that the notice is delivered must be determined with reference to a consideration of the interest of the partnership as a whole.

- x) Just or lawful cause – A partner may obtain a court order to dissolve the partnership provided that his actions in doing so are justifiable and reasonable under the circumstances of the particular case. The court may make this order even though the other partners are against the dissolution of the partnership. Gross and persistent negligence; the constant bickering and quarrelling of the partners – and not largely due to the applicant – which has the effect of the partnership business being suspended; and the prolonged absence of one of the partners are some of the causes which were held by a court to constitute just and reasonable causes for the dissolution of the partnership.

2.5 *Taxation of Partnerships*

It was confirmed in *R v Levy & others*¹² that a partnership is not a separate legal entity in South Africa, and therefore is not subject to tax. Instead, the partners are subject to tax in their individual capacities on the profits generated in the partnership, as is confirmed by section 77(7) of the ITA. However, in determining the profits of the partnership, section 66(15) of the ITA requires that a joint return be submitted in respect of the partnership. In theory, each partner is individually liable to present a joint return. The practice of SARS on the other hand is to accept a copy of the financial return of the partnership from one partner. SARS would then apportion the taxable income of the partnership amongst the partners according to their profit-sharing ratio.

The date of the accrual of such partnership profits was a contentious issue for many years. The importance of the accrual concept stems from its use in the definition of 'gross income' as is found in section 1 of the ITA. This definition, in so far as it is relevant here, reads as follows:

''gross income', in relation to any year or period of assessment, means-

- (i) in the case of any resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such resident; or**

¹² *R v Levy & others* [1929] AD 312

(ii) in the case of any person other than a resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such person from a source within or deemed to be within the Republic,

during such year or period of assessment, excluding receipts or accruals of a capital nature"

The date of the receipt or accrual of income determines in which year of assessment the taxpayer would be taxed on such income. As is indicated in the 'gross income' definition, SARS must include an amount in the taxpayer's income either when it is received by, or when it accrues to, the taxpayer. It was confirmed in the *CIR v Delfos*¹³ case that SARS may not tax the income in both the year in which such income accrues and is received by the taxpayer. The meaning of the term 'accrual' was settled by the Appellate Division case of *CIR v Peoples Stores (Walvis Bay) Pty Ltd*¹⁴. The court found that an accrual was an amount to which the taxpayer became entitled. This judgment confirmed Watermeyr J's interpretation of the term 'accrual' in *Lategan v CIR*¹⁵.

In the case of partnerships, each partner's share of the partnership profits would accrue to him before he actually received it. This is because the date of accrual would occur once the profits of the partnership are determined in the financial statements of the partnership, as was confirmed in the *Sacks v CIR* judgment discussed further below, while such partnership profits would later be distributed between the partners according to their profit-sharing ratio. The date of accrual is therefore of vital importance in respect of partnerships as it would determine the tax year in which each of the partners would be taxed on their share of the partnerships profits, notwithstanding the date it is received by them. There was thus much scope for partners to manipulate the tax year in which they were taxed on their partnership profits. Partners would delay the drawing up of the partnership's financial statements bringing about the result that for so long as the partnership profits were not determined, there were no profits which accrued to them.

The introduction of section 24H of the ITA settled the date of accrual of partnership profits for years of assessment ending on or after 1 January 1989. The section is generally aimed at the settling of the date of accrual in respect of partners and in regulating the tax treatment of limited partners specifically. Section 24H(1) includes in the definition of a 'limited partner' a partner of an extraordinary partnership. Section 24H(2) deems each

¹³ *CIR v Delfos* 1933 AD 242

¹⁴ *CIR v Peoples Stores (Walvis Bay) (Pty) Ltd* 1990 (2) SA 353 (A)

¹⁵ *Lategan v CIR* [1926] 2 SATC 16

partner of the partnership to be carrying on the trade or business of the partnership. Thus, despite the fact that a limited partner would not participate in the business of the partnership, he would nonetheless be deemed to be carrying on the business of such partnership for tax purposes. De Swart (2008:389) notes that section 24H(3) serves as an anti-avoidance provision to discourage the use of limited partnerships in anti-avoidance schemes. The subsection limits the deduction a limited partner may claim in respect of the partnership business to the sum of the amount for which he is or may be held liable to any creditor of the partnership, and any income received by or accrued to him from that partnership business. The remainder of the deduction or allowance so disallowed is to be carried forward to the next year of assessment in terms of section 24H(4).

Section 24H(5) deals with the date of accrual of the profits of the partnership to the partners. The subsection stipulates that any income which has been received by or accrued to the partners in common is deemed to accrue to the partners in their profit-sharing ratio on the same date on which it is received by or accrues to the partnership. Expenses and allowances relating to such amounts are also deemed to be those of the individual partners in terms of section 24H(5)(b). This subsection was introduced in response to the judgment in *Sacks v CIR*. In that case, the court held that the date which the profits of the partnership accrued to the partners was when such profits became ascertainable at the conclusion of the agreed period for the accounting of the profits. It was noted by Watermeyr CJ in delivering the judgment that:

"[i]t is clear that during the subsistence of a partnership agreement the partnership property is owned in common in undivided shares. Consequently, save in so far as the partnership agreement may modify the position, the receipts and accruals in the partnership business are acquired by the partners in common and no one partner acquires any several right of ownership in the receipts or accruals of the partnership. Furthermore, a partnership agreement almost invariably provides, either expressly or by implication, for the division of profits after the lapse of fixed periods of time. The effect of such a clause in a partnership agreement is to place an obligation upon the partners to continue to hold the receipts and accruals of the partnership business in common, subject to an obligation to bring them into account at the end of each fixed period for the purpose of ascertaining the profit or loss for the accounting period. When that time arrives, then, for the first time under the partnership agreement, a partner becomes entitled to claim a separate determinable share of the partnership profits and then, for the first time under the partnership agreement, that determinable share accrues to him as gross income. Besides a partner's right to claim such separate share of the partnership profits under the conditions of the partnership agreement, he also acquires such a right when the partnership agreement terminates, eg, by dissolution, and in that case also an accrual of a right to a determinable amount takes place."¹⁶

¹⁶ *Sacks* op cit at 349

The effect of section 24H(5) then is that the income, deductions or allowances of the partnership accrue to the partners on a daily basis with no regard to the accounting period of the partnership.

In *Chipkin (Natal) (Pty) Ltd v CSARS*¹⁷ a further principle was developed. In the judgment, it was held that once a partner sold his share in the partnership he in fact recouped a portion of the allowances previously granted in respect of the partnership assets. The recoupment would arise notwithstanding the fact that the partnership assets were still in use by the partnership.

2.6 Case Law on Partnerships

The prevailing case law on partnerships from a domestic perspective is largely centered on family partnerships. The issue in these cases is whether the parties were successful in having established the partnership. The onus in such cases is on the taxpayer, in terms of section 82 of the ITA, to prove that a partnership actually exists. From a taxation perspective, the importance of successfully establishing the existence of the partnership lies in the fact that the partnership profits would be shared amongst the partners and would be taxed in their hands as opposed to all of the profits being taxed in one person's hands.

The leading case in this area is *Hoheisen v CIR*¹⁸. In this matter, the taxpayer was a building contractor who had been assisted by his son for seven years. At one point the taxpayer had to visit Europe for a period. Before his departure, he informed his son that he would take the son up as his partner if the son managed to run the business to his satisfaction in his absence. When the taxpayer returned from his visit, and having found that his son had managed the business well, he offered the partnership to his son. While his son had accepted the offer, nothing further was done. The existence of the partnership was not conveyed to the taxpayer's bankers, employees or business associates. Nor did the son contribute any capital toward the partnership. No partnership agreement had been drawn up between the taxpayer and his son, and the financial records of the business did not reflect the son as a partner. The Commissioner taxed the total profits of the business in the hands of the taxpayer. The taxpayer objected to this, arguing that as a partnership had been

¹⁷ *Chipkin (Natal) (Pty) Ltd v CSARS* [2005] 67 SATC 243

¹⁸ *Hoheisen v CIR* [1931] 5 SATC 207

formed between himself and his son half of the profits fell to be taxed in his son's hands. The court upheld the lower's court's finding that the taxpayer had promised to take the son into partnership with him, which the son had accepted. However, this promise was never implemented so as to in fact establish a relationship of partnership between the parties. The court therefore confirmed the correctness of the assessment raised by the Commissioner.

The importance of drawing up a partnership agreement was emphasized in *ITC 315*¹⁹. The taxpayer earned rentals from the leasing of certain properties owned by him and interest income. He argued that the assets generating the income were held by him in partnership with his wife and stepdaughter. The court was not convinced, especially as the exact date when the partnership was alleged to have come into existence was not known. The court noted that no disclosure of the partnership was made by the taxpayer to anyone. While the court took into account the relative simplicity and lack of sophistication of the parties involved, the court stated that it did nonetheless expect some definiteness and precision from them with regard to their business arrangements. The absence of a partnership agreement was lamented by the court before it held that the taxpayer had failed to prove the existence of the partnership.

