

# Reconciling the taxation of partnerships in South Africa relative to its legal recognition.

Does South African income tax legislation adequately deal with the taxation of ordinary commercial partnerships?

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# I ABSTRACT

## i.i Research question

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The purpose of this dissertation is to examine whether South Africa's approach to the taxation of ordinary partnerships flows clearly from its legal recognition thereof, or whether further clarity is needed from South Africa's fiscal legislation.

## i.ii Background and research method

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Peculiarities inherent in South Africa's taxation of ordinary partnerships versus the legal nature of a partnership, is discussed in detail with reference to a comparison of the local treatment of foreign legal and tax systems. The legal systems of the United Kingdom, Ireland and the United States of America, have evolved out of the same common law as is recognised in South Africa, and so have already dealt with the issues illustrated in this dissertation, namely:

- Legally, partners own the assets of the partnership in joint and undivided shares. For tax purposes, however, each partner is treated as having a fractional interest in the assets of the partnership. The two approaches are different and give rise to an analysis as to how our tax legislation achieves conformity.
- Legally, when a partner *'joins'* or leaves a partnership, there is a legal dissolution of the partnership, and thereby a disposal by each partner of his or her share in the underlying assets. In tax, a disposal is likely to give rise to income and/or capital gain considerations. In the event that a legal dissolution of a partnership arises, and should the taxation consequences follow, the extent of any concomitant disposal must be determined, and whether any relief (roll-over or recognition of a divided interest) should be provided to such disposals and the subsequent consequences (such as valuation).

The evolution of the ordinary commercial partnership is discussed, with particular reference to its use as a regulatory avoidance structure, for example by the circumvention of the *usury* doctrine. Those characteristics which have survived in the modern-day legal recognition of partnership, in light of their history, contextualise the ensuing discussion as to the necessity, or otherwise, of legislative intervention. One of the tenets of a robust legal system which exudes the qualities of the rule of law, is clarity. It is therefore incumbent on Government to address any lack of clarity in the application of the law if adherence to the rule of law is to be upheld.

Once it is established that a valid ordinary commercial partnership is constituted, the relevant mechanics flowing from the model, which require legislative clarification are more easily identified. The approaches taken by the foreign jurisdictions considered in this dissertation provide some guidance as

to possible methods of addressing and overcoming those legal-versus-tax dichotomies discussed herein. Whether it is necessary for South Africa to reject the aggregate approach in law with harmonious intervention coming from tax legislation, such as the practice in the United States; or whether the aggregate approach be retained subject to clear legal treatment as demonstrated by the UK, remains a question for further research.

It is submitted that the UK, Ireland and the US have taken extensive legislative measures to overcome the dichotomy between the legal-versus-tax recognition and treatment of partnerships, and that South Africa might not require such extensive codification. Rather, the specific areas in which the greatest discord exists are discussed in this dissertation, and it is submitted that bespoke intervention, as suggested in the concluding paragraphs of this dissertation, would go far towards achieving legal certainty in this regard.

### i.iii Findings

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Section 24H and paragraph 36 of the Eighth Schedule to the Income Tax Act 58 of 1962 (“the Act”) deal adequately with the income and capital gains arising during the continuation of a partnership, as well as in the event of a change in the profit and loss sharing ratios of the partners. It is submitted, however, that on the commencement of a partnership, including the introduction of a person to an existing partnership or an asset by a partner into a partnership, and on termination of a partnership or a partner’s interest therein, the legal considerations are not clearly dealt with by existing tax legislation. It is also possible that unbusiness-like results at these tax trigger-points could be avoided with pragmatic legislative intervention.

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# 1. INTRODUCTION

## 1.1. Background

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Partnership is *prima facie* a relatively simple concept. A partnership can be either non-commercial, for example a marriage, or commercial in nature and purpose. This paper is primarily concerned with the taxation of the *ordinary commercial partnership* in which two or more persons align their commercial intention and endeavours in the hopes of returning joint reward. The intention to comprise a partnership is a subjective inquiry and is recognised as being necessary both in the conclusion of contracts in South Africa, and also in the formation of partnership<sup>1</sup>. The United States of America differs in this approach where, for example, section 202 of the Uniform Partnership Act of 1997 recognises that the conduct of the parties, and not their subjective intention, ultimately determines whether a partnership is formed. Being decisive as to the existence of a properly constituted partnership in South African law, then, *intention* is discussed at greater length under its own heading further below.

The evolution of the partnership model is varied, and this dissertation discusses certain of the more relevant iterations this business form has embodied since its inception. It is submitted that an historical overview provides insight into the modern resultant tax treatment of partnership. For example, historically a *leonine* partnership was determined to constitute something closer to a donation, rather than a partnership in which the partners share profits and losses. The tax treatment of partnerships requires an appreciation of how a legal system views the model. In some jurisdictions, a partnership is generally viewed as separate from its members (the entity approach), while in others, such as in South Africa, it generally and for most purposes is not (the aggregate approach)<sup>2</sup>. The legal recognition of partnership is the source from which tax consequences flow. A discussion as to the taxation of partnerships, and any proposals to amend or supplement the legislation governing the taxation thereof, would thus not be complete without an analysis of its legal recognition.

It is submitted that there is a discord between the legal appreciation of partnership in South Africa, and the tax treatment of the ordinary commercial partnership vehicle. For example, legally, partners own the underlying assets held in partnership in joint and undivided shares. For tax purposes, however, each partner is treated as having a *fractional interest*<sup>3</sup> in the underlying assets of the partnership. The impact

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<sup>1</sup> Muhlmann v Muhlmann 1981 (4) SA 632 (W) at 634 where McCreath J states:

*“It is a sound practical guide that where Pothier’s four requirements are shown to be present the court will find a partnership established unless such a conclusion is negated by a contrary intention disclosed on a correct construction of the agreement between the parties.”*

<sup>2</sup> The “*aggregate approach*” and by contra-distinction the “*entity approach*” are discussed at greater length in **Chapter 2**. Briefly, the aggregate approach does not treat a partnership as separate from the partners, while the entity approach does.

<sup>3</sup> The concept of “*fractional interest*” appears in the South African Revenue Service Comprehensive Guide to Capital Gains Tax (CGT Guide). While not a legal concept in South African law, it is the same term used by the UK in describing the effect of their Taxation of Chargeable Gains Act 1992. In the HM Revenue and Custom’s “*Helpsheet*” 288 on Partnerships and Capital Gains Tax, the HMRC describe a partner as owning a *fractional interest* in the assets of the partnership.

of this difference becomes more apparent when applying the principles of taxation. Notably, the foreign jurisdictions discussed herein have bridged this lacuna by legislative intervention, and this is looked at in more detail in the transactional analysis of the taxation of partnerships discussed in subsequent chapters below.

## 1.2. Research question

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The purpose of this dissertation is therefore to examine whether South Africa's fiscal legislation provides clarity with respect to the taxation of partnerships.

Adopting an aggregate approach to the legal recognition of partnership, as South Africa does, presents certain challenges with respect to the tax consequences of, for example, changes in the partners to a partnership. Legally, at such an event, and in accordance with the aggregate approach, the partnership dissolves and a new partnership begins. This dissolution brings about a disposal, in whole or in part<sup>4</sup> of each partner's share, legally seen as a joint and undivided share but for tax seen as a fractional interest, potentially triggering tax effects such as: capital gain; part-disposals; base cost adjustments; recoupments; basis for claiming an allowance for the remainder of the allowance period (if any), etc.

Naturally, the opposite approach, being the entity approach, presents its own set of taxing challenges; however, in either instance what is required is clarity as regards the legal recognition, and the tax treatment thereof. Legal certainty, as a pillar fundamental to the rule of law, should be achieved by codification where necessary. In South Africa, however, it is submitted that the legal position regarding the taxation of partnerships is not clearly determinable from existing legislation.

The United States ("US") adopt a pure entity approach to partnerships in law. A reading of the US Partnership Act<sup>5</sup> as well as the Internal Revenue Code<sup>6</sup> as it applies to partnerships, highlights the areas in which the entity approach does not naturally produce the desired tax results; and hence the need for the abovementioned legislative intervention.

The United Kingdom ("UK"), as well as the Republic of Ireland, have adopted the aggregate approach; however, the UK has also promulgated the Partnership Act of 1890. More recently, extensive legislation dealing specifically with the taxation of partnerships has been promulgated.

Scotland, while being part of the UK, have distinguished themselves from the rest of the counties in the UK in their approach to the recognition and taxation of partnerships by adopting more of an entity-based approach.

South Africa may be described as having a mixed legal system made up of common law; codified law (legislation) and customary law. The common law, out of which the ordinary commercial partnership

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<sup>4</sup> Part-disposals are discussed more fully below.

<sup>5</sup> Revised Uniform Partnership Act 1997

<sup>6</sup> US Internal Revenue Code (as amended at 2018)

arises, has its roots in Roman-Dutch law as well as British law. The UK has the benefit of a body of legislation regulating the legal recognition and taxation of partnerships, and in light of the similar aggregate approach shared with South Africa, provides a useful comparative when legislative intervention is considered in a South African context.

It is therefore submitted that an investigation into the influence of legislation on the taxation of partnerships would not be complete without considering a foreign comparative approach; the above jurisdictions being considered the most relevant for the purposes of this dissertation. The basis behind an analysis of these jurisdictions over others, is the influence a shared common law has had in the development of each legal system to date. To that end, English common law, as well as a recognition of Dutch and Roman-Dutch common law principles, is common amongst them<sup>7</sup>. Each jurisdiction represents a unique approach to the taxation of partnership, notwithstanding that the resulting tax liability might be the same. This dissertation analyses the approach of each with regards to the specific tax inconsistencies experienced in the South African context discussed herein.

By comparing each jurisdiction's similarities and differences, with respect to the specific tax events discussed in this dissertation, it may be determined whether South Africa's current legislation achieves its purposes and is clear in doing so.

### 1.3. Research method

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This doctrinal method of legal interpretive research adopts a critical analysis of the ontological approach to the taxation of partnerships. It is submitted that while an underlying presumption that legislative reform may be necessary in curing the mischief currently experienced in the field of the taxation of partnerships in South Africa, an inductive reasoning approach is taken in that a lack of specific partnership taxation exists.