It is important to note that even if a partnership agreement is in place, it does not mean that such action alone will establish a partnership. The agreement must be implemented in order for the partnership relationship to be formed. This was the court's finding in *ITC 248*²⁰. In this matter, a taxpayer had established a lucrative business and claimed that he had formed a partnership with his three sons. He therefore argued that he was only entitled to one-fourth of the profits, and should be taxed accordingly. While a partnership agreement was drawn up *in casu*, its terms made it clear that there was no actual intention for the sons to share in the profits of the business. Also, while the sons were credited with their share of the profits in the books of the business, none of them actually withdrew anything from the partnership. The court further noted that no disclosure of the partners, as was then required in terms of the Registration of Business Act (since repealed), had been made; the change from a sole proprietor to a partnership was not advertised; and the business' bankers were not informed of the change. In fact, everything continued as if nothing had changed. In making its finding that the taxpayer had failed to prove the

¹⁹ *ITC 315* [1934] 8 SATC 163

²⁰ *ITC 248* [1932] 6 SATC 382

existence of the partnership, the court found the following dictum of Rowlatt J in *Dickenson v Gross*²¹ in point:

"They think by putting a piece of paper in the drawer they can make an income tax partnership, and they can go on treating the undertaking as though it were still the sole uncontrolled property of one person, the father, instead of a partnership."²²

Finally, in *ITC 1083*²³, the court accepted that a certain degree of laxity may be involved in the management of family partnerships. The taxpayer carried on a hotel and grocery business in association with his two brothers. Each brother was allocated a task in the running of the business. The bank account of the business was in the name of the one brother, the lease of the premises and the municipal license to trade was in the name of the wife of one of the brothers, and the eldest brother entered into contracts on behalf of the business in his own name. The court held that rational explanations existed for this state of affairs, not least of all being the minority status of the youngest brother. The court held that while the brothers were not familiar with normal business standards and that they had a fairly elementary understanding of a partnership, they had succeeded in proving the existence of an equal partnership between them.

As these cases illustrate, the greatest hurdle facing family partnerships is not so much the greater scrutiny SARS would afford such a business vehicle but rather the laxity inherent in such family affairs. As a general guideline, De Swart (2008:389) proposes that the following steps be taken in order to ensure that the onus resting on the taxpayer to prove the existence of a family partnership be met:

- i) A partnership agreement must be drawn up;
- ii) A bank account for the partnership should be opened and used by the partners;
- iii) The existence of the partnership should be disclosed to customers, creditors and other business associates of the business;

²¹ *Dickenson v Gross* 11 T.C. 614

²² *Dickenson* op cit at 620, 621

²³ *ITC 1083* [1966] 28 SATC 157

- iv) Each partner should contribute something to the partnership; and
- v) The partnership agreement should be given effect to in the books of the business, with all of the partners being accounted for in the business records of the business.

2.7 *Conclusion*

It is evident that while the formation and management of a partnership is relatively simple and straight-forward, there are certain steps which must nonetheless be taken to ensure that a partnership has actually been established – particularly in the eyes of SARS. From a domestic taxation perspective, the importance lies in the fact that the failure to properly establish a partnership would result in all of the profits arising from the business venture being taxed in one person's hands – and not spread between all of the partners. With family partnerships there is an inherent risk that the vital steps to establish a partnership will not always be followed. From an international taxation perspective, the importance of this lies in the fact that the failure to properly establish a partnership would result in the profits being taxed in one person's hands as his/her personal income rather than as business profits which may have very different international tax consequences. This aspect will be discussed in more detail in Chapter 3 below.

3 INTERNATIONAL TAXATION OF CROSS-BORDER PARTNERSHIPS

3.1 *Introduction*

The taxation of cross-border partnerships has been the subject of much debate over the last few years. This particular issue has particular relevance for the international community given the preponderance of partnerships in one form or another across various jurisdictions. In response to the growing need to develop a coherent international approach to the tax treatment of cross-border partnerships and all the issues related thereto, the OECD published its report on the application of the OECD model tax convention²⁴ to partnerships in 1999. However, as the commentators on the Partnership Report have noted below, this work seemed to create as many problems as it sought to resolve.

²⁴ OECD Model Tax Convention on Income and on Capital

In examining the Partnership Report and the works of commentators thereon, this work will focus on the issues related to conflicts between states on their classification of the relevant income. Such conflicts arise when two or more states interpret a provision in the DTA differently and accordingly apply the DTA differently (Rust, 2003:45). If the nature of the income is classified differently it could well fall under different articles of the applicable DTA between two countries (states).

Besides the classification of income, DTA's seek to address a fundamental conflict relating to which State has the right to tax the income. In cross-border transactions, there are two states – namely, the source and the residence state – that would be entitled to tax the income arising from such transaction. The source state entitlement to tax is based on the fact that the income arose as a result of the activities conducted within its borders. Olivier & Honiball (2008:59) note that rules to establish the source of income is usually absent from treaties. As a result, it would seem that source must be determined with reference to the domestic laws of the relevant state involved. From a South African perspective, the *Lever Bros* judgment determined that the source of income is the originating cause of the income or what gave rise to the income. The source concept is further discussed in Chapter 4 below. On the other hand, the residence state is entitled to tax on the basis that its domestic laws entitles it to tax its residents on their worldwide income. DTA's are designed to resolve this conflict which exists between the source state and residence state's overlapping entitlement to tax the same income in the same person's hands and therefore avoid juridical double taxation.

Articles 6 to 21 of the OECD model convention, on which most DTA's are based, either grants or limits the source state's right to tax the income generated in its territory. Article 23 of the OECD model convention concerns the residence state. This article specifies the manner in which the residence state is to relieve the taxpayer of the burden of double taxation in instances where the source state is entitled to tax the income pursuant to articles 6 to 21. Rust (2003:46) notes that in most cases articles 6 to 21 would not concern the residence state. In fact, the residence state often does not even have to classify the income at all. All that is required of the residence state is that it grants relief from double taxation under article 23 in instances where the source state taxes the income in accordance with the provisions of the treaty (Rust, 2003:46).

This particular aspect of international tax is an area of continual debate and of importance for partnerships as they continue to be regarded as viable vehicles for international investment and business undertakings.

3.2 *The OECD Partnership Report*

The Partnership Report largely discusses the application of the OECD model tax conventions to partnerships. In order for a partnership to have access to the relief afforded in a DTA, it must be regarded as a person who is a resident of one or both of the Contracting States to the DTA in terms of article 1 of the DTA.

Article 3(1) of the OECD model convention defines a person as including an individual, a company and any other body of persons. The Partnership Report confirms that a partnership is a 'person' for purposes of a DTA. Article 4(1) of the OECD model convention further defines a resident as "any person who, under the law of that state, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature". Baker (2002:2) notes that the OECD has adopted the view that "liable to tax" does not mean that the person must actually be paying tax in the state. Rather, an entity would be "liable to tax" so long as the state could assert jurisdiction to tax that entity on its worldwide income in terms of one of the internationally accepted bases for full tax liability (Baker, 2002:3). In its application to partnerships, the Commentary on the OECD model tax convention further takes the view that a fiscally transparent partnership would not be liable to tax in the state in which it is so regarded. As a result, the partnership cannot be a resident as contemplated in article 4(1). The partnership would accordingly have no access to the relief provided to residents in the DTA.

The Partnership Report recognises that the real complexities involve situations where one state would regard a partnership as fiscally transparent while another would regard it as opaque. In its endeavour to develop a coherent approach to the taxation of cross-border partnerships in light of the complexities involved in the differing treatment of partnerships internationally, the Partnership Report considers various possible scenarios concerning the tax treatment of an international partnership and proposes certain solutions and principles

to resolve the problems arising in those situations. Baker (2002:5) summarises these principles as follows:

- i) Partnerships are "persons" as defined in article 3(1) either because they are a body of persons or because they fall within the definition of a 'company'²⁵;
- ii) A fiscally transparent partnership cannot be a resident as contemplated in article 4(1);
- iii) Fiscal transparency would be determined with reference to whether the personal characteristics of the partners determine the amount of tax which would be payable on the partnership income;
- iv) The partners of fiscally transparent partnerships would be entitled to the benefits of the treaty, as entered into by such partners' state of residence, in respect of the partnership income allocated to such partner. The nature and source of the partnership income shall be retained, and the income shall also be regarded as having been paid to or derived by the partners; and
- v) The source state should take into account whether the state of residence has treated the partnership as fiscally transparent or opaque.

Baker (2002:4) comments that the solutions proposed by the OECD in its Partnership Report are largely pragmatic and reason-driven as opposed to legally motivated. Also, Lang (2000:37) notes that the OECD has largely failed to provide reasons for its proposed solutions. This failing on the part of the OECD has greatly reduced its efficacy in that its persuasive authority is severely limited. However, Lang (2000:37) does comment that this particular area does raise difficult questions and some progress may be discerned from the fact that the OECD has chosen not to completely ignore these issues.

²⁵ Article 3(1)(b) of the OECD Model Tax Convention on Income and on Capital defines a company as "any body corporate or any entity that is treated as a body corporate for tax purposes"

3.3 *International Solutions Proposed to Classification of Income Difficulties*

The differing tax treatment of partnerships across jurisdictions raises the real possibility that the income generated from such partnerships would not be classified in the same way across those jurisdictions. The Partnership Report proposes that in cases where different articles of the DTA are applied to the partnership income by the two states as a result of their differing treatment of partnerships, the residence state is merely required to determine whether the source state has taxed the income in accordance with the provisions of the DTA when such residence state applies article 23 (Rust, 2003:45). The residence state is therefore not required to categorise the income itself (Rust, 2003:45). Article 23 of the OECD model convention would require the residence state to provide relief from the instance of double taxation notwithstanding the conflict of the classification of the income between the two states.

This view is reflected in the Commentary on article 23A and B, as reflected in the 2000 version of the OECD Commentary:

"[w]here, due to differences in the domestic law between the State of source and the State of residence, the former applies, with respect to a particular item of income, provisions of the convention that are different from those that the State of residence would have applied to the same item of income, the income is still being taxed in accordance with the provisions of the convention, in this case as interpreted by the State of source. In such a case, therefore, article 23 requires that relief from double taxation be granted by the State of residence notwithstanding the conflict of qualification resulting from these differences in domestic law."²⁶

Lang (2000:98) takes a different view. According to Lang (2000:98), in instances where the one country taxes the partnership at the level of the partnership and the other taxes the partnership at the level of the partners, it amounts to an instance of economic double taxation. There is no obligation on contracting states to provide relief from instances of economic double taxation, only from juridical double taxation. There is therefore no basis on which one may argue that the residence state should provide relief in terms of article 23, as is argued in the Partnership Report.

Daniels (1991:185) argues, on the other hand, that article 23 does not impose a requirement of subject identity in that the provision does not specify that it must be the partner himself

²⁶ Commentary on the OECD model tax convention at para 32.4

who must be subject to tax in both countries. The narrow view adopted by Lang cannot therefore be supported by the text of article 23.

On evaluating the arguments raised above, Barenfeld (2005:197) comments that although Daniels' argument is compelling and attractive, the OECD Commentary on article 23 specifically states that the article is meant to provide relief from juridical and not economic double taxation. However, the amendment to the Commentary in the wake of the Partnership Report now suggests that economic double taxation may well be covered by article 23 in the case of partnerships. The amended Commentary states that in instances where the partner's residence state classifies the partnership as fiscally transparent, both the income and the taxes paid by the partnership in the other country should flow through to the partners. Barenfeld (2005:197) notes that the partner's residence state is therefore obliged to provide a credit even though it is the partnership and not the partner that has been subject to foreign tax. Barenfeld (2005:198) expresses the view that it is unlikely that the pragmatic approach taken in the Commentary will convince the partner's residence state to change its position. This is especially as the flow-through principle suggested by the OECD would essentially require the partner's state of residence to abandon its classification of the foreign entity for purposes of applying the DTA (Barenfeld, 2005:198). The OECD model tax convention does not require such abandonment from any contracting state (Barenfeld, 2005:198). Barenfeld (2005:198) also laments the OECD's decision not to make the appropriate changes to the text of the model convention itself, particularly as the Commentary on the model convention now seems to be contradictory.

Barenfeld (2005:252) proposes four of his own solutions to the classification of income issues involved in the taxation of cross-border partnerships. These are as follows:

- i) The Elimination of Residence Taxation – Barenfeld (2005:252 and 253) deemed this proposal to lack feasibility as the use and acceptance of source and residence basis of taxation is firmly established in the international community. It would be unrealistic to expect that all countries would abandon the residence basis of taxation, as is required by this proposal.

- ii) The Harmonisation of Partnerships and Other Entities – Barenfeld (2005:253) also deems this proposal to lack feasibility. Barenfeld (2005:253) notes that this proposal would be faced with the great difficulty of overcoming differences in legal tradition and structures as well as balancing competing political interests. This proposal would further require an overarching international body to monitor the implementation of the proposal and also to supervise the stability of any harmonisation which would be achieved (Barenfeld, 2005:253). It is unlikely that this could be put in place.

- iii) Development of Classification Rules that would Ensure Symmetry – Barenfeld (2005:254) considers this proposal to be feasible. This approach proposes that classification rules should be established to ensure that a global balance is achieved in the taxation of cross-border partnerships, and that instances of double taxation are avoided. These rules can either be established on a per country basis through the use of DTA's or through the implementation of domestic legislation. Barenfeld (2005:254) further argues that this proposal could work when one considers that it is a very specific set of rules which would require change.

- iv) Development of Rules Ensuring Double Tax Relief Regardless of Any Asymmetry – Barenfeld (2005:255) also considers this proposal to be feasible. It is in fact the approach adopted by the OECD in its Partnership Report. Barenfeld (2005:255) argues that one can either change the design of a country's DTA or the design of its unilateral rules for double tax relief. Changing the DTA would allow the legislation to be tailored to fit the specific needs of a country's business vehicles, but would involve the time-consuming task of renegotiating DTA's (Barenfeld, 2005:255). On the other hand, changing the unilateral rules would apply to all cross-border business vehicles in its attempt to achieve the specified goal of avoiding double taxation, and would not require the specific consent of another country (Barenfeld, 2005:255). However, such rules would not allow the specific characteristics of a particular business vehicle to be specifically catered for and addressed (Barenfeld, 2005:255).

Jones (2002:269) suggests that the qualification of income conflicts could be avoided by the OECD clarifying in its model convention that article 23 does not require the residence state to itself classify the income in order to determine whether the source state should have taxed the income and, thus, whether it should give relief. Jones further suggests three more solutions to the classification of income conflicts. Jones (2002: 320) proposes that either the residence state of the partner is to follow the source state's categorisation of the partnership as either transparent or opaque, or the state that regards the partnership as opaque is to follow the other state's classification of the partnership as transparent. Both instances require one state to defer to the classification made by the other state (Jones, 2002:320). Alternatively, Jones (2002:320) proposes that the treaty itself should categorise the partnership as either opaque or transparent. Jones (2002:320) notes, however, that the OECD model convention as it now stands is not equipped to make such classification. This is as the OECD model convention fails to make the distinction between companies and partnerships based on how such entities are taxed (Jones, 2002:315). The definition of a company is found in article 3(1)(b) of the OECD model tax convention as follows:

"the term 'company' means any body corporate or any entity that is treated as a body corporate for tax purposes."

In terms of this definition, Jones (2002:315) notes that a body corporate – which he has equated to a legal person – would be a company notwithstanding whether it is in fact taxed as such. Because of this definition, it is possible for some transparent partnerships to be treated as companies on account of their being body corporates (Jones, 2002:315). Jones (2002:316) thus proposes that the OECD model convention be amended to remove the assumption that all companies are opaque and all partnerships are transparent. Jones (2002:315) notes that while the assumption in respect of partnerships may be true generally in that 32 of the 37 types of general partnerships are transparent in the OECD countries mentioned in the Partnership Report, this assumption is now the subject of several exceptions. Such amendment would greatly assist in future treaty developments as states attempt to deal with conflicts in the classification of partnership income (Jones, 2002:320). Ultimately, Jones (2002:320) advocates that the conflicts in the classification of income should be addressed through the development of treaty solutions, and not solutions proposed in the form of commentary to the treaty provisions.

Rust (2003:45) adopts the view that the approach proposed in the Partnership Report and the 2000 version of the OECD Commentary leads to sound results in that the approach does avoid both double taxation and double non-taxation in instances of a conflict in the qualification of income between states. However, Rust (2003:45) further notes that this approach has its limits, and that uncertainty still exists as to whether the new approach would also be applicable to DTA's concluded before the 2000 amendments to the OECD Commentary.

According to Rust (2003:50) the approach has its limits in that it depends on the residence state applying article 23. In instances where both states are entitled to tax the income in terms of the DTA, the residence state must apply article 23 to grant relief from double taxation even though in its interpretation of the DTA it has the exclusive right to tax the income (Rust, 2003:50). The approach proposed in the Partnership Report may be applied successfully in such instances to provide relief. However, Rust (2003:50) notes that the efficacy of the proposed approach is doubtful in instances where the residence state's application of the DTA would have it precluded from taxing the income at all. In such instances, cases of double non-taxation would arise where the source state is also of the view that it is precluded from taxing the income. Such instances cannot be remedied through the application of article 23. Rust (2003:50) therefore concludes that the approach proposed by the Partnership Report does not work in instances where, according to the residence state, the exclusive right to tax the income vests in the source state. In light of the distinct lack of a better approach, Rust (2003:50) argues that the approach proposed in the Partnership Report should nonetheless be followed until a better solution is developed. This will ensure that at the very least double taxation and double non-taxation can be avoided in the greater majority of cases (Rust, 2003:50).

3.4 *International Case Law*

An interesting case arose in France, *SA Diebold Courtage*, where the Conseil d'Etat sought to apply the suggestions proposed in the Partnership Report. France as the state of source had considered the tax treatment of the partnership in the partnership's state of residence, and had applied the OECD's flow-through principle to conclude that it was the partners who were in fact entitled to the treaty benefits as the residents of the Netherlands.

In *SA Diebold Courtage*, a French company made rental payments to a Dutch limited partnership in respect of a sale and leaseback arrangement of certain computer equipment. Both the limited and the general partner were companies resident in the Netherlands. Approximately 65% of the rentals were then on-paid to a Swiss company. The French company partner argued that the rental payments were exempt from French tax in terms of article 12 of the France/Canada DTA of 16th March 1973 which deals with royalties. This article reads as follows:

"1. Royalties arising in one of the States and paid to a resident of the other State shall be taxable only in that other State.

2. The term "royalties" as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work (including cinematograph films and films or tapes for television or radio broadcasting), any patent, trade mark, design or model, plan, secret formula or process, or for the use of, or the right to use, industrial, commercial or scientific equipment, or for information concerning industrial, commercial or scientific experience.

3. The provisions of paragraph 1 shall not apply if the recipient of the royalties, being a resident of one of the States, has in the other State in which the royalties arise a permanent establishment, or a fixed base for the carrying out of professional services, with which the right giving rise to the royalties is effectively connected. In that case the provisions of Article 7 or Article 14, as the case may be, shall apply.

4. Where, owing to a special relationship between the payer and the recipient or between both of them and some other person, the amount of the royalties paid, having regard to the use, right or information for which they are paid, exceeds the amount which would have been agreed upon by the payer and the recipient in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In that case, the excess part of the payments shall remain taxable according to the States' own laws, due regard being had to the other provisions of this Convention."

France was entitled to tax the income earned by the Dutch partnership as the source of such receipts was the use of the computer equipment in France. On the other hand, the Netherlands was entitled to tax its residents on their worldwide income.

The Conseil d'Etat, as the state of source, examined the fiscal treatment of the partnership in the state of residence, and noted that the partnership was fiscally transparent in the Netherlands. Accordingly, the Conseil d'Etat held that it was not the partnership which was the resident entitled to the treaty benefits, but rather the partner companies who were so entitled. Based on the evidence set forth before the Conseil d'Etat, there was nothing to persuade it that the partner companies were not in fact the beneficial owners of the rental income. The Conseil d'Etat then concluded that the rental income was taxable only in the Netherlands as the state of residence in terms of article 12(1) of the DTA.

It is interesting to compare this case with an earlier decision of the Conseil d'Etat where it was not a foreign partnership but a French partnership involved. In *Re Société Kingroup*²⁷, a Canadian company had a 33% interest in a French groupement d'intérêt économique ("GIE") which carried on business in France and was established under French law. In terms of French law, a GIE is not a partnership but its tax treatment is substantially similar to that of most partnerships in France. The GIE is required to submit tax returns, but the profits generated in the GIE are taxed in the hands of the associates of the GIE in proportion to their interest. Canada was entitled to tax the Canadian associate's share of the GIE profits as the residence state, while France was entitled to tax the GIE profits as the state of source. Understandably, the Canadian associate argued that profits were to be taxed in Canada either as business profits under article 7, royalties under article 12, or dividends under article 10 of the France/Canada DTA.