### 1.4. Limitation of scope

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This work is limited to an analysis of the ordinary commercial partnership, in the context of taxation.

It is submitted that, while forming part of the income tax calculation of an entity, it is more the tax consequences of a capital nature flowing from the commercial events as discussed herein, that forms the emphasis of this dissertation.

Non-commercial partnerships, such as civil unions, are not discussed as the tax consequences arising between these types of partners are not of a commercial nature. Such partnership is generally not

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<sup>7</sup> Summarising British Common Law, the Encyclopaedia Britannica explains the evolution of thereof as initially sufficiently reliant on Anglo-Saxon law, and thereafter Anglo-Norman law to the exclusion of Roman law influence until around the 13<sup>th</sup> century. Thereafter, Roman law formed part of English common law as evidenced by the work attributed to Henry de Bracton, 1235 "*On the Law and Customs of England (De legibus et consuetudinibus Angliae)*".

It is trite that the United States is a former colony of Britain, whose independence was not recognised until during 1781 following the British defeat in Yorktown. As such the modern legal system is based on centuries of English law principles.

constituted with a view to aligning commercial endeavours in the pursuit of joint economic benefit. This element of commercial purpose, being a distinguishing feature of a commercial partnership, is discussed in **Chapter 2**.

Limited liability and international partnerships are likewise excluded from the ambit of this dissertation, as it is submitted that these arrangements are regulated to a greater extent than the common law partnership with which this dissertation is concerned.

## 1.5. Structure of the dissertation going forward

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This dissertation therefore begins by looking at the history behind the evolution of the ordinary commercial partnership. Included in this historical analysis, is a description of those elements of the partnership model which have led to the discord submitted to exist between the legal recognition of partnership and the concomitant tax treatment thereof. While this discord is submitted to persist in South Africa, the relatively recent legislative intervention of the foreign countries discussed herein serve as an example of comparable approaches to the alignment of the legal recognition of partnerships and the tax treatment.

South Africa's modern-day legal recognition of partnership thereafter confirms those transactional mechanics which would be viewed as most problematic when aligning the modern-day tax principles thereto; namely, the *formation* of a partnership; the *continuation* of a partnership, the *variation* of partnership and the *termination* thereof. For this reason, each transaction stage is discussed in its own chapter. Unless otherwise stated, any reference to "the Act" or "the Income Tax Act" is a reference to the Income Tax Act 58 of 1962.

Having described the discord in light of foreign comparisons, final recommendations are then made including the recommendation that further research into this area be conducted. Wider foreign jurisprudence should be looked at from this transactional analysis of partnerships. South Africa should take steps to addressing the discord between the legal recognition and tax treatment of partnerships.

## 2. HISTORY AND EVOLUTION OF PARTNERSHIP

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South Africa has refrained from the promulgation of bespoke partnership legislation which would confirm and regulate its legal recognition of partnership. Rather, South Africa's legal recognition of partnerships and the concomitant tax treatment thereof is rooted in its common law, which comprises Roman-Dutch Law, English law and the decisions of South African courts<sup>8</sup>. What follows, therefore, is a description of the ordinary commercial partnership, and a brief, select history of the evolution of

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<sup>8</sup> The influence of court decisions on the interpretation and application of the law in South Africa is known as the principle of precedent, or *stare decisis et non quieta movere*, which translates as *to stand by decisions and not to disturb settled matters*. It is abbreviated to *stare decisis*.

the ordinary commercial partnership model which sets the scene for the ensuing discussion on the tax consequences applying thereto.

While partnerships are likely to have preceded written record, the Code of Hammurabi *circa* 1792 - 1750 bc, is reportedly perhaps the oldest and most extensive collection of laws evidencing the appreciation of partnership as a commercial vehicle (Henning, 2014:1).

Where a partnership exists for joint economic benefit, it is considered to be a commercial partnership. Henning (Henning, 2014:1) describes a commercial partnership widely as

*“... joint economic endeavour for mutual benefit.”*

Similarly, the British Partnership Act of 1890 describes the nature of partnership in section 1(1) widely where it states:

*“Partnership is the relation which subsists between persons carrying on a business in common with a view of profit.”*

Naturally, these wide descriptions do not sufficiently limit themselves to partnerships as we understand them in an ordinary commercial sense. For example, an investor in a business who has put funds at risk and acquired an interest in the economic success of the business could also be a partner. That does not mean that every investor is a partner in the business in which they have invested their funds. The investment might take the form of a purchase of a share in the business, or a loan to the business with or without interest. As such, the validity of the existence of a partnership or other comparable arrangement requires an element of scrutiny.

## 2.1. Usury

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Historically, it was considered a sin to charge excessive interest on monies loaned to others, known as *usury*<sup>9</sup>. This strengthened into a prohibition against *usury* in some religions (Henning, 2014:38), for example the Islamic principles of Sharia law prohibit *riba*, being interest paid on loans of money, in terms of the Quran (Terry, 2018). This prohibition limited a borrower’s access to loan funding, as lenders would not be able to charge interest on the amount lent and so were not inclined to do so. Instead, other arrangements were explored to gain access to loan funding which satisfied the needs and preferences of the lenders, while remaining within the confines of accepted business principles or laws of the times.

One such construct found its essence in partnership. Owing to the similar commercial position which could be achieved by way of a partnership rather than an arrangement of loan, parties were able to circumvent the prohibition against usury. A distinguishing feature of a partnership as opposed to a loan

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<sup>9</sup> Exodus 22:25; Leviticus 25:36-37, Deuteronomy 23:20, Ezekiel 18:13 and Ezekiel 22:12 condemns taking interest from the poor and from within the Jewish community.

agreement however, is the risk assumed (if any) by the lender or investor. In this regard, Henning states (Henning, 2014:37):

*“In principle, a partnership will not be formed unless the participants’ contributions to the enterprise are exposed to the risks of the venture. Where capital is advanced to a business upon the basis that the full amount plus interest must be returned at a later stage irrespective of the fortunes of the business, the agreement is one of loan and not partnership.”*

## 2.2. Triple contract

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Taking a partnership share in a venture is, however, a restrictive solution not necessarily suitable for all lenders of funds. In response hereto, the triple contract came into being. The *contractum trinius*, or the triple contract, was a set of three contracts which appeared to result in a commercial partnership between the parties; but on analysis, the element of risk required to constitute a partnership had been contracted away (Henning, 2007:43) (Henning, 2014:43). It was devised purely to circumvent the prohibition against usury, and has been described as a “*fictitious contract of partnership*” (Pothier, 1854:17).

At its essence, a partnership agreement was concluded, as well as an insurance agreement whereby one ‘partner’ insured the other against loss. A third purchase contract was also concluded which gave the ‘borrower’ the right to any amount of profit made with respect to an agreed upon percentage of the investment. The arrangement was likened to the *societas leonine*, or leonine partnership, and was eventually outlawed by Pope Sixtus V during 1586 (Henning, 2014:42), however it stands as an example of a permutation of a purported partnership model which fails the test to determine the existence of a valid partnership. This test, as it is relevant to present day, is discussed below.

## 2.3. Leonine partnership

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A leonine partnership, mentioned previously, is a partnership in which one partner is entitled to the ‘lion’s share’ of the profits, usually with a limited exposure to the losses of the partnership. South Africa’s common law presumes such a partnership to be null and void (Henning, 2014:33) on the basis that the leonine partnership should be seen as a donation disguised as a fictitious partnership. The *bona fides* of the parties is described as the test for the validity of this type of partnership agreement.

## 2.4. Partnership *en commandite*

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The *contractum trinius* may distinguished from the *societas leonine* by virtue of the sharing of profits; whereby in the former all partners participate, while in the latter all partners do not (Henning, 2014:44). Common, however, to both the *contractum trinius* as well as the *societas leonine*, is a limitation of the liability of one partner to the partnership. Such a limitation of liability falls within the umbrella

description of a commanditarian partnership, or a *societe en commandite*. While both these former constructs of partnership are specific instances which have been criticised on the basis of validity, a partnership *en commandite*, being one in which the liability of at least one of the partners is limited, is an accepted partnership form in South African law (Henning, 2014:33), for example as referred to in the definition of “*limited partnership*” in section 24H(1) of the Income Tax Act<sup>10</sup> (“the Act”).

The ability to limit the risk of loss for a partner enables persons with differing appetite’s for risk to nonetheless work in partnership with each other. One further such permutation involves a sleeping partner, or one which prefers to remain anonymous. The difference between the anonymous partnership and the partnership *en commandite* was described by Munnik AJ in *Eaton and Louw v Arcade Properties (Pty) Ltd 1961 (4) SA 233 (T)* where at [239] and [240] he states:

“[239] ... *The anonymous (or sleeping) partnership is created where parties agree to share the profits of a business which is to be carried on by one or more of the partners in his or their name while the partners whose names are not disclosed remain anonymous partners ... . Although the anonymous partner may be described as a partner, the essence of the arrangement is that this fact must be carefully concealed from the outside world ... . Furthermore, the anonymous partner may not participate actively in the business of the partnership (see Sabatelli v St Andrews Building Society 1933 WLD 55).*

[240] *The partnership en commandite has the same features as the anonymous partnership save that the anonymous or undisclosed partner, while sharing in the profits, is not liable for losses in excess of the fixed sum contributed by him to the partnership as capital ... .”*

## 2.5. Validity of a partnership

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In light of the above, it is submitted that where a partnership limits the losses of a partner, or is comprised in terms of an inequitable sharing of profits and losses, or where a partner is undisclosed or absolved entirely of the losses of the partnership, or for any other reason, it should be determined whether the partnership is valid or whether it is instead some other sort of commercial arrangement, such as *inter alia* a loan agreement or a donation. It is only valid, ordinary commercial partnerships with which this dissertation is concerned.

South Africa has no bespoke partnership Act, and partnerships are not registered with a regulatory body. Further, South Africa recognises verbal contracts as valid and binding<sup>11</sup>. As a result, the terms of

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<sup>10</sup> Act 58 of 1962

<sup>11</sup> *Goldblatt v Fremantle 1920 AD 123 128.*

agreement between “partners”, and by extension the existence of a valid partnership, may be difficult to confirm.