The Conseil d'Etat adopted an interesting interpretation of 'business profits' in making its decision. It held that the term business profits under article 7 only applied to such profits which had been generated directly by the Canadian company, and not to the share of the profits of the GIE to which the Canadian company was entitled. Furthermore, the GIE profits distributed to the Canadian associate was neither a dividend nor a royalty. Accordingly, the DTA offered no exemption to the Canadian associate and the GIE profits distributed to it was subject to tax in France.

A further interesting case dealing with the taxation of cross-border partnerships is that of the Belgium case of *Rouquier et Rivay*²⁸. A French form of a partnership known as a *Société Civile Immobilière* ("SCI") was established with Belgian resident partners. A SCI is a special purpose vehicle used in France to build or acquire immovable property for the purposes of letting such property. SCI's are used to manage such rental activities. A SCI can either have the title to the immovable property automatically allocated to its partners (*SCI d'attribution*) or the title could remain in the SCI. In terms of French law, the SCI is an entity with separate legal personality but is treated as transparent for tax purposes (Neves, 2008:173). While the profits of the SCI are computed at the SCI level, the income

²⁷ *Re Société Kingroup* (with translation) (1997) 1 OFLR 399, decision of 4th April 1997

²⁸ Cass. 2 December 2004, *T.F.R.* 2006/304

generated by the SCI are allocated to and taxed in the hands of its partners as income from real estate (Neves, 2008:173).

France had taxed the income of the SCI in the hands of the individual partners as real estate income in the year in which such income was earned by the SCI. Once such profits were distributed to the individual partners, Belgium sought to tax the distribution as dividends received by the Belgian resident partners. In terms of the Court of Appeal decision, the court held that from a Belgian perspective the SCI was to be treated as a separate legal entity for tax purposes. This was regardless of the manner in which the entity was treated in France. Thus, the distribution received by the Belgian residents was a dividend and was to be taxed accordingly. The Court of Appeal further came to the decision that there was nothing in the France/Belgium DTA (dated 10 March 1964) which applied to classify such income as real estate income. Heavy reliance was placed on the Protocol to the DTA which was in force at the time. Article 2 of the Protocol (which corresponds to article 10 of the OECD model convention) confirmed that profits generated by a SCI *d'attribution* were taxable in France, while Belgium reserved its right to tax the profit distributed from such SCI's as dividends (Neves, 2008:175). Quaghebeur (2005:866) notes that the Protocol only applies to a specific kind of SCI and the entity in question was not of that kind. Quaghebeur (2005:866) further notes that the decision of the Court of Appeal was heavily criticized before the matter was finally resolved by the Supreme Court.

This decision was overturned by the Supreme Court. The Supreme Court held that article 2 of the Protocol was inapplicable in this instance. The Supreme Court noted that "dividends" was defined in article 15(5) of the DTA and this article specifically referred to the definition of a dividend under French law. Under French law, a dividend is confined to profits distributed by a company which are subject to French corporate income tax. The SCI was not subject to French corporate income tax. The Supreme Court further held that a Belgian court cannot classify income as a dividend when it was classified as real estate income under French law.

The Supreme Court held that the income was correctly taxed by France as real estate income in terms of article 3(2) of the DTA (which corresponds with article 6(2) of the OECD model convention). Article 3(2) stated that "the term immovable property shall be defined in accordance with the law of the Contracting State in which the property in

question is situated". As a result, Belgium was not entitled to tax the income in terms of article 3(1) and (2) read with articles 19(A)(2) of the DTA. Article 19(A)(2) of the DTA provides that "income shall be exempt from the Belgian taxes if France has the exclusive right to levy taxes thereon".

Quaghebeur (2005:866) welcomes the decision of the Supreme Court as he notes that relief has now been provided to Belgian resident companies. Had the income been classified as a dividend, the full amount of such dividend would have been subject to Belgian corporate income tax and the Belgian residents would not have had access to a participation exemption which otherwise exists under Belgian domestic law for dividends (Quaghebeur, 2005:866). The participation exemption is only available in respect of distributions made by a company subject to Belgian corporate income tax (Quaghebeur, 2005:866).

Neves (2008:171) notes in his analysis of the judgment that the approach adopted by the Supreme Court in arriving at its decision is not provided in the judgment. As a result, certain questions have remained open (Neves, 2008:171). It is unclear from the judgment whether the court actually regarded the income generation and distribution phases as irrelevant in arriving at its decision (Neves, 2008:171). On the other hand, it is equally unclear whether the court considered, on the correct reading of the DTA, whether the income was to be classified as real estate income rather than as dividend income (Neves, 2008:171). Such uncertainty is unfortunate as this case seemed to embody exactly the classification of income issues sought to be addressed in the Partnership Report. Had the court provided its reasoning for the approach it decided to follow, it would have added great persuasive value to the debate.

3.5 *Conclusion*

The issue of the taxation of cross-border partnerships raises several difficult questions. The OECD attempted to address some of these difficulties with its Partnership Report. However, although this report is certainly a step in the right direction, the OECD's distinct failure to make use of legal motivations in favour of its use of pragmatic and outcome-based reasoning has served to severely reduce the persuasive authority the report otherwise would have had on an international level. The OECD as well as many commentators proposed various solutions and approaches to adopt in harmonizing the taxation of

partnerships across jurisdictions. It would seem, however, that the solution proposed in the Partnership Report – namely, the particular interpretation of article 23 – will remain as the only solution largely accepted by the international community at this point, notwithstanding the limitations of this solution as pointed out by commentators.

4 SOUTH AFRICAN TAXATION OF CROSS-BORDER PARTNERSHIPS

4.1 Introduction

It was remarked by Zaaiman (2008:5) that while there is certainly an increase in the number of South Africans investing in offshore entities, such investors typically have limited choice in the legal form of the entity in which they invest. Their lack of choice largely stems from the fact that the type of legal structure implemented internationally is shaped by the tax and commercial concerns relevant to the foreign jurisdiction in which such structure is established (Zaaiman, 2008:5). Many South Africans may find themselves investing in what is essentially a partnership. This adds impetus to the need to develop a coherent South African approach to the taxation of international partnerships.

The taxation of cross-border partnerships bears particular relation to the competing interests of the state of residence and the state of source to tax the income generated either by its residents or within its borders. Since 2001, South Africa has adopted the residence basis of taxation in that all its residents would be taxed on their worldwide income. However, source is still relevant to the South African tax regime as non-residents of South Africa are taxed on their South African source income only. Source is also relevant in the international tax arena. As was mentioned at paragraph 3.1 above, the source state's right to tax profits generated within its borders is dealt with in the OECD model tax convention at articles 6 to 21. Source was defined in the *CIR v Lever Brothers and Unilever Ltd*²⁹ as follows:

"the source of receipts, received as income, is not the quarter whence they come, but the originating cause of their being received as income and that this originating cause is the work which the taxpayer does to earn them, the quid pro quo which he gives in return for which he receives them. The work which he does may be a business which he carries on, or an enterprise which he undertakes, or an activity in which he engages and it may take the form of personal exertion, mental or physical, or it may take the form of employment of capital either by using it to earn income or by letting its use to someone else."³⁰

²⁹ *CIR v Lever Brothers and Unilever Ltd* [1946] 14 SATC 1 (*Lever Bros*)

³⁰ *Lever Bros* op cit at 8

South African residents have the choice to seek relief from double taxation either through the application of a DTA or section 6quat of the ITA. Although the two options are similar in that both provide relief from double taxation, they are mutually exclusive in that section 6quat(2) specifically stipulates that the relief afforded under section 6quat cannot be used in addition to that granted under a DTA. Section 6quat is discussed in more detail at paragraph 4.6 below in so far as it may be a viable means of providing relief from double taxation to partners of a cross-border partnership.

The existing body of law regarding the application of DTA's to cross-border partnerships has recently been somewhat shaken by the delivery of the *Grundlingh v CSARS*³¹ judgment in 2009. This judgment has raised several issues regarding the taxation of cross-border partnerships, not least of all being its relation to the Appellate Division decision of *CIR v Epstein*³². The comments made regarding partnerships in the *Lever Bros* judgment also seems to conflict with the *Grundlingh* case.

This chapter will begin the process of reconciling our sources of law into one coherent South African approach to the taxation of cross-border partnerships through setting out the judgments of *Epstein*, *Lever Bros* and *Grundlingh*. In doing so, it is noted that the *Epstein* and *Lever Bros* cases were decided before South Africa changed from a source basis to a residence basis of taxation, while *Grundlingh* was decided after this change. The published commentaries on these cases will be considered before a reconciliation of the dicta espoused in the cases is proposed.

4.2 *Consideration of CIR v Epstein*

4.2.1 Judgment

This judgment centred on determining the source of income earned by a South African resident taxpayer in partnership with a non-resident. In terms of this partnership, it was agreed that the non-resident partner would find a purchaser for asbestos and lock the purchaser in at a certain price through a contract concluded in Argentina. He would then notify the taxpayer of the quality & quantity of asbestos required and also which supplier

³¹ *Grundlingh v CSARS* [2009] 72 SATC 1 (*Grundlingh*)

³² *CIR v Epstein* [1954] 19 SATC 221 (*Epstein*)

to approach at the agreed price. The taxpayer would arrange with the supplier, and have the asbestos shipped to Argentina where it was sold to the purchaser. The profits remaining after covering the cost of freight and other costs were split equally between the two partners, while losses were also shared equally. The Commissioner sought to tax the taxpayer's share of the partnership profits in South Africa. The taxpayer argued that the source of the income so earned was not South Africa. At the time of this case, South Africa taxed its residents on a source-basis.

The court was divided as to the source of the income. The majority of the court, per Centlivres CJ held that the source of the income was in South Africa while the minority held that it was in Argentina. In delivering the majority judgment, Centlivres CJ noted that all of the taxpayer's activities in respect of this arrangement were carried out in South Africa. The court made reference to *Millin v CIR*³³ where in that judgement, the court held that the source of the royalties earned was where the taxpayer had exercised her wits and labour which had produced the royalties. As she had exercised her wits and labour in South Africa, the source of the royalties was accordingly in South Africa.

Centlivres CJ held the following:

"Applying what Solomon, C.J., said in Millin's case – which was not referred to in the judgments of the Special Court and the Provincial Division – to the facts of the present case there can, in my opinion, be no doubt that the respondent's profits in connection with his dealings in asbestos were received from a source within the Union³⁴. He carries on business in Johannesburg. He renders no services and spends no money outside the Union in connection with his association with Hendrickse and Company and he uses his own banking account for the purpose of financing the transactions in respect of asbestos. All of the activities of the respondent were carried on in the Union and it was as a result of these activities that he earned the profits which the Commissioner now seeks to tax. It therefore follows that those profits were received from a source within the Union."³⁵

The minority held a different view. Schreiner JA noted that the present case dealt with the taxation of profits of a business. Schreiner JA further noted that what was of importance was the place where the business profits were realised, and not where the taxpayer himself has personally exerted himself. A business may be carried on through partners or other agents. Another important remark made by the minority was that the transactions in both

³³ *Millin v CIR* [1928] 3 SATC 170

³⁴ The Union of South Africa

³⁵ *Epstein* op cit at 232

countries were the transactions of both partners, and the income which each received as a result of such transactions had to originate in the same place. In determining the location of such place, Schreiner examined foreign case law and found that the majority of the cases adopted the view that the origin of the profits from the sale of goods was the place where the goods were sold. Schreiner JA distinguished *Millin v CIR* on the basis that *Millin* was not a case of the buying and selling of goods. In agreeing with the view adopted in foreign jurisdictions, Schreiner JA held that the source of the profits earned was the place where the goods were sold; namely, the Argentine.

4.2.2 Commentary on the Case

Hahlo (1954:292) commented on the difficulty in following the reasoning of the majority of the court. Given that the partnership is not a separate legal entity and the partners are assessed individually on their respective share of the partnership profits, the logical conclusion must be that the originating cause of the partners' share of the partnership profits must be the same as that of the partnership profits (Hahlo, 1954:293). Hahlo (1954:293) notes that the majority recognised this and attempted to address it. The court stated that in the case of a partnership consisting of partners operating in two countries, the source of the partnership profits is derived from two sources. The source of each partner's share of the partnership profits is within the country in which such partner had carried on his activities on behalf of the partnership.

Hahlo (1954:293) further commented that the Appellate Division should have followed the English decision of *Sulley v The Attorney-General*³⁶, a judgment which had consistently been followed for eighty-four years and which was directly in point to the *Epstein* case. The *Sulley* case dealt with a partnership consisting of partners residing in New York and England. The appellant was the partner residing in England. He was charged with the purchase of the goods in England which were then shipped to New York to be resold at a profit. The court in *Sulley* held that there was no carrying on of a trade in England, and that the partner's principle place of trade in the sense that it was the place where his profits came home to him was New York. The majority of the court in *Epstein* adopted the view that *Sulley* was inapplicable as the case had been decided in terms of an English statute while this case was to be decided in terms of section 7 of the ITA. Hahlo (1954:293) takes the view that this reasoning is irrelevant to the issue at hand. The differences between the

³⁶ *Sulley v The Attorney-General* (1860) 5 H. & N. 711; 2 T.C. 149

two statutes had no bearing on the issue to be decided in either case (Hahlo, 1954:293). The issue in *Sulley* was exactly the same as the issue to be decided in the *Epstein* case.

Gillooly (1981:386) also remarked on the difficulty encountered in following the reasoning of the majority of the court in *Epstein*. Gillooly notes that while the Special Court reached the decision in *ITC 749*³⁷ that when a Johannesburg accountant ventured to Lourenco Marques to conduct an audit he did so as a member of a firm and that the originating cause of his income was outside South Africa, the majority of the court in *Epstein* ventured a different path. The conclusion reached by the majority of the court in *Epstein*, and the position of South African law as a result, bears an intrinsic problem in that it requires the partner to virtually contract with himself. The partnership is not a separate legal entity. Therefore, the partner's share of the partnership profits would essentially be paid to him for the services he has rendered to himself as forming part of the partnership (Gillooly, 1954:386).

4.3 *Consideration of CIR v Lever Brothers and Unilever Ltd*

4.3.1 Judgment

The decision in *CIR v Lever Bros* concerned the determination of the source of interest income. Lever Bros, an English company, sold some of its assets to a Dutch company for £11 million on loan. The Dutch company accordingly became liable to pay the interest on such loan. As security for the loan, the Dutch company gave Lever Bros shares in a United States company of a value exceeding that of the loan. The shares were lodged with an English company acting as a trustee. In March 1939, a South African company was formed. All the security shares vested in this South African company, and it duly assumed the Dutch company's rights and obligations in terms of the original agreements. Payment was moved from Rotterdam to London, and the South African company was to make all future payments. The Commissioner sought to tax Levers Bros on this interest received as being from a South African source.

Once again the court was split as to the source of the income. The judgment of the majority of the court was delivered by Watermeyr CJ while the minority judgment was delivered by Schreiner JA. Watermeyr CJ held that the source of receipts was the originating cause of

³⁷ *ITC 749* [1952]18 SATC 319

the income being received. This originating cause was the work which the taxpayer does to earn the income. In applying this to the case, the court found that the originating cause of the interest received by Lever Bros was the provision of credit. More specifically, the court held that it was Lever Bros' making and carrying out of the agreement relating to the £11 million which had earned it the income. While the court failed to make a ruling as to the exact location of the originating cause in this case, it did rule that as Lever Bros did not conduct any activities of any kind in South Africa the originating cause was most certainly not located in South Africa. Schreiner JA adopted a different view to the majority of the court. The minority held that the originating cause of the interest was the debt itself. In determining the location of such originating cause, the minority found that this was to be the residence of the debtor. Accordingly, as the debtor was a South African resident the interest was of a South African source.

Of importance for the purposes of this paper is Schreiner JA's comments – albeit *obiter dicta* – regarding the source of a partnership's income. Schreiner JA's remarks as follows:

"In the case of shares it is possible that the shareholder might under some income tax statutes be looked upon as a partner in the company's business, but no one would speak of the purchase of his shares as the source of his income any more than one would speak of the partnership agreement as the source of the income of a partner."³⁸

4.3.2 Commentary on the Case

The dictum of the *Lever Bros* case is widely accepted in South African law, and is oft-quoted. In terms of the *ratio decidendi* of the judgment, it has been rendered obsolete with the introduction of the deemed source provisions of sections 9(6) and 9(7) of the ITA in 1998.

Section 9(6) of the ITA provides that interest shall be deemed to be of a South African source where the interest-bearing borrowed funds are "utilised or applied" or applied in South Africa. Section 9(7) of the ITA determines that funds shall be deemed to be "utilised or applied" at the place where, in the case of a natural person, the lender is ordinarily resident and, in the case of a person other than a natural person, where its place of effective management is situated. It is important to note that these deeming provisions do not

³⁸ *Lever Bros* op cit at 17

overrule the true source rules, as set down in the *Lever Bros* case, but are intended to supplement them. The deeming provisions are therefore to be applied once application of the true source rules fails to produce a result.

Furthermore, the Supreme Court of Appeal judgment of *First National Bank of Southern Africa Ltd v CSARS*³⁹ seems to reject the *Lever Bros* view regarding the source of interest. The taxpayer in this case had access to foreign currency through loans it would make from foreign banks interested in lending money to South Africa. The taxpayer's client would request foreign currency in its rand equivalent. The client would then obtain the rand equivalent of the foreign currency in South Africa through the taxpayer's treasury account in New York. The South African client would then be debited in South Africa, in rand, in the books of the taxpayer's branch at which it was a customer. If the foreign currency was paid to the client overseas, or paid out overseas on its behalf, its branch account with the taxpayer would be debited with the then rand equivalent and, in addition to the capital of the loan, the client would be debited in South African rand with the interest charged by the foreign bank together with an added margin on the interest (representing the taxpayer's remuneration or profit) as well as a premium for forward exchange rate cover, if this was required. The foreign currency loan was pegged to the foreign currency in question and had to be repaid to the taxpayer in New York in that currency on the maturity date. Where the client utilised the taxpayer's services for this purpose, which was usually the case, payment was effected by converting the client's South African rand into the required foreign currency in the foreign exchange department at the taxpayer's head office in South Africa and passing the necessary credits by means of appropriate book entries. This resulted in the client's branch account in South Africa being credited in rand with the amount repaid and the equivalent foreign currency being transferred to the taxpayer's Chase Manhattan Bank account via its treasury account in New York. The taxpayer argued that in terms of the *Lever Bros* case, the source of the interest was in New York as this was determined to be the place where the funds attracting the interest were made available to the taxpayer.

The Supreme Court of Appeal, however, was of a different opinion. The court held that the taxpayer's reliance on the *Lever Bros* case was misplaced as the facts of the case were materially different from that of *Lever Bros*. Of significance to the court was that all the

³⁹ *First National Bank of Southern Africa Ltd v CSARS* [2002] 64 SATC 245

important factors which caused the interest income to arise (and which constituted the dominant cause of the receipt of the interest) had their origin in South Africa and flowed from the taxpayer's business activities and operations in South Africa. The only connection with New York was the fact that contractually the foreign currency had been made available to the borrowing client in New York and had to be repaid there. The court found that the view adopted by the taxpayer was very narrow in that it only focused on where the funds had been made available and had to be repaid. The court held that regard would have to be had to the essence of the whole transaction which generated the interest with a view to determining the location of its source. As such, the source of the interest was South Africa when one had regard to the overall factual matrix applicable in this case.