Notwithstanding the foregoing, a valid partnership agreement is still required in order for a partnership to exist<sup>12</sup>. This is achieved by ensuring that the partnership agreement embodies the following *essentialia*:

- Each partner must bring something into the partnership, or bind themselves to bring something into it, whether it be money or labour or skill<sup>13</sup>;
- The business must be carried on for the joint benefit of each partner<sup>14</sup>;
- The object should be to make profit<sup>15</sup>;
- The contract must be a legitimate contract<sup>16</sup>;
- Each partner must intend to constitute a partnership<sup>17</sup>; The “*intention test*” is expanded upon with reference to the foreign comparisons below.

The British Partnership Act of 1890 demonstrates the recognition by the UK legislature of the similar nature which a lender could bear to a partner of the borrower. Section 2 of this Act sets out rules for determining the existence or otherwise of a partnership, and in particular subsection 2(3)(d) regulates that where a lender, in certain circumstances, wishes to avoid being seen as a partner in relation to the borrower, the loan agreement must be “... *in writing, and signed by or on behalf of all the parties thereto*;”. The wording of the provision has been criticised as perhaps failing to clearly convey the intended meaning (Henning, 2014:50), but be that as it may, the section provides an example of the UK’s attempt at legislative intervention to regulate *inter alia* those partnership forms referred to above. Notably, the Law Commission of England and Wales and the Scottish Law Commission have embarked on a process of review of the UK partnership legislation, noting that certain provisions are problematic (HMRC, 2017: “*Partnership taxation: Proposals to clarify tax treatment*”). Owing to aggregate approach common to both the UK as well as the South African legal recognition of partnerships,

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<sup>12</sup> *Joubert v Tarry & Co 1915 TPD 277*.

<sup>13</sup> *Joubert v Tarry & Co 1915 supra; Pothier on Partnership [1.3.8.14]*.

<sup>14</sup> *Joubert v Tarry & Co 1915 supra; Pothier on Partnership [1.3.8.14]*.

<sup>15</sup> *Joubert v Tarry & Co 1915 supra; Pothier on Partnership [1.3.8.14]*.

<sup>16</sup> *Joubert v Tarry & Co 1915 supra; Pothier on Partnership [1.3.8.14]*. Note: In South Africa, the requirements for a legitimate contract, may be summarised as follows (Christie, 2011:Chapters 2 - 11) summarised by *Professor R.H Christie* in “*The law of contract in South Africa*” are:

- The parties must intend to be bound to the extent which gives rise to legal obligations;
- The terms of the contract must be certain, and neither vague nor ambiguous;
- The parties must be *ad idem* as to each and every element of the contract;
- The performance thereof must be neither impossible nor unlawful;’
- The parties must have the necessary capacity to enter into the agreement, and must do so voluntarily; and
- When required by law, constitutive formalities must be complied with.

<sup>17</sup> *Muhlmann v Muhlmann 1981 (4) SA 632 (W) at 634; Purdon v Muller 1961 (2) SA 211 (A) at 218*.

discussed below, it is recommended that any legislation promulgated by the UK on partnership taxation be studied for potential inclusion into South Africa's legislation.

## Intention

While not currently required by law, but rather inspired *inter alia* by the risk of ambiguity and the approach of the UK legislature, it is recommended that where the parties *intend* a South African partnership to be validly constituted, that a written agreement is concluded which complies with those requirements referred to above. Likewise, where the parties intend that no partnership is concluded, same be expressed in a written agreement. Notwithstanding the foregoing, South African courts will consider the substance of the arrangement<sup>18</sup>, the circumstance in which it was made and the conduct of the parties<sup>19</sup>, over any written instrument and as such although a written contract may be useful as evidence of the terms of agreement between persons, it is not decisive of the nature of the relationship *inter se*.

The “*intention test*” embraced by South Africa and referred to above is expressly departed from in the United States (US), for example in section 202(a) of the Uniform Partnership Act of 1997 which states:

“... *the association of two or more persons to carry on as co-owners a business for profit forms a partnership, whether or not the persons intend to form a partnership.*”

Section 202 read as a whole determines the formation of partnership for US purposes. In terms of this section, a partnership may be established solely by conduct, regardless of the intention of the parties. It is submitted that the express departure from the intention of the parties is as deliberate and as vast as the US expressly rejecting the aggregate approach to partnerships, arising from the common law and inherited by the US from English principles<sup>20</sup>, in favour of the entity approach.

## 2.6. Aggregate versus entity approach

Early Roman law permutations of the partnership model exude the characteristics that a partnership is nothing more than a contract regulating the rights and obligations of the partners *inter se*, and not an entity in its own right (Henning, 2014:143). This idea, that the partnership is a collection of individuals and not a separate entity in its own right, is referred to as the aggregate approach, also known as the

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<sup>18</sup> *Zandberg v Van Zyl (1910) AD 302*. It is to be noted that in the UK case of *Cox v Hickman 1860 8 HLC 268*, the House of Lords relied to a greater degree on the intention of the parties as well as the substance of the agreement, than merely the form thereof. This decision would have been taken into account in the drafting of the subsequent Partnership Act of 1890, however.

<sup>19</sup> *Pezutto v Dreyer 1993 (3) SA 379 (A)* at page 31.

<sup>20</sup> Prior to the US defeat of the British forces in Yorktown during 1781, the US was colonised largely by Britain and other European forces. As such, and in the words of United States attorney Ashley Duggar (Duggar, 2018):

“*[The] modern American law system is based on centuries of English principles ... This English common law system combines with U.S case decisions and statutes to form what we know as law.*”

common-law theory of partnership (Henning, 2014:142) due to the prevalence of its adoption in English common law. It is reported that during the sixteenth century, partnership accounts began to be kept in the practise of double-entry bookkeeping (Henning, 2014:145). This approach of viewing the partnership as capable of holding its own assets and liability, as capable of status in its own right, is known as the entity approach.

While it may be said that South Africa (Henning, 2014:150) (Cassim et al., 2013:18) (CGT Guide, 2018:378) and the United Kingdom<sup>21</sup> adopt predominantly the aggregate approach for the purposes of the taxation of income and capital gains; and the United States of America<sup>22</sup> and Scotland<sup>23</sup> adopt predominantly the entity approach, no system subscribes purely to the one and not the other, each exhibiting an appreciation of both approaches in certain circumstances (Henning, 2014: Chapter 7).

The interaction between the laws of the United Kingdom, and those geographically limited to Scotland and which differ therefrom, is submitted to provide an interesting area for further research. The UK adopt the aggregate approach, while Scotland adopts the entity approach. Scotland, however, falls under UK regulation and control, particularly with reference to taxation. While Scotland retains the power to *inter alia* set the rates of tax applicable to Scottish taxpayers in terms of section 80C of the Scotland Act<sup>24</sup>, the Government of Scotland confirms that Scottish income tax remains part of the existing UK income tax systems and is not a devolved tax<sup>25</sup>.

Some distinguishing consequences flowing in law from a strict adoption of one approach versus the other are summarised with reference to Henning, 2014 in the comparative table below. Without legislative intervention, a strict application of legal principles would require an appreciation of these consequences and which, it is submitted, may lead to unintended results. Note, this comparison is not exhaustive.

Aggregate approach (Henning, 2014:142)

Entity approach (Henning, 2014:140)

*“Common law” partnership*

*“Mercantile” partnership*

- |  |  |
|--|--|
| <ul style="list-style-type: none"> <li>▪ <i>The firm is not a separate legal entity;</i></li> <li>▪ <i>The firm cannot acquire rights, nor can it incur obligations;</i></li> <li>▪ <i>The firm cannot hold property;</i></li> </ul> | <ul style="list-style-type: none"> <li>▪ <i>The firm is a separate legal entity;</i></li> <li>▪ <i>The firm can acquire rights and obligations;</i></li> <li>▪ <i>The firm can hold property;</i></li> </ul> |
|--|--|

<sup>21</sup> For example, section 848 of the UK Income Tax Act 2005 states, “*Unless otherwise indicated (whether expressly or by implication), a firm is not to be regarded for income tax purposes as an entity separate and distinct from the partners.*”

<sup>22</sup> For example, section 201 of the Uniform Partnership Act of 1997 states, “*(a) A partnership is an entity distinct from its partners.*”

<sup>23</sup> For example, section 4(2) of the British Partnership Act 1890 states, “*In Scotland a firm is a legal person distinct from the partners of whom it is composed ...*”

<sup>24</sup> Scotland Act 1998.

<sup>25</sup> <https://www.gov.scot/policies/taxes/income-tax/>

- *The partners are the owners of the partnership property and the rights and liabilities of the partnership are their rights and liabilities;*
- *The rights and liabilities of the partnership are the collection of the individual rights and liabilities of each of the partners;*
- *A partner may be the debtor/creditor of his partners, but he cannot be the debtor/creditor of the partnership or be employed by it, inasmuch as a person cannot contract with himself;*
- *A change in the membership of a firm destroys the identity of the firm. The 'old' firm is dissolved, and if the surviving members continue in partnership (with or without additional partners) a 'new' firm is created.*
- *The firm has its own name and domicile;*
- *The firm can sue and be sued;*
- *The partners are the agents for the transactions of and sureties for the liabilities of the firm insofar as the assets of the firm are insufficient to meet them;*

## 2.7. Legislative certainty

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It is submitted that South Africa's aggregate approach to partnership, which flows from its common law and uncodified recognition thereof, without clarity in its taxing statute the Income Tax Act 58 of 1962, has led to commercial uncertainty and the call for clarity in this area.

As noted, the Interpretation Act<sup>26</sup> defines a partnership as a person in section 1. The inability of a partnership to be treated as a person for the purposes of tax on income and capital gains, is only as a result of the wording of section 24H and paragraph 36 of the Eighth Schedule to the Act. The fact that the assets in the partnership are held in joint and undivided shares in terms of South Africa's Roman-Dutch common law does have an effect on the commencement, variation and termination of the partnership. The result is a lack of certainty as to the reconciliation of the taxing principles and the legal treatment of certain mechanics of ordinary commercial partnerships.

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<sup>26</sup> Act 33 of 1957.