The *Lever Bros* view on the source or originating cause of interest therefore no longer stands as authority in South African law.

4.4 *Consideration of Grundlingh v CIR*

4.4.1 Judgment

The taxpayer *in casu* was a resident of South Africa and a partner in a law firm established in Lesotho. South Africa sought to tax the partnership profits earned by the resident based on the residence of the taxpayer, while Lesotho sought to tax the profits on the basis of the income being of a source within Lesotho. Lesotho taxes partnerships in the same manner as South Africa in that the partnership profits are taxed in the hands of the individual partners, and not at the partnership level. An assessment was raised by the Commissioner in terms of which the partnership profits were included in the taxpayer's taxable income, while a credit was recognised for the taxes paid in Lesotho on the same income. The taxpayer objected to this assessment, and sought to invoke the provisions of the Lesotho/South Africa DTA to produce a different result.

The parties had agreed that the partnership business constituted a permanent establishment in Lesotho. A fixed place of business and office were located in Lesotho. The taxpayer argued that Lesotho was granted the sole right to tax the partnership profits in terms of article 7 of the DTA. Article 7(1) of the relevant DTA reads as follows:

"The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein."

The taxpayer argued that the partnership itself was the 'enterprise of a Contracting State' (Lesotho), as contemplated in article 7(1). Accordingly, and as the taxpayer's argument went, South Africa was precluded from taxing the taxpayer on the profits of the partnership on the basis that the partnership did not have a permanent establishment in South Africa and the partnership paid tax in Lesotho.

In analysing this case, it is necessary to consider both the judgments of the Bloemfontein Tax Court (*ITC 1819*⁴⁰) and the Free State High Court⁴¹.

4.4.1.1 Tax Court Decision

The court rejected SARS argument that it was article 14 and not article 7 of the DTA which applied *in casu*. Article 14 relates to the income earned from 'independent personal services'. Article 14(2) defines 'independent personal services' as including independent scientific, literary, artistic, educational or teaching activities as well as the independent activities of physicians, lawyers, engineers, architects, dentists and accountants. In terms of article 14, the state in which the fixed base of a professional person is located would be entitled to tax the income attributable to such fixed base, regardless of the right of such person's resident state to tax the income.

The court reasoned that when one is dealing with a 'share of profits', as the parties agreed was the case here, 'independent services' as is contemplated in article 14 would not feature. The court also drew from the manner in which the profit share was calculated that the court was not dealing strictly with fee income. This was as the calculation of the profit share did not include fees which were attributable to the taxpayer on account of the taxpayer having rendered services to a particular client who had duly paid those fees to the partnership. In the absence of such attribution, it could not be argued that article 14 was applicable.

⁴⁰ *ITC 1819* [2007] 69 SATC 159

⁴¹ *Grundlingh v CSARS* [2009] 72 SATC 1

On the other hand, the court did not completely find in the taxpayer's favour either. The court rejected the taxpayer's argument that the application of article 7 to the facts produced the results which the taxpayer sought; namely, his share of partnership profits being exempt from tax imposed in South Africa. The court also rejected the taxpayer's argument that it was the partnership which was the 'enterprise of a Contracting State' as envisaged in article 7(1). The court held that it was only persons who were residents in terms of the DTA who would be entitled to the benefits of the DTA. A 'resident' is defined in article 4 of the Lesotho/South Africa DTA as follows:

"1. For the purposes of this Agreement the term 'resident of a Contracting State' means:

(a) in Lesotho, any person who, under the laws of Lesotho, is liable to tax therein by reason of his residence, place of management or any other criterion of a similar nature; and

(b) in South Africa, any individual who is ordinarily resident in South Africa and any other person which has its place of effective management in South Africa.

3. Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident of the State in which its place of effective management is situated."

A South African resident is thus "any individual who is ordinarily resident in South Africa and any other person who has its place of effective management in South Africa". It was clear that the taxpayer partner was a resident of South Africa. However, the partnership was not a resident of Lesotho as it was not liable to tax in Lesotho. It was the individual partners of the partnership who were liable to tax in Lesotho. Therefore, for the purposes of article 7, it was the partner who was the 'person' who carried on an enterprise in Lesotho together with his partners. As such enterprise carried on business in Lesotho through a permanent establishment in Lesotho, Lesotho was entitled to tax the profits so generated from the permanent establishment. On the other hand, South Africa as the residence state is entitled to tax its resident on the profits generated from the partnership in Lesotho. Article 22 of the DTA would have South Africa provide the taxpayer relief from the double taxation through those taxes paid in Lesotho being credited against the taxes due on the same income taxed in South Africa.

4.4.1.2 Free State High Court Decision

The taxpayer appealed against the Tax Court decision to a full bench of the Free State High Court. The taxpayer argued that the lower court had erred in not finding that it was the

partnership which was the enterprise of Lesotho for the purposes of article 7(1) of the DTA, as the lower court had accepted that the partnership carries on its business in Lesotho through the taxpayer and the Lesotho resident partners. Also, it must be noted that the Commissioner argued its case on the basis that it was entitled to tax the partnership income in terms of article 7(1), and in the alternative it relied on article 14.

The court confirmed the lower court's finding that it was the taxpayer partner who was liable to tax in Lesotho on his share of the partnership profits. The taxpayer was deemed to carry on the business of the partnership. The partnership was not a 'person liable to tax' and accordingly was not a resident as defined in the DTA. The court also found that the fact that the partnership was required to register for tax purposes in Lesotho, and the fact that the partners were required to file a consolidated return in Lesotho did not mean that the partnership was liable to tax in Lesotho. The partnership was therefore not entitled to claim any relief in terms of the DTA. The court further found that article 7(1) was therefore not applicable *in casu*.

An interesting point is the court's reliance on section 24H of the ITA in coming to such conclusion. Both the Tax court and the High court relied on section 24H(2) of the ITA in finding that the taxpayer was deemed to carry on the business of the partnership. Thus, the profits generated from the partnership were accordingly profits generated from the business of the South African resident partner.

4.4.2 Commentary on the Cases

4.4.2.1 Commentary on ITC 1819

Gutuza (2008:517) draws into question in her article the court's reliance on section 24H in its decision-making. It was commented in her work that section 24H(2) is a deeming provision. Therefore, while article 3(2) of most DTA's would entitle the country invoking the DTA to attribute its domestic meaning of an undefined term used in the DTA, article 3(2) does not make reference to the use of a deeming provision found in such domestic legislation (Gutuza, 2008:517). Section 24H(2) reads as follows:

"(2) Where any trade or business is carried on in partnership, each member of such partnership shall, notwithstanding the fact that he may be a limited partner, be deemed for the purposes of this Act to be carrying on such trade or business."

Also, article 3(2) reads as follows:

"2. In the application of the provisions of this Agreement by a Contracting State, any term not otherwise defined herein shall, unless the context otherwise requires, have the meaning which it has under the laws of that State concerning the taxes which are the subject of this Agreement."

She further argues that while the DTA and the ITA should be read together, one must consider the fact that the deeming provisions may undermine or affect the application of the DTA altogether (2008:518). In support of this statement, she notes that were it not for the deeming provision of section 24H(2), the partnership in Lesotho may not necessarily be a trade or business carried on by the resident partner – as was the case in *CIR v Epstein*.

Gutuza (2008:519) further makes the argument in her article that the use of section 24H(2) in the manner espoused in *ITC 1819* is to use the section out of its context. She argues that the purpose of the section is to regulate the tax treatment of partnership income. As the section was introduced in response to the *Sacks v CIR* judgment, it ensures that the taxation of the partnership income is not deferred through the income remaining in the partnership and not distributed to its partners. Thus, she argues that section 24H(2) should not be used beyond its purpose in allowing the partners access to the deductions and allowances which would not necessarily have been available to them without such a deeming provision.

4.4.2.2 Commentary on the Grundlingh Case

Hattingh (2010:45) comments that the judgment contains a basic inaccuracy in the manner in which the conclusion was reached by the court. The court held that article 7(1) did not apply, and therefore it did not have to deal with article 14. The court further held that the Commissioner had been correct in crediting the Lesotho taxes paid by the partner against the partner's taxes due in South Africa. Hattingh further notes that this comment made by the court may be read as effectively overturning the lower court's judgment that article 7 did apply. This represents a particular difficulty as article 7 does in fact apply in the circumstances of the case.

Hattingh notes that in terms of understanding the application of a DTA, one of the distributive rules of the DTA must be applicable to the income before it can be said that an obligation arises under the DTA to provide relief from double taxation. Article 7(1) was clearly applicable as the taxpayer carried on business in Lesotho through a permanent establishment located in that country (Hattingh, 2010:46). Hattingh (2010:47) is accordingly of the view that the conclusion reached in *ITC 1819* is the correct one. Also, the reasoning adopted by this court in determining that article 14 was not applicable is also convincing (Hattingh, 2010:47).

4.5 *Proposed Reconciliation of Case Law*

It is submitted that because of the introduction of section 24H into the ITA in 1988 the majority judgment of *Epstein* can no longer be applied. The decision in *Grundlingh* therefore represents our law on the issue of the taxation of cross-border partnerships. This submission finds support in the view adopted by Olivier (2009) where it was stated that as section 24H(2) views the partnership as one business, the minority view expressed by Schreiner JA would be more fitting in the new legislative landscape.

In making this submission, it is necessary to consider the criticisms levelled against the judgments.

i) Reliance on the Deeming Provision of Section 24H(2)

Gutuza (2008:517) argues that it is article 3(2) of the DTA which entitles a country to make use of its domestic law to interpret the provisions of the DTA. Article 3(2) does not seem to encompass deeming provisions of such domestic law (Gutuza, 2008:517).

It is submitted that while article 3(2) does bring domestic law of the country seeking to use the DTA into the interpretation of such DTA, section 108 of the ITA does this as well. Section 108(2) specifically states that as soon as the procedures in terms of section 231 of the Constitution⁴² have been followed and Parliament has approved the DTA, such DTA shall have the effect as if it were enacted in terms of the ITA. The DTA would therefore

⁴² Constitution of the Republic of South Africa, Act 108 of 1996

form part of the ITA, and the two should be read as forming one composite whole (Olivier & Honiball, 2005:36). As a result, in terms of South African law the provisions of the DTA would not bear a special status in relation to domestic provisions (Olivier & Honiball, 2008:36). Therefore section 24H with its deeming provision of section 24H(2) must be read with the DTA, in terms of section 108(2) of the ITA. Section 24H(2) also specifically states that partners are to “be deemed for the purposes of this Act to be carrying on such trade or business”.

This is confirmed by the following statement in *ITC 1544*⁴³ where it was held that:

“The effect of s 108(2) of the Act is to grant statutory relief in certain circumstances where the South African Act imposes a tax, where the provisions of a double-tax Convention grants an immunity or exemption from such tax to persons governed by the Convention. Tax is not payable to the extent to which an immunity or exemption from tax is granted in terms of a binding double tax Convention which has been proclaimed and thus has statutory effect. Secretary for Inland Revenue v Downing 1975(4) SA 518(A) at 523. The terms of a double tax Convention on which statutory status has been conferred are to be considered as any other statutory provisions to determine the extent to which these conflict with the provisions of another statute and whether such provisions have been modified thereby. Ostone (Inspector of Taxes) v Australian Provident Society 38 TC 492 at 514(HL); Commissioner for Inland Revenue v Collis Dealing Ltd 39 TC 509 at 521(HL).” (*Emphasis added*)

The current legislative landscape requires one to make use of domestic legislation to interpret the provisions of a DTA. Such licence to resort to domestic legislation may be found in article 3(2) of the DTA and also section 108(2) of the ITA. These provisions make it clear that one cannot ignore domestic law in the interpretation process, and further that one may rely on domestic definitions and deeming provisions in such process.

ii) Section 24H(2) used out of its Context

Gutuza (2008:519) argues that the purpose for the introduction of section 24H(2) of the ITA is to allow partners access to the deductions and allowances of the ITA which may not otherwise have been available to certain partners in the absence of the express provisions of section 24H(2). The section was therefore not meant to be used for the purpose of interpreting a DTA with a view to determining which article applied. Gutuza (2008:517) further argues that such use may undermine or affect the application of the DTA.

⁴³ *ITC 1544* [1992] 54 SATC 456

The concerns of Gutuza were to a certain extent shared by SARS before the introduction of section 24H in 1988 (Meyerowitz, 1988:31). SARS was well concerned that the partner *en commandite* would be denied access to the deductions in terms of section 11 of the ITA, according to the statement made in the *Explanatory Memorandum on the Income Tax Bill, 1988*⁴⁴. However, this concern stemmed from the fact that SARS was of the view that the partner *en commandite* cannot be said to be carrying on the business of the partnership when our common law prohibited such partner from participating in the business of the partnership (Meyerowitz, 1988:31). As a result, SARS believed that it was only the general partner who could be said to be carrying on the trade of the partnership (Meyerowitz, 1988:31). The Explanatory Memorandum (1988:22) states that the purpose for the introduction of section 24H(2) is to clarify that a limited partner would be considered to be carrying on the business of the partnership, notwithstanding the limitations imposed on such partner.

Meyerowitz, however, argues that this provision is unnecessary (1988:31). Meyerowitz (1988:31) notes that the partnership consists of a group of persons all carrying on a trade for the benefit of all. It was made clear in *Bester v Van Niekerk*⁴⁵ that each partner must contribute something towards the partnership and this may be in the form of labour, money or skill. From this it is clear that it is not necessary that each partner must contribute labour towards the partnership. Accordingly, Meyerowitz (1988:31) argues that there is no rational basis on which it can be argued that all of the partners of a partnership where all of the partners contribute their labour are carrying on a trade, while other partners who are prohibited by law or agreement from participating in the business of the partnership – but have well contributed their capital – are not carrying on a trade. In both cases, all of the partners bear the risk that the partnership would incur losses – some partners to a lesser degree than others – and all would share in the profits realised by the partnership (Meyerowitz, 1988:31). There is no doubt therefore that all of the partners would therefore be carrying on a trade in respect of that partnership.

It is clear from the above that even in the absence of section 24H(2), a silent partner or partner *en commandite* would be regarded as carrying on a trade in respect of the partnership notwithstanding the fact that such partner may be prohibited, in terms of our

⁴⁴ Hereinafter referred to as the "Explanatory Memorandum"

⁴⁵ *Bester v Van Niekerk* [1960] (2) SA 779 (AD)

domestic common law or in terms of the partnership agreement, from participating in the partnership business. Such partners would therefore have access to the allowances and deductions of the ITA even in the absence of section 24H(2). Furthermore, given that the deeming provision is in fact unnecessary in determining whether a silent partner or partner *en commandite* would be carrying on the business of the partnership, the use of the deeming provision in the interpretation of a DTA would not undermine or affect the application of a DTA as the position would be the same with or without such deeming provision.

iii) Methodology adopted by the courts

Hattingh (2010:47) proposes the following methodology to be adopted by South African courts in future in order to avoid the confusion which seemed to permeate both the *ITC 1819* and *Grundlingh* judgments.

First, a court must determine how the partnerships are treated in terms of the domestic law of the two states (Hattingh, 2010:47). Second, it should be examined whether application of the DTA would produce a result different to the one generated from an application of the two domestic regimes (Hattingh, 2010:47). In this step, each state would apply the provisions of the DTA while using its domestic law to interpret the undefined terms of the DTA. It is at this stage when the issue of the taxation of cross-border partnerships becomes tricky. However, it must be borne in mind that from the residence state's perspective, such state's interest in the DTA would only be to the extent that the DTA requires it to grant the taxpayer relief as the income is taxable in the source state (Hattingh, 2010:49). It is therefore required that the residence state agrees that the source state is entitled to tax the income in accordance with the DTA (Hattingh, 2010:49). International debate in the form of Commentary to the OECD Model Tax Convention on Income and on Capital could assist in resolving the differences which may arise in the two states in respect of the classification of the income in terms of the DTA. Certain solutions were proposed by the OECD and were discussed under chapter 3 above. In the *Grundlingh* case, matters were simplified by the fact that both Lesotho and South Africa classified the income in the same way, and both regimes taxed partnerships in the same manner. Hattingh (2010:50) is of the view that following this approach would ensure consistency in the manner in which DTA's are examined and applied in South African courts.

A consistent approach could also be found in following that proposed by Edwardes-Ker as cited by Oliver & Honiball (2008:11). In terms of this approach, the first step would be to determine whether domestic law imposes a tax liability on the taxpayer (Olivier & Honiball, 2008:11). Should no liability arise, there would be no need to resort to the treaty given that no double taxation would exist (Olivier & Honiball, 2008:11). In the event that domestic law does impose a tax liability, the next step would be to consider the provisions of the DTA to determine which of the two states is entitled to tax the income (Olivier & Honiball, 2008:11). Should the treaty not allow the state to tax the income, and despite the existence of domestic legislation imposing the tax liability, the state is precluded from taxing the income (Olivier & Honiball, 2008:11). In the event that the treaty does entitle the state to tax the income, the third step would be to determine whether such treaty provision places any limitation on such state's right to tax (Olivier & Honiball, 2008:11).

4.6 *Section 6quat and Cross-Border Partnerships*

Section 6quat of the ITA and the relief it could provide becomes particularly relevant when one considers that not all countries conclude DTA's. Moreover, DTA's specifically do not provide relief from economic double taxation. In this section, a very limited account of the provisions of section 6quat in so far as it may apply to cross-border partnerships is provided.

The relief section 6quat provides is either in the form of a credit (rebate) or a deduction. The mechanics of the credit method is that the foreign taxes paid by the resident taxpayer are credited against such taxpayer's tax liability. The deduction method, on the other hand, has the foreign taxes paid reducing the taxpayer's taxable income subject to South African tax. Usually, it is more beneficial for the foreign taxes to be recognised as a credit rather than a deduction under section 6quat as the credit method would have the foreign taxes reducing the South African taxes due on a like-for-like basis. Unfortunately, the taxpayer does not have a choice whether the foreign taxes paid will be recognised as either a credit or a deduction under section 6quat.

Wilson (2005:8) summarises the types of income included in the taxpayer's taxable income under section 6quat(1) of the ITA which would qualify for the rebate or credit:

- i) Any income, excluding a foreign dividend, received by or accrued to the taxpayer from a non-South African source that is not deemed to be of a South African source;
- ii) Any part of a CFC's income;
- iii) Any foreign dividend;
- iv) Any taxable capital gain in so far as it is attributable to a foreign asset that is not deemed to be of a South African source; and
- v) Any income deemed to be that of the taxpayer's in terms of section 7, the attribution rules of the Eighth Schedule, or section 25B of the ITA.

The amount of such rebate is determined under section 6quat(1A) as an amount equal to the sum of any taxes on income proved to be payable without any right of recovery (other than a right of recovery in terms of any entitlement to carry back losses arising during any year of assessment to any prior year of assessment) to the government of the foreign country. The rebate is limited under section 6quat(1B) to an amount that does not exceed an amount that bears to the total normal tax payable the same ratio as the total taxable income attributable to the income derived from the other country bears to the total taxable income. Any excess beyond such limit is not lost but is carried forward to the following year of assessment.

Foreign taxes payable without a right of recovery by a South African resident on income which does not fall into one of the categories listed under section 6quat(1) shall be deducted from the resident's taxable income under section 6quat(1C) of the ITA.

It is interesting to note that the proviso to section 6quat(1A) of the ITA provides that in the event that the partnership is treated as a separate entity in another state, a proportion of the tax paid by such partnership entity as is attributable to the resident partner is deemed to

have been paid by such resident partner. As a result, section 6quat would provide resident partners of cross-border partnerships relief from economic double taxation. Section 6quat would certainly be of assistance to resident partners in instances where the DTA does not apply or where there is no DTA in existence at all.