It is trite that *clarity* is a fundamental pillar of an authoritative legal system. Section 1(c) of the Constitution of the Republic of South Africa (1996) dictates that South Africa is founding on the values of the rule of law<sup>27</sup>. Willes Principles has described the accepting principles of the rule of law, and upon which South Africa is founded, as (Bradfield et al., 2015:18):

“

- *Generality: Law must consist of rules rather than ad hoc decisions;*
- *Promulgation: Law must be published so that they are made known to those to whom they apply;*
- *Non-retroactivity: Law must govern behaviour that takes place after its creation rather than past events;*
- *Clarity: Law must be formulated in such a way that it is possible to understand that it requires;*
- *Non-contradictory: Law must not contradict itself or require inconsistent behaviour, for if it does, it is not possible to comply with the law;*
- *Possibility of compliance: Laws must not demand the impossible;*
- *Constancy through time: Laws must not be changed so frequently that it is impossible to adjust one's behaviour to the law's requirements;*
- *Congruence between official action and declared rules: The law as administered must coincide with the law as declared.*

”

South Africa operates within a mixed legal system comprising the common law, customary law and codified law. Where there is uncertainty, clear codification is suggested in order to maintain South Africa's adherence to the rule of law. As emphasised by Lord Bingham in the work “*Rule of Law*” (Bingham, 2011),

*“The law must be accessible and so far as possible intelligible, clear and predictable. ... Questions of legal right and liability should ordinarily be resolved by the application of the law and not the exercise of discretion.”*

What follows, then, is an analysis of this lack of clarity, and the dichotomy resulting therefrom, with reference to the tax consequences at the various transactional stages of the partnership form; namely:

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<sup>27</sup> Barro, R.J in his work “*Determinants of Economic Growth: A Cross Country Empirical Study (Cambridge, MA: MIT Press, 1997)*” describes the rule of law as being a determining factor in assessing a country's attractiveness in terms of international investment (Barro, 1997:19).

- The formation of a partnership;
- The continuation of a partnership;
- The variation of a partnership;
- The termination of a partnership.

Whether South Africa should provide greater clarity in its taxing statutes, or whether a “*Partnership Act*” is preferable is submitted will require further research. This dissertation concludes with a summary of the dichotomy identified to exist at present, along with recommendations going forward.

## 2.8. Perpetual Succession

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A consistent quality of all permutations of the common law ordinary commercial partnership, is its lack of “*perpetual succession*”; a term used to describe the ability of an entity, such as a company, to continue to exist notwithstanding a change in its members (Bradfield et al., 2015:397).

It is submitted that South Africa’s current taxation of the ordinary commercial partnership does not properly deal with this legal consequence and is therefore expanded upon at length in the chapters which follow.

## 2.9. Conclusion

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The ordinary commercial partnership has evolved from its early use as a simple vehicle to align joint economic endeavour, and one which enabled the circumvention of the prohibition against usury, and into the accepted agreement between persons to carry on business in the pursuit of joint reward.

Where a partner’s risk is limited, the balance between the entitled to reward must be considered in light of the historic leonine partnership, and the potential for any donations considerations attaching thereto. Notwithstanding the foregoing, the partnership *en commandite* is one in which at least one partner’s risk to the partnership is limited to the amount of the contribution made by him or her to the partnership, and this is accepted in South African law.

A written agreement is not required to constitute a valid partnership. The parties must, however, be *ad idem* as to the intention to constitute a partnership, as well as those essential elements as set out in paragraph 2.5 above, with reference to the case of *Joubert v Tarry & Co*<sup>28</sup>.

While South African courts have accepted instances where a partnership may continue to survive amongst partners despite the death of one of them<sup>29</sup>, the general principle is that any change in the membership of a partnership will result in its termination (Cassim et al., 2013:37).

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<sup>28</sup> *Joubert v Tarry & Co* 1915 TPD 277.

<sup>29</sup> *Dickinson & Brown v Fisher’s Executors* 1916 AD 374.

For purposes of insolvency<sup>30</sup> or for value-added tax purposes<sup>31</sup>, a partnership is treated as an entity separate from its members, however these specific instances depart from the general state of aggregate recognition.

It is South Africa's aggregate approach to the taxation of partnerships which is submitted to produce certain ambiguous taxing results, and this is discussed more extensively in the ensuing chapters; each chapter dealing with a particular mechanic of the partnership structure. The requirement to consider secondary, non-binding interpretive sources such as the Comprehensive Guide to Capital Gains Act 2018, is not satisfactory and highlights the lack of adequate legislation on the taxation of partnerships. The foreign jurisprudence considered in this dissertation has addressed the taxation of these elements of partnership, and influence may be drawn therefrom when considering legislative intervention to clarify the intended tax treatment in South Africa.

### 3. FORMATION OF A PARTNERSHIP

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In South African law, a partnership commences either by the conclusion of a valid partnership agreement, or by the conduct of the parties. At its commencement, a partner may be required to contribute cash, assets and/or skill to the partnership. Each of these will be dealt with in turn.

On formation of an ordinary commercial partnership, each partner acquires a right to share in, and an obligation to account for, the profits and losses of the partnership<sup>32</sup>. Regardless of the form of the contribution, once a person becomes a partner, they are considered to be connected<sup>33</sup> to all other partners and persons connected to those partners for the purposes of the Income Tax Act<sup>34</sup> ("the Act").

#### 3.1. Partnership and connected persons

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The effect of this connectedness is submitted to be excessively extensive in establishing a partner's connectedness to "... *any connected person in relation to any member of such partnership ...*" in subparagraph (c)(ii) of the definition of "connected person" in section 1 of the Act. The basis for this submission relies on an analysis of the definition as a whole, as all instances of connectedness in relation to any partner must then be determined.

Thus, in terms of the definition as it currently stands, a partner in a partnership is connected to a relative<sup>35</sup> of any other partner, and any trust of which that other partner is a beneficiary<sup>36</sup>. Further, if a

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<sup>30</sup> For example, in section 13 of the Insolvency Act 24 of 1936.

<sup>31</sup> For example, in the definition of "person" in section 1 of the Value-Added Tax Act 89 of 1991.

<sup>32</sup> *Sacks v CIR 1946 AD 31 13 SATC 343 at page 349 to 353.*

<sup>33</sup> Section 1 of the Income Tax Act defines a "connected person" in relation to a partner in subparagraph (c).

<sup>34</sup> Act 58 of 1962

<sup>35</sup> Subparagraph (a)(i) of the definition of "connected person".

<sup>36</sup> Subparagraph (a)(ii) of the definition of "connected person".

trust is a partner, all other partners are connected persons to any beneficiary of that trust, and any person connected to any beneficiary of that trust<sup>37</sup>, or connected otherwise to the trust itself<sup>38</sup>. If a company is a partner (“member company”), all other partners are connected to any other company which holds at least 50% of the equity shares or voting rights in the member company, or a company which holds at least 20% thereof if the member company has no other shareholders which hold the majority of the voting rights; or any person other than a company who holds, either directly or jointly with any connected person to that person, at least 20% of the equity shares or voting rights in the member company.

The connected nature of persons determines certain tax consequences which attach to transactions *inter se*<sup>39</sup>, and as such, in the case of a partnership, it is necessary to determine the extent of this connectedness where a partner is involved in a transaction with either the other partners or with persons connected to them. For example, when a partner buys into a partnership, the enduring partners will be considered to have disposed of a portion of their interests<sup>40</sup> in the partnership to the incoming partner. This is a natural concomitant of a dilution of the enduring partner’s interests in favour of the incoming partner. The amount paid or contributed by the incoming partner to the partnership, will need to have increased the value of the reduced interests at least to what the value of those interests were prior to the dilution. The result will be that while a partner may have previously held a 50% partnership interest, their now reduced 33,3% interest is equal in value to the erstwhile 50% interest by virtue of the incoming partner’s valuable contribution to the partnership.

If these values are not equal, due to the connected nature of the partners, paragraph 38 may be applied to subject the transaction to tax. Further, the value shifting provisions<sup>41</sup> of the Eighth Schedule to the Income Tax Act determines that any decrease in the value of a partner’s interest by way of a value shifting arrangement is a disposal in terms of paragraph 11(1)(g) of the Eighth Schedule to the Act, and is subjected to tax on a capital gain determined with reference to the market value of the portion of the partnership interest deemed to have been disposed of.

It is submitted that the academic argument may exist that the incoming partner is not a connected person in relation to the existing partners, until such time as they become a partner. It may be ambiguous, for example, where a person purchases a partnership interest subject to a condition which suspends the admission of that person to the position of partner. Therefore, when the interest is purchased, and until

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<sup>37</sup> Subparagraph (b) of the definition of “connected person”.

<sup>38</sup> Subparagraph (bA) of the definition of “connected person”.

<sup>39</sup> For example, paragraph 38 of the Eighth Schedule to the Income Tax Act requires that a transaction between connected persons attract tax consequences as though the transaction occurred at market value if the consideration is determined to not reflect an arm’s length price.

<sup>40</sup> While legally a partner holds a joint and undivided interest in the assets of the partnership, for tax, a partner is treated as having a fractional interest in the partnership. This dichotomy is discussed in a separate part of this dissertation, as deserving further expansion.

<sup>41</sup> Definition of “value shifting arrangement” in paragraph 1 of the Eighth Schedule to the Income Tax Act 58 of 1962.

fulfilment of the suspensive condition, the person is not connected to the other partners and no market related considerations apply to the transaction. Naturally, other considerations would then need to be taken into account, such as loan funding or donations. It is suggested, therefore, that the legislature clarify the moment of connectedness in relation to the acquisition of a partnership interest.

### 3.2. Cash contribution

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If each partner contributes cash to the partnership, the amount of such cash will be credited to each partner's capital account. As cash is not an "*asset*" for the purposes of capital gains tax<sup>42</sup>, no capital gains tax issue arises. As cash is introduced as original capital, no income tax issue arises either. Further, a contributing partner's capital account will reflect the cash contribution and as such any profit and loss sharing ratios between the partners are, at this point, irrelevant.

### 3.3. Assets

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If one partner contributes an asset to the new partnership, and the other partner contributes cash, the values of each contribution will again be credited to each respective partner's capital account. Commercially, neither partner is impoverished nor enriched by the action of the other. Let us assume that the contributions are equal in market value and that the partners will share equally in profits and losses. The following questions might then arise:

- Does the partner introducing assets realise a "*disposal*"?
- Does the partner receive "*proceeds*", actual or deemed, in respect of the "*disposal*"?

The considerations are different, however, if the contribution is made to an existing partnership. In such a case there is a variation in the partners to the partnership, and this is dealt with in **Chapter 5**. The ensuing discussion is limited to the introduction of an asset to a newly formed partnership.