4.7 Conclusion

With the introduction of section 24H into the ITA in 1988, the taxation of partnerships was codified in South Africa. This introduction has also significantly changed the common law of the taxation of cross-border partnerships. The *Epstein* case was the authority on determining the source of a partner's share of the partnership profits for over fifty years. Despite the inherent difficulties in following the reasoning of the majority, the judgment has been applied without fail for a number of years according to our doctrine of *stare decisis*.

It is submitted that the *Grundlingh* case now reflects the South African position on the taxation of cross-border partnerships. It is further submitted that as the *Grundlingh* case is distinguishable from *Epstein*, the judgment of *Epstein* was not binding on the High Court which decided *Grundlingh*. *Epstein* was decided before the introduction of section 24H(2) while *Grundlingh* was decided after the introduction of this section into the ITA. This has significantly changed the decision-making matrix used by the court in making its decision in *Grundlingh*. As was stated in the arguments above relating to the reliance on section 24H(2) in the *Grundlingh* case, section 24H must be read with the DTA in terms of section 108(2) of the ITA. As *Epstein* predated section 24H, it was irrelevant to the issue before the court in the *Grundlingh* case. However, given that the authority of *Epstein* was nonetheless in existence at the time that the *Grundlingh* judgment was taken, it is unfortunate that neither the Tax Court nor the High Court referred to the *Epstein* judgment at all.

The current South African position is that each partner of a partnership is deemed to carry on the trade of the partnership in terms of section 24H(2) of the ITA. As each partner is carrying on a trade, article 14 of the DTA would not be applicable as it is not personal independent services which are rendered by each partner. Instead, each partner is carrying on the business of the partnership from which it is expected that business profits would be

generated. Article 7 (business profits) would therefore be of application in determining which country of the two countries involved in the cross-border partnership would be entitled to tax the partnership profits.

At the same time, it is important to bear the possible relief which section 6quat of the ITA may be able to provide resident partners in mind. It would be particularly useful in instances where the DTA would not apply, such as in instances of economic double taxation, and would be essential where there is no DTA between South Africa and the other country.

5 PRACTICAL EXAMPLE OF THE SOUTH AFRICAN APPROACH

5.1 Circumstances of the Practical Example

In order to understand the South African approach to the taxation of cross-border partnerships, it may be useful to consider a practical example. Example 18 of the Partnership Report will be considered and adapted to include a South African resident partner. This example is selected as it represents the most common scenario which would arise in the taxation of cross-border partnerships in South Africa.

A partnership, P, is established in State P and has a permanent establishment in that state. One of the two equal partners of P, X, is a resident of South Africa. State P regards the partnership to be a separate legal entity for tax purposes, while South Africa treats the partnership as a transparent entity for tax purposes. In year 1, P earns profits of R1 million. In year 2, P distributes the profits to the resident partners. In year 2, the partnership distributes to resident partner X his share of the partnership profits being an amount of R300 000.

Under State P's domestic laws, P is a company and the profits would be taxed in year 1 at 40% (R400 000). In year 2, a further withholding tax (R30 000) on the distribution to X would be imposed (by treating it as a dividend). Under South Africa's domestic law, P is fiscally transparent. South Africa would tax X in year 1 on X's 50% share in P's profits (R500 000). South Africa would treat the distribution in year 2 as having no effect.

5.2 *OECD Approach*

The following difficulties are raised in the Partnership Report:

- i) State P taxes two different events while South Africa (as the other state) would only recognise one, as the earning of the profits;
- ii) The timing mismatch as a result of State P taxing the distribution in year 2 while South Africa would impose the tax in year 1; and
- iii) The tax levied in State P on the partnership profits would be paid by the partnership while the tax levied in South Africa on the same income would be paid by the resident partner.

In overcoming these difficulties, the Partnership Report proposes the following approach:

- i) The assumption is made that article 7 (business profits) of the model tax convention applies;
- ii) No double taxation would arise on the distribution of the profits. Such profits would only be subject to tax in State P as South Africa only recognises one taxable event – the earning of the profits.
- iii) South Africa cannot be expected to credit the taxes paid in State P on distribution against the taxes in year 2 levied in South Africa on the generation of the profits in year 1;
- iv) The timing mismatch is now irrelevant;
- v) In addressing the fact that the taxes paid on the generation of the profits is paid by two different taxpayers, the OECD proposes that the flow-through principle

must be applied in that South Africa is obliged in terms of the model tax convention to credit the taxes paid by the partnership in State P against the taxes due in South Africa by the resident partner on his share of the partnership profits. This principle is set out in the Partnership Report as:

"To the extent that State R [South Africa] flows-through the income of the partnership to the partners for the purpose of taxing them, it should be consistent and flow-through the tax paid by the partnership for the purposes of eliminating double taxation arising from its taxation of the partners. In other words, if the corporate status given to the partnership by State P is ignored for purposes of taxing the share in the profits, it should likewise be ignored for purposes of giving access to the foreign tax credit."⁴⁶

This approach has been incorporated in the Commentary on the OECD model tax convention at para 69.2 of the Commentary on article 23A and B.

5.3 *South African Approach*

From a domestic law perspective, the resident partner would be subject to tax in South Africa on his share of the partnership profits generated in State P. The resident partner's share of the partnership profits would be allocated to him under section 24H(5)(a) of the ITA at the time that such profits are generated. This is while State P would tax the partnership on the generation of the profits in year 1 and its distribution in year 2.

In determining South Africa's likely approach to this scenario, it is important to note that the Appellate Division in *SIR v Downing*⁴⁷ accepted that the Commentary on the OECD model tax convention may be used in interpreting tax treaties. This is despite the fact that South Africa is not a member state of the OECD. Olivier and Honiball (2008:33) state that this means that the Commentary forms part of South Africa's customary international law. As such, and given that South African tax treaties largely following the OECD model tax convention, the Commentary would be relevant when a South African court is to interpret a provision of a tax treaty to which South Africa is a party. Of course, it must be borne in mind that the Commentary would only be relevant for all treaties entered into after the date the particular provision was included in the Commentary (Olivier & Honiball, 2008:34). (It is the subject of much international debate whether the later Commentary would be

⁴⁶ OECD Partnership Report op cit at para 139

⁴⁷ *SIR v Downing* [1975] 37 SATC 249

applicable to treaties concluded before such Commentary was included (Olivier & Honiball, 2008:34)).

6 CONCLUSION

The issue of the taxation of cross-border partnerships is a varied and not completely resolved debate. From a South African perspective, the following points may be noted in determining the South African approach to the taxation of cross-border partnerships:

- i) The *Grundlingh* judgment is the authority on the taxation of international partnerships in so far as it determines that it is business profits which are generated by the partners of the partnership, and not income arising from the rendering of independent personal services.
- ii) Each partner of a partnership is deemed to carry on the trade of the partnership in terms of section 24H(2) of the ITA. This is even though South African common law has each of the partners carrying on the business of the partnership provided they had each made a contribution to such partnership. As each partner is carrying on a trade, article 14 of the DTA would not be applicable as it is not personal independent services which are rendered by each partner. Instead, each partner is carrying on the business of the partnership from which it is expected that business profits would be generated. Article 7 (business profits) would therefore be of application in determining which country of the two or more countries involved in the cross-border partnership would be entitled to tax the partnership profits.
- iii) The approach South African courts are to adopt in dealing with the interpretation of treaties as proposed by Hattingh has merit. In terms of this approach, a court should first determine how the partnerships are treated in terms of the domestic law of the two states (Hattingh, 2010:47). Second, the court should determine whether the application of the DTA would produce a different result from that of the domestic regimes of the two states (Hattingh, 2010:47). In this step, each State would apply the provisions of the DTA while using its domestic law to interpret the undefined terms of the DTA. Should the

domestic legislation of either state not impose a tax liability, there would be no need to resort to the DTA. In the event that both states impose a liability, the DTA would have to be applied to determine which state is entitled to tax the income.

- iv) In the event that the two states differ in their classification of the income, South Africa should follow the international view in adhering to the approach proposed in the Partnership Report. This is as section 233 of the Constitution places an obligation on the court to prefer any reasonable interpretation that is consistent with international law over any alternative interpretation that is inconsistent with international law (Olivier, 2008:32). The international approach to the resolution of conflicts in the classification of income may be found in the approach adopted by the OECD in its Commentary on articles 23A and B, as discussed at paragraph 3.3 above. Although many commentators have expressed their views on this approach, the OECD approach nonetheless represents the view of the majority of states as most states follow and apply the OECD model tax convention and the Commentary thereon. From a South African perspective, Olivier and Honiball (2008:42) note that South African courts have in the past recognised and applied the OECD Commentary. Therefore, in the event that South Africa is the residence state, South Africa would be obliged to grant the relief from double taxation under article 23, in terms of the Commentary on article 23A and B, notwithstanding the fact that South Africa may be of the view that the source state's classification of the income is incorrect.
- v) It has yet to be seen whether the Partnership Report's proposal will continue to be the only viable solution to the partnership classification of income issues, or whether we will see the OECD adhering to the calls of the international commentators to provide solutions in the provisions of the model convention itself, and not merely in the Commentary thereto.
- vi) Finally, the provisions of section 6quat should not be overlooked in the resident partner's bid to avoid double taxation. It may represent a useful alternative to

the application of a DTA, and would be essential in instances where South Africa does not have a DTA with the other state involved.

At this point, the South African tax treatment of cross-border partnerships is in keeping with the approach adopted by the international community. Much uncertainty exists in this field, and one may expect further developments proposed with a view to providing a more consistent approach across the globe. Given the international scope of this area, it is hoped that the OECD makes further strides in removing the cross-border inconsistency which seems to dog international partnerships.

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Abbreviations

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<i>SALJ</i>	<i>South African Law Journal</i> Cape Town Juta 1901
<i>TSAR</i>	<i>Tydskrif vir Suid-Afrikaanse Reg</i> Faculty of Law Rand Afrikaans University of Cape Town Juta 1976

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University of Cape Town