In law, the contributing partner's interest in the asset contributed changes from full ownership to an ownership of the whole asset in joint and undivided shares with the other partners, and in accordance with the agreed upon profit-sharing ratios. The nature of the partner's asset, being ownership, has changed or, to use tax parlance, has *varied*.

### 3.4. Disposal

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Paragraph 11 of the Eighth Schedule to the Income Tax Act defines a "*disposal*" as including any event which results in a *variation*, transfer or extinction of an asset. It does not exclude the transfer of an

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<sup>42</sup> Cash falls within the concept of *currency*, which is expressly removed from the definition of "*asset*" in paragraph 1 of the Eighth Schedule to the Income Tax Act 58 of 1962.

asset into a partnership relationship in exchange for a *fractional interest*<sup>43</sup> in all the underlying assets of the partnership. Paragraph 11 of the Eighth Schedule to the Act, is not at all concerned with whether the net value of the partner's interest has changed, but only whether their interest in the particular asset has.

Strictly, the partner contributing the asset has disposed of the whole asset in return for a partnership interest. Commercially, however, (s)he still retains the value of the asset in the form of a capital account in the partnership, plus, in substance, a *fractional interest* in the asset as represented by his or her profit-sharing ratio as set out in the partnership agreement. The value to be recorded in the capital account of the partner contributing the asset, is submitted to be the market value of the asset at the moment of contribution to the partnership.

The approach taken by the South African Revenue Service (SARS), as explained in the Capital Gains Tax Guide (issue 7) (CGT Guide) treats this transaction as a disposal by the partner of part of the asset and a "... *retention of a fractional interest ...*" in the cash or assets contributed (CGT Guide, 2018:378). This is based on the premise that a partner cannot dispose of an asset to himself (in his capacity as a partner) nor to the partnership (because it is not recognised as a person for tax purposes).

While not a legal concept in South African law, the term "*fractional interest*" is also used by the United Kingdom, for example, in describing the effect of the UK Taxation of Chargeable Gains Act 1992. In the HM Revenue and Custom's Helpsheet 288 of Partnerships and Capital Gains Tax, the HMRC describe a partner as owning a "*fractional interest*" in the assets of the partnership. It is perhaps indicative that South Africa is looking to the United Kingdom in its interpretation of the intended consequences of the taxation of capital gains arising out of partnership interests.

Notwithstanding the above, the need to consult non-binding secondary sources of interpretation such as the CGT Guide highlights the failure by South African legislation to provide legal certainty. Certainty is submitted to be a fundamental tenet of an authoritative legal system. In *Shilubana v Nwamitwa*<sup>44</sup> at paragraph 47, the Constitutional Court again referred to legal certainty as a "*value*". It is recommended that the legislature intervene to better align the legal recognition of partnership with the tax effect surrounding a partner's interest therein.

The fractional interest approach gives effect to the view that the partner bringing an asset into the partnership is effectively disposing of part of their interest in that asset to their fellow partners who, at the point in time that the disposal takes place, are connected person in relation to that partner. This

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<sup>43</sup> The concept of "*fractional interest*" appears in the South African Revenue Services (SARS) Comprehensive Guide to Capital Gains Tax (CGT Guide), for example at paragraph 9.2.2 where SARS discuss guidelines for the treatment of partnerships (CGT Guide, 2018:378).

<sup>44</sup> *Shilubana v Nwamitwa* 2009 (2) SA 66 (CC)

part-disposal, and the requirement to consider any recoupment on an allowance asset so contributed, is revisited in greater detail in the discussion on variation of the partners to a partnership, in **Chapter 5**.

South Africa's *fractional interest* tax treatment amounts to the same result as that in the UK where, as explained in the HM Revenue and Customs Policy Paper<sup>45</sup> (2015:5)

*“5.2 Where an asset is transferred to a partnership by means of a capital contribution, the partner in question has made a part disposal of the asset equal to the fractional share that passes to the other partners. The market value rule applies if the transfer is between connected persons or is other than by a bargain at arm's length. Otherwise the consideration for the part disposal will be a proportion of the total amount given by the partnership for the asset. That proportion equals the fractional share of the asset passing to the other partners.”*

In summary, in exchange for the contribution of an asset to the partnership, the contributing partner is receiving an interest in the assets (or cash) contributed by the other partner(s). This reflects the “*proceeds*” for his or her contribution (on the basis of the *fractional interest* approach). In law, however, these “*proceeds*” would be the value of the interest. For practical purposes, these values should be the same at the commencement of the partnership.

The disposal may therefore result in a capital gain and/or a recoupment in the hands of the partner who contributed the asset to the partnership, without a corresponding increase in liquidity which would enable him or her to pay any tax arising from this fractional disposal. While this issue has been dealt with by the legislature insofar as companies are concerned, i.e. by enabling a tax roll-over where a person puts assets into a company in return for the issue of shares in terms of section 42 of the Act, no such relief exists for assets contributed to a partnership in exchange for a partnership interest.

### 3.5. Skill

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The contribution by a partner of skill, in the absence of cash or other tangible asset, is a contribution of an intangible asset which should be valued at the moment of the person becomes a partner. This is because in exchange for the contribution of skill, the partner acquires a fractional interest in the cash and assets contributed by the other partner(s)<sup>46</sup>. The value of the fractional interest so acquired will be treated as the “*base cost*” of the skilled partner's interest in terms of paragraph 33 of the Eighth

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<sup>45</sup> MH Revenue and Customs Policy Paper “*Statement of Practice D12: Partnerships*”

<sup>46</sup> CGT Guide, 2018: 378 is silent on the treatment of a contribution of skill, and states,  
“9.2.2.1 Introduction of a new partner

*When a new partner joins the partnership and contributes an asset or cash to the partnership, the pre-existing partners must be treated as having disposed of a part of their share in the pre-existing assets in exchange for a fractional interest in the assets or cash contributed by the incoming partner. A capital gain or loss must accordingly be determined in respect of the part disposed of by the pre-existing partners. The base cost of the part disposed of must be determined under paragraph 33 [of the Eighth Schedule to the Income Tax Act 58 of 1962].”*

Schedule to the Act. However, if this partner withdraws from the partnership say on day two, (s)he cannot claim any part of the partnership asset. Skill, however, is not an asset as defined in paragraph 1 of the Eighth Schedule to the Act, and practically, it is submitted, skill can never form part of the assets of the partnership. As such, the cost of acquisition of a partnership interest to a partner whose contribution is purely skill, should be nil. Such a partner therefore only sharing in any growth over and above that value and in accordance with the partnership profit-sharing ratios. It is submitted that this be clarified by way of further legislative intervention in South Africa.

It may be argued that skill forms an element of goodwill, being an intangible asset. SARS recognise that goodwill should not always be imputed into a transaction for the acquisition or disposal of a partnership interest (CGT Guide, 2018:390) in order to inflate the consideration actually paid for the interest in line with the deeming provisions of paragraph 38.

### 3.6. Conclusions regarding commencement of a partnerships

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The Income Tax Act does not deal adequately with the commencement of a partnership, and particularly the contribution by persons of assets and/or skill thereto in exchange for a partnership interest.

SARS take the pragmatic approach by treating the contributing partner as having disposed of *fractions* of the asset to the other partners. This is not in line with the true legal position, or with any provision in the Income Tax Act. The result of the fractional approach is that an incoming partner may have a capital gain or a capital loss on the “*transfer*” of the asset into the partnership without any liquidity to pay any tax that may arise if a gain is made on the introduction of the asset. The fact that the incoming partner may receive no consideration or a consideration not measurable in money, does not, however, mean that a capital gain does not arise.

The introduction of an asset into a partnership is not a donation. The value of the asset contributed by a partner is normally credited to a partner’s capital account. This could be seen as a consideration for the purposes of determining a capital gain. Section 1 of the Income Tax Act defines a partner as being a connected person in relation to the other partners. The result is that paragraph 38 of the Eighth Schedule to the Act may deem the contributing partner to have disposed of the relevant *fraction* of the asset at its then market value, with no realising of funds to settle the capital gains tax liability arising as a result thereof.

It is suggested, therefore, that the Act cater clearly for the tax effects that will arise when assets, tangible or intangible, are contributed to a partnership both at its inception and during its subsistence, for example by the admission of a new partner to an existing partnership. The latter instance and a discussion on variation of the partners which result in part-disposals and possible recouplements is discussed further in **Chapter 5**.

In order to have horizontal equity between companies and partnerships, the roll-over rules in section 42 of the Act (which apply to assets introduced into companies by shareholders) should be harmonised for use by partners to address the inequity currently inherent in this element of partnership taxation. This will have the result that tax liability will be deferred until the partnership disposes of the asset. It would ease the incoming partner's cash flow and remove the disadvantage that partnerships have in relation to companies.

## 4. CONTINUATION OF A PARTNERSHIP

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Where a valid partnership exists and remains unchanged as to the partners or their agreed upon profit-sharing ratios, it is submitted that the Income Tax Act 58 of 1962 ("the Act") deals adequately with the continuation of partnership for the purposes of achieving the intended tax treatment of the partners.

### 4.1. Income

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Section 24H of the Act is the primary taxing provision for the income of a partnership and has the effect of attributing the income of the partnership on the individual partners *pro rata* in the ratio in which profits or losses are to be shared.

While section 24H of the Act deals adequately with the attribution of profits and losses to the partners during a year of assessment, it does not deal with attributing any part of the cost, value or ownership of the assets to the partners.

Section 24H(1) of the Act defines "*limited partner*" for the purposes of the section as any partner whose liability is limited. In light of the discussion above on the various permutations of the partnership model, examples would include *inter alia* a partnership *en commandite* or a leonine partnership.

Section 24H(2) of the Act imputes the trade or business of the partnership onto each partner such that the partners themselves are deemed to be carrying on the trade of the partnership. It is submitted that the effect of section 24H(2) of the Act is to maintain the nature of income earned by a partner as a result of his or her interest in the partnership. It is further noteworthy to compare the wording and operation of this section to the following foreign provisions:

Section 24H(2) states:

*"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."*

Section 852 of the UK Income Tax Act<sup>47</sup> (“UK ITA Act”), which establishes the fiction of “*notional trades*” carried on by the partners to the partnership for the purposes of the taxation of each partner’s share of the income of the partnership, calculates partnership liability for tax with reference to an allocation, between the partners, of the firm’s profits and losses in terms of section 850 UK ITA Act. The section proceeds then to deal with the tax implications of this notional trade, for example the tax implications on an exit to another country by a partner.

Section 852(1) UK TA states:

*“For each tax year in which a firm carries on a trade (the “actual trade”), each partner’s share of the firm’s trading profits or losses is treated, for the purposes of Chapter 15 of Part 2 (basis periods), as profits or losses of a trade carried on by the partner alone (the “notional trade”).”*

Section 71 of the Irish Income Tax Act<sup>48</sup> (“Irish ITA”), which establishes the fiction of “*several trades*” carried on by the partners to the partnership. It appears that this section imputes both income as well as gains realised by the partnership on the partners during a year or period. Section 71(1) describes the mechanics of the several trade and appears below. Section 71(2) determines the amount to be taken into account by each partner during a year or period with reference to the income or gains made in partnership.

Section 71(1) Irish ITA states:

- “
- (1) *In the case of a partnership trade this Act shall, subject to the provisions of this Chapter, have effect in relation to any partner in the partnership as if for any relevant period -*
- (a) *any profits or gains arising to him from the trade and any loss sustained by him therein were respectively profits or gains of, and loss sustained in, a trade (hereafter in this Chapter referred to as a several trade) carried on solely by him being a trade -*
- (i) *set up or commenced at the beginning of the relevant period, or if he commenced to be engaged in carrying on the partnership trade at some time in the relevant period other than the beginning thereof, at the time when he so commenced, and*

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<sup>47</sup> UK Income Tax Act (Trading and other income) Act 2005

<sup>48</sup> Irish Income Tax Act 6 of 1967

- (ii) *when he ceases to be engaged in carrying on the partnership trade, either during the relevant period or at the end thereof, permanently discontinued at the time when he so ceased, and*
- (b) *he had paid the part he was liable to bear of any annual payment paid by the partnership.”*

Section 701 of the US Internal Revenue Code<sup>49</sup> (“the US IR Code”). While section 201 of the US Uniform Partnership Act of 1997 expressly rejects the aggregate approach to partnerships in favour of the entity approach, section 701 of the US IR Code requires that the partners and not the partnership be subjected to tax. Thus, while section 703 of the US IR Code requires a partnership tax calculation to be done, and for an annual report thereon to be filed, the liability for payment of the tax thereon passes to the partners in accordance with their profit and loss sharing ratios. This “*passing through*” establishes a mechanic in line with the aggregate approach to partnerships, an example of the mixed approach which each jurisdiction takes at various stages for specific purposes of the taxation of partnership.

The relevant sections appear below:

*“Section 701 US IR Code*

*A partnership as such shall not be subject to the income tax imposed by this chapter. Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities.*

*Section 703 US IR Code*

*A partnership must file an annual information return to report the income, deductions, gains, losses etc., from its operations but it does not pay income tax. Instead, it ‘passes through’ any profits or losses to its partners. Each partner includes his or her share of the partnership’s income or loss on his or her tax return.”*

It is submitted that the pragmatic result of each section compared is much the same, but the methods differ, and the narrative of the relevant foreign jurisprudence referred to above provides insight into legislative attempts to codify effective tax treatment of the income of a partnership during its subsistence. The South African Income Tax Act 58 of 1962 is largely silent, however, in dealing with many of the identifiable commercial events inherent in a partnership model. It is submitted that it could do better.

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<sup>49</sup> US Internal Revenue Code on Partners and Partnerships (Subchapter K)

Section 24H(3) of the Act limits a limited partner's deduction or allowance as provided by the Act, in terms of his or her interest in the trade or business of the partnership, to the amount for which the partner may be held liable by creditors of the partnership, added to the amount of any income received by or accrued to the limited partner taxpayer from the partnership trade or business.

Section 24H(4) of the Act enables the limited partner to carry forward the balance of any deduction or allowance not permitted in one year, to the next year. It is to be noted that similar versions of this carry-forward is common to each of the foreign jurisdictions referred to<sup>50</sup>.

Section 24(5) of the Act deems the income of the partnership to accrue to the partners, "... *on the date upon which such income was received by or accrued to them in common.*". The section, therefore, not only determines the timing of accrual of amounts received in partnership to the individual partners, but it goes further to actually split the amount received in common to the partners individually. Likewise, in terms of subsection 24H(5)(b) of the Act, any deduction or allowance which the partner is entitled to apply follows this accrual in the same profit and loss sharing ratio.

This section, however, only deals with amounts received by the partners in common. There is no clear way to deal with amounts accruing to only some of the partners.

## 4.2. Capital

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Paragraph 36 of the Eighth Schedule to the Act, likewise, deals adequately with the attribution of capital gains and losses. It too, however, does not deal with the attribution of any part of the interest; cost, value or ownership of the assets to or in the respective partners.

Where a partnership asset is disposed of, the proceeds accrue to the partners in their profit-sharing ratios (CGT Guide, 2018:379) at the time of the disposal in terms of paragraph 36 of the Eighth Schedule to the Act, each being subject to tax in that period.

Paragraph 36 of the Eighth Schedule to the Act treats the proceeds received by a partner, either in terms of the disposal of a partnership asset, or for disposing of their interest in a partnership asset, as having accrued to that partner at the time of that disposal. Naturally, a capital accrual will not occur unless and until there is a disposal as defined of a partner's interest in a partnership asset. Both section 24H of the Act and paragraph 36 of the Eighth Schedule to the Act imply a fractional approach to partnership taxation. In doing so, both provisions guide the taxpayer as to the timing of the accrual in the hands of the taxpayer.

If part of an interest in an asset is disposed of, an adjustment should be made to the base cost of each adjusted partner's interests accordingly (CGT Guide, 2018:379).

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<sup>50</sup> For example, section 385 of the Income and Corporation Taxes Act 1988; section 309(1) Irish Income Tax Act 6 of 1967; section 704(d)(2) of the US IR Code.

Disposals and recoupments will be discussed at greater length in **Chapters 5** and **6** as the tax consequences of a disposal of a partnership asset (including all partnership assets on liquidation and dissolution as discussed in **Chapter 6**) are the same in the hands of each individual partner as the consequences to a partner of a disposal of his or her partnership interest. The only difference being that in the case of the former, all partners realise a portion of the gain in terms of their profit-sharing ratios; while in the latter case, the non-disposing partners realise a part-acquisition of the interest disposed of by the disposing partner. This variation of partnership interest is discussed in **Chapter 5**.

#### 4.3. Conclusions regarding continuation of partnerships

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The dichotomy presented by the application of both sections 24H and paragraph 36 of the Eighth Schedule to the Act, is that the income and capital gains arising in the partnership are deemed to accrue to the partners notwithstanding that such amounts are actually received in joint and undivided shares by the partnership structure at a time when no individual partner has a claim to his or her share of the income or capital proceeds due to the provisions of the partnership agreement.

In the United States, the partnership tax computation occurs at partnership level, but the partners themselves carry the liability for payment of the tax; evidence of an aggregate approach to taxation in a legal arena of entity recognition of partnership.

In the United Kingdom, partnership taxation is submitted to be uniquely achieved and extensively codified. Naturally, a partnership may be comprised of natural as well as juristic persons; each attracting a different tax rate. For example, in South Africa an individual would have been taxed at 45% income tax on their notional trade income (if on the maximum marginal rate of tax), while a juristic partner would have been taxed at 28% of its notional trade income. The question which arises is what tax rate to the apply to the partnership trade? This is addressed in the UK by section 114 of the UK Income and Corporation Taxes Act<sup>51</sup> (“UK ICT Act”) which confirms that different tax rates will apply to different entity partners and requires that, in the assessment of any particular partner’s liability to tax in terms of their notional trade (or portion of the profits of the partnership), one must treat all partners as if they are all the same type of entity.

It is submitted that, but for those minor issues raised above, South African legislation currently in force has this stage of partnership taxation well covered, and no development nor clarification is required.

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<sup>51</sup> UK Income and Corporation Taxes Act 1988

## 5. VARIATION OF A PARTNERSHIP

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In South African law, a partnership does not survive a change in the persons who comprise the partners (Henning, 2014:142). This lack of perpetual succession is intrinsic to the aggregate approach to partnership, as opposed to the entity approach.

*“A change in the membership of a firm destroys the identity of the firm. The ‘old’ firm is dissolved, and if the surviving members continue in partnership (with or without additional partners) a ‘new’ firm is created. This non-recognition of the firm as a legal entity is one of the most marked differences between partnerships and incorporated companies.”* (Henning, 2014:142)

Strictly, therefore, a change in the partners to a partnership results in the following legal and concomitant tax consequences on a strict application thereof:

- In law: every partner is seen to dispose of and realise their entire joint and undivided share of the partnership assets and liabilities and acquire a new similar interest on creation of the new partnership.
- For tax: a disposal, by each partner, of their entire partnership interest occurs as well as an acquisition by the surviving and incoming partners of a different partnership interest. The South African Revenue Service (SARS) have acknowledged that *“practical difficulties”* would arise should a strict application of these legal consequences be applied to the taxation of partnership<sup>52</sup>. The lack of clarity in South African legislation on this element to partnership taxation has resulted in the *fractional interest* approach being applied as a pragmatic solution (CGT Guide, 2018: 378). The necessity to apply the *fractional* approach, as a departure from a strict application of the provisions of the Income Tax Act, highlights the lack of clarity in the application of taxing principles to the legal recognition of the partnership mechanics in the variation of the partners to a partnership.

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<sup>52</sup> The Comprehensive Guide to Capital Gains Tax issue 7 of 2018 states the following on page 378 under paragraph 9.2.2:

*“The taxation of partnerships poses a number of practical difficulties. Every time a new partner joins or a partner leaves, the existing partnership is dissolved and a new partnership comes into existence. Were this common law principle to be applied, the effect would be to trigger a disposal of the entire interest of each partner each time a partner joined or left.*

*Since CGT is concerned with the disposal of rights, it is not intended that partners be regarded as disposing of their entire interests in the partnership assets every time a new partner is admitted or an existing partner leaves. Instead, each partner must be regarded as having a fractional interest in each of the partnership assets.”*

As mentioned in the conclusion to **Chapter 2**, the Value-Added Tax Act 89 of 1991 takes the entity approach. The partnership remains the same vendor, notwithstanding the introduction or exist of any partner.

A variation which similarly constitutes a disposal for the purposes of the Eighth Schedule to the Act, would occur when there is any change to the profit and loss sharing ratios of partners in a partnership, whether or not as a result of a change in the makeup of the partnership. Both instances trigger a disposal for the purposes of the Eighth Schedule to the Act, and a discussion on each follows.

#### United Kingdom

By comparison, the United Kingdom (“UK”) have addressed the inherent lack of perpetual succession of partnerships and the concomitant tax consequences by enabling the partners to elect whether the partnership should survive a change to the partners for income tax purposes *inter alia* in terms of section 113(2) of the UK ICT Act<sup>53</sup>. It is submitted that a similar approach in South Africa would override the strict legal position discussed above.

As to the capital allowances consequences arising from a change in the partners for tax purposes, sections 263 and 265 of the UK Capital Allowances Act<sup>54</sup> (“UK CA Act”) treats the outcome of the election of the partners separately, depending on whether the partners have elected that the change results in a “*permanent discontinuance*” of the partnership. Essentially, where no permanent discontinuance results, section 263 of the UK CA Act provides a roll-over of the allowances, calculated with reference to any “*balance charge*” or “*balancing allowance*” to what it refers to as the “*present partners*” as distinguished from the “*predecessors*”<sup>55</sup>.

#### Ireland

The ability of a partnership constituted under Irish law to survive a change in in the partners differs from that in the United Kingdom, by the omission of any election provided to partners that the partnership should survive. Section 59 of the Irish Income Tax Act<sup>56</sup> (“Irish ITA”) confirms that a change in the partners to a partnership results in a permanent discontinuance of the partnership. This approach is confirmed, *inter alia*, in section 69 of the Irish Taxes Consolidation Act 1997 (“Irish TCA”).

#### United States of America

One of the fundamental determinants in the US rejecting the aggregate approach in favour of the entity approach, is reported in the commentary to section 28 of the Uniform Partnership Act<sup>57</sup> (“Uniform Partnership Act”) as being to avoid these common law consequences of a change in the partners to a partnership triggering a dissolution or “*permanent discontinuance*” of the partnership. Article 6 of the Uniform Partnership Act recognises that a partner may “*dissociate*” and thereby exit as a partner

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<sup>53</sup> UK Income and Corporation Taxes Act 1988

<sup>54</sup> UK Capital Allowances Act 2001

<sup>55</sup> The “*balancing charge*” and “*balancing allowance*” is a mechanism used to align accounting practise with tax practise with reference to “*basis periods*”. It is submitted to be similar to South Africa’s recoupment regime.

<sup>56</sup> Irish Income Tax Act 6 of 1967

<sup>57</sup> US Uniform Partnership Act 1997

without interruption to the existence of the partnership. The Uniform Partnership Act then regulates *inter alia* the “buy-out price” of the exiting partner’s interest, as well as the liability of the exiting partner to the partnership for a period after exit.

The Uniform Partnership Act as read with the relevant provisions of the US Internal Revenue Code<sup>58</sup> is submitted to have provided certainty regarding the taxation of US partnerships when a change in the partners occurs.

## 5.1. The admission or withdrawal of a partner

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When a new partner joins a partnership, or when there is a change in the profit-sharing ratios of the partners to a partnership, the event may attract tax consequences. Further, when a disposal occurs it must be determined whether or not the asset disposed of is an “allowance asset”<sup>59</sup>, in which case a recoupment will arise if the proceeds received from the disposal exceed the tax value of the asset disposed of.

It is submitted that where a partnership acquires an allowance asset, and claims the allowances to which it is entitled, complications may arise when a new partner is admitted during the allowance period. A question to consider would be whether the incoming partner is entitled to claim its portion of the capital allowance afresh, or whether it is limited to claiming only so much of the allowance which remains unclaimed by the original partners.

SARS correctly notes that on the admission of a new partner to the partnership, the old partners realise a disposal of part of their share/interest in the underlying partnership assets<sup>60</sup>. It follows, then, that if the underlying asset is an allowance asset, each such partner would also need to account for a recoupment.

### Allowance assets

A deduction or allowance may be described as an amount which is applied to reduce the nett income of a taxpayer; nett income (in this case) being the result of deducting exempt income from gross income<sup>61</sup>. Thus, an allowance asset may be described as one upon which the taxpayer is allowed to reduce its

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<sup>58</sup> US Internal Revenue Code on Partners and Partnerships (Subchapter K)

<sup>59</sup> The term “allowance asset” is used to describe an asset upon which the capital allowances provided to an owner in the Income Tax Act 58 of 1962 were applied to reduce the taxpayer’s taxable income. This is expanded upon below.

<sup>60</sup> The Comprehensive Guide to Capital Gains Tax issue 7 of 2018 states the following on page 378 under paragraph 9.2.2.1:

*“When a new partner joins the partnership and contributes an asset or cash to the partnership, the pre-existing partners must be treated as having disposed of a part of their share in the pre-existing partnership assets in exchange for a fractional interest in the assets or cash contributed by the incoming partner. A capital gain or loss must accordingly be determined in respect of the part disposed of by the pre-existing partners. The base cost of the part disposed of must be determined under paragraph 33.*

*The new partner will acquire a corresponding interest in the pre-existing partnership assets in exchange for that partner’s contribution and retain a fractional interest in the cash and assets contributed to the partnership.”*

<sup>61</sup> Note that the Income Tax Act 58 of 1962 defines this “nett income” merely as “income” in section 1.

income by an amount with reference to the type of asset. These allowances were introduced because of the limitation inherent in the ability of a taxpayer to deduct trade expenses only in terms of section 11(a) of the Act, not being of a capital nature. Allowance assets are, by implication, capital in nature.

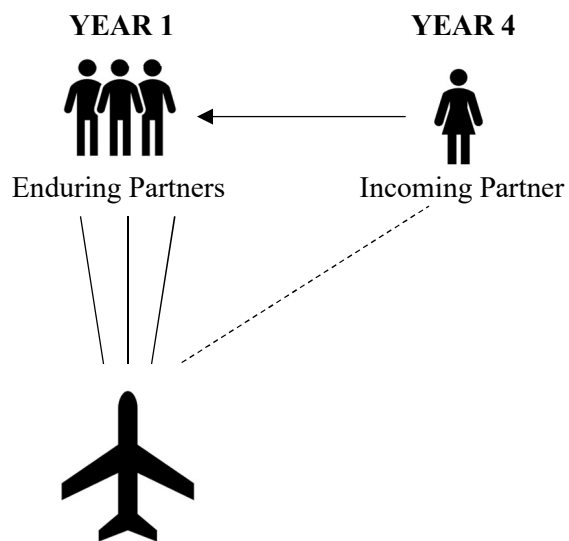
The Act provides the taxpayer with a deduction or allowance from income of an amount in respect of the acquisition by the taxpayer of an allowance asset. On disposal of that asset, however, section 8(4) of the Income Tax Act requires so much of the amount applied by the taxpayer to reduce its taxable income over the allowable period to be added to the taxpayer's income, to the extent that the proceeds received from the disposal exceed the tax value of the asset, limited to the allowance claimed. This is called a "recoupment".

The deduction or allowances mechanism, therefore, is not much more than a cash-flow tool implemented with a view to assisting the taxpayer, in cases where the value of the asset does not decrease by as much as the allowance.

#### Incoming partner example

Partners A, B and C ("the Enduring Partners") have pooled their resources and decided to purchase an aircraft for R3 million. Their intention will be to set up and run a charter business transporting wealthy individuals. They decide to do so in partnership, each contributing R1 million, and each committing to performing various administrative, marketing and other useful functions in support of the charter business.

Section 12C(1)(f) of the Act provides a deduction to a taxpayer in respect of any:



*“aircraft owned by the taxpayer or acquired by the taxpayer as purchaser in terms of an agreement contemplated in paragraph (a) of the definition of ‘instalment credit agreement’ in section 1 of the Value Added Tax Act and which was or is brought into use for the first time by the taxpayer for the purposes of his or her trade (other than an aircraft in respect of which an allowance has been granted to the taxpayer under section 12B);*

*a deduction equal to 20 per cent of the cost to that taxpayer to acquire that machinery, plant, implement, utensil, article, ship, aircraft or improvement (hereinafter referred to as the asset) shall be allowed in the year of assessment*

*during which the asset is so brought into use and in each of the four succeeding years of assessment: ...”*

Assume that the aircraft purchased in the partnership satisfies the requirements of the section 12C deduction in the Act. Thus, section 12C grants a deduction against income of 20% of the cost of the aircraft for 5 years of assessment, including the year in which the aircraft was brought into use for the first time.

This means, then, that in year 1 each partner will, in terms of section 24H(5)(b) of the Act read with section 12C, be entitled to a deduction against his or her income of:

$$\frac{20\% \times 3\,000\,000}{3} = R200,000$$

As such, in year 1 each partner reduces their income by R200,000 on their tax return. This practice continues in years 2 and 3.

At the commencement of year 4, Partner D joins the partnership and is required to purchase her share from the other partners. By then, the market value of the aircraft is R4 million as it has been very well maintained by the enduring partners. The partners therefore agree that a fair price for the acquisition of D’s partnership interest would be R2 million, taking into account the growth in value of the aircraft to R4 million, as well as the goodwill generated by the hard work put in by the enduring partners over the years.

Each partner’s share of the goodwill receipt gives rise to a capital gain or R333,333 each.

D, is also acquiring 25% of the underlying asset, the aircraft. Each of the enduring partners will have to dispose of 8,333% (or a quarter of their interest) with the result that at the end of the transaction each partner will hold a 25% interest in the partnership and its assets.

Under current law, the tax effect of this transaction for each enduring partner would be:

| <u>Partner A</u>                    | <u>Before sale</u> | <u>After sale</u> |
|-------------------------------------|--------------------|-------------------|
|                                     | 33,33%             | 25%               |
| Cost of aircraft (R3m/3)            | R1,000,000.00      |                   |
| Year 1, section 12C                 | (200,000)          |                   |
| Year 2, section 12C                 | (200,000)          |                   |
| Year 3, section 12C                 | <u>(200,000)</u>   |                   |
| Tax value (base cost) <sup>62</sup> | R400,000           |                   |

<sup>62</sup> Base cost is reduced by an allowance claimed, in terms of paragraph 20(3)(b) of the Eighth Schedule to the Act.

|                                   |                     |            |
|-----------------------------------|---------------------|------------|
| Disposal to D                     | <u>(100,000)</u>    | R300,000   |
| Year 4, section 12C               |                     | (150,000)  |
| Year 5, section 12C               |                     | (150,000)  |
| Tax value                         |                     | <u>nil</u> |
| Proceeds in year 4                |                     |            |
| for 25% of 33,33% of R4,000,000 = | <u>R333,333 (A)</u> |            |
| Cost of this portion              |                     |            |
| 25% x R1,000,000 =                | <u>R250,000 (B)</u> |            |
| Tax value of this portion         |                     |            |
| 25% x R400,000 =                  | <u>R100,000 (C)</u> |            |
| Recoupment <b>(B) – (C) =</b>     | <u>R150,000</u>     |            |
| Capital Gain <b>(A) – (B) =</b>   | <u>R83,333</u>      |            |

For years 4 and 5, A will still be entitled to a section 12C allowance, however the value of this allowance is now adjusted to R150,000.00 per year. The difference between the allowance claimed in prior years being recouped in terms of the part-disposal to D, the incoming partner. This recoupment is 25% of the allowances of R600,000 because the portion of the aircraft was sold for more than cost, i.e.

$$R600,000 \times 25\% = R150,000$$

Partner A will also have a capital gain on the portion disposed of calculated as follows:

*'Proceeds' minus Recoupment = Actual Proceeds*

$$R333,333 - R150,000 = R183,333$$

*'Base Cost' minus Allowances = Base Cost*

$$R250,000 - R150,000 = R100,000$$

*Actual Proceeds less Base Cost = Gain*

$$R183,333 - R100,000 = R83,333$$

It is trite that where a partnership interest is disposed of, the value of which is attributable in whole or in part to an underlying allowance asset, the disposal will trigger a recoupment which is deducted from the consideration received in arriving at the net amount of the proceeds. This calculation is illustrated in the CGT Guide on page 375 in Example 10.

In explaining the example given by SARS, the CGT Guide refers to *Chipkin (Natal) (Pty) Ltd v C:SARS*<sup>63</sup>, where Cloete JA:

*“... upheld the earlier decision in ITC 1784 (2004) 67 SATC 40 (G), namely, that a company that disposed of 99% of its interest in an aircraft partnership was subject to recoupment under s8(4)(a) in respect of the s14bis<sup>64</sup> allowances it had claimed on its undivided share in the aircraft.”*

In summary of the above, then:

- The inclusion of a new partner to a partnership triggers a part-disposal of each partner's fractional interest in the partnership to the incoming partner.
- This part-disposal has concomitant recoupment implications.
- Each partner may realise, and be required to recognise, a capital gain as a result of receiving proceeds as compensation for the reduction of their interest in the aircraft.

This example shows how cumbersome it is to take a fractional interest approach to the ownership of partnership assets. However, the tax result does match the commercial realities of the transaction.

Withdrawal of a partner

Referring to the case of *GB Mining and Exploration SA (Pty) Ltd v C:SARS*<sup>65</sup>, the Comprehensive Guide to Capital Gains Tax (2018:379) confirms the SARS's approach to the application of current tax provisions to the withdrawal of a partner from a partnership and states:

*“A partner leaving a partnership will have disposed of his or her interest and a capital gain or loss must be determined. The remaining partners who acquire that partner's interest will reflect an increase in base cost.”*

*Ipsa facto*, the withdrawing partner will have to account for a disposal and the concomitant capital gains tax consequences flowing therefrom; while the remaining partners will realise an acquisition, or a “*part-acquisition*”, and an increase in the base costs of their respective interests in the underlying assets of the partnership.

It is submitted that the position of the withdrawing partner is clear. A disposal of his or her entire fractional interest must be accounted for at market value<sup>66</sup>. This is different from a disposal of a partnership asset, which is dealt with under termination of the partnership below. It is submitted,

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<sup>63</sup> *Chipkin (Natal) (Pty) Ltd v C:SARS 2005 (5) SA 566 (SCA)*

<sup>64</sup> Note section 14bis was repealed by section 50 of Act No. 31 of 2013.

<sup>65</sup> *GB Mining and Exploration SA (Pty) Ltd v C:SARS 2015 (4) SA 605 (SCA)*

<sup>66</sup> Paragraph 38 of the Eighth Schedule to the Income Tax Act 58 of 1962 requires that transaction between connected persons, such as partners, be subjected to tax at market value.

however, that South African tax law should provide a roll-over until such time as the partner actually disposes of the asset or his or her share thereof. This is currently not the case.

The remaining partners will endure similar tax considerations to a withdrawing partner, as that which would have applied if the profit-sharing ratios *inter se* were varied notwithstanding any change in the partners. As such, the position of the remaining partners is considered at greater length below in a discussion on the tax consequences of a variation of the partner's interest or profit-sharing ratios in the partnership.

A question to consider, however, is how to continue to apply any allowances in respect of the remaining partners if the exit occurs during an allowance period. It is submitted that this is not clearly dealt with in the Income Tax Act. The remaining partners are instructed to adjust the respective base costs, and it follows, then, that the balance of the allowance remaining in terms of an allowance asset should be applied to the reduced number of partners such that each partner enjoys an increased allowance *pro rata* to their profit-sharing ratios, this increase arising from the extra cost incurred in acquiring the fraction from the outgoing partner.

## 5.2. Variation of a partner's interest and/or profit-sharing ratio

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As a variation of a partner's interest in a partnership constitutes a disposal<sup>67</sup> for the purposes of the Eighth Schedule to the Act, regard must be had to the calculations set out in the Eighth Schedule to the Act to determine the taxable gain or loss to be accounted for. This gain or loss is brought into the taxpayer's income tax calculation by virtue of section 26A of the Act. For the purposes of this chapter, it is accepted that a partner's interest in a partnership is of a capital nature.

The variation of the partner's interests to the partnership will result in "*part-disposals*" by some (CGT Guide, 2018:334) and concomitant "*part-acquisitions*" by others<sup>68</sup> in order that the total value of the underlying assets of the partnership is re-allocated in terms of the amended profit-sharing ratios.

Paragraph 33 of the Eighth Schedule to the Act deals with the treatment of "*part-disposals*", and is relevant where there is a change in partners' profit-sharing ratios *inter se*. A reduction in *fractional interest* against receipt of proceeds<sup>69</sup> is a part-disposal (CGT Guide, 2018:334). The base costs of the portion of the interest disposed of is determined in terms of paragraph 33, and essentially amounts to

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<sup>67</sup> The tax consequences of a disposal are discussed in **Chapter 3** where the change from full ownership to a fractional interest in an asset contributed to a partnership is discussed. The important nature of a "*disposal*" in terms of paragraph 11 of the Eighth Schedule to the Act, which also applies here, is the recognition in the definition of a "*variation*" of a person's rights as constituting a disposal. Therefore, where there is a variation in the profit-sharing ratios *inter partes* in a partnership, or when a new partner is introduced, a disposal is triggered.

<sup>68</sup> Note the term "*part-acquisition*" does not appear in the Income Tax Act 58 of 1962; but is used by the author to describe the corollary to the regulated "*part-disposal*" provisions in paragraph 33 of the Eighth Schedule to the Income Tax Act 58 of 1962.

<sup>69</sup> It is submitted that, as partners are connected persons and as transactions *inter se* are deemed to be at market value regardless of actual value, any variation in the value of the partners' *fractional interests* will fall within the provisions of paragraph 33 of the Eighth Schedule to the Act read with paragraph 38 of that Schedule.

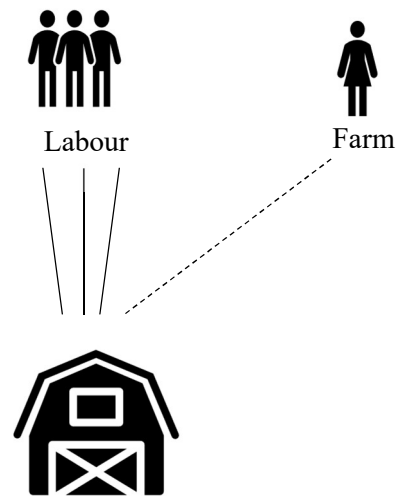
an apportionment “... *between the part kept and the part disposed of* ...” (Haupt, 2018:715) relevant to the market value. An increase in *fractional interest* is a part-acquisition resulting in adjustment of the base cost of thereof<sup>70</sup>.

The Eighth Schedule to the Act deals with this shift in the respective values of the partner’s *fractional interests*. Paragraph 1 of the Eighth Schedule to the Act defines a value shifting arrangement as:

*“value shifting arrangement means an arrangement by which a person retains an interest in a company, trust or partnership, but following a change in the rights or entitlement of the interests in that company, trust or partnership (other than as a result of a disposal at market value as determined before the application of paragraph 38), the market value of the interests of that person decreases and -*

- (a) *the value of the interest of a connected person in relation to that person held directly or indirectly in that company, trust or partnership increases; or*
- (b) *a connected person in relation to that person acquires a direct or indirectly interest in that company, trust or partnership.”*

For example: Assume that one partner contributes a farm to an existing partnership in exchange for a 40% profit-share therein but does not work on the farm. Three other partners contribute the skill and labour required to work the farm, but no capital, in exchange for 20% profit-share each of the partnership. The farm becomes a partnership asset, the value of the contribution being reflected in the one partner’s capital account. The values of the 20% partners, however, has increased by virtue of the new partnership asset. Over time, the three working partners tire of the lack of contribution of the farm contributor and require the profit-sharing ratios to be renegotiated. Fearful of losing the three partners, the 40% partner agrees to reduce her profit share to 25%. The question is whether any value has shifted between the partners, and if so the extent to which a disposal must be accounted for.



A value shifting arrangement constitutes a “*disposal*” for capital gains tax in terms of paragraph 11(1)(g) of the Eighth Schedule to the Act, which states:

<sup>70</sup> Paragraph 20 of the Eighth Schedule to the Income Tax Act 58 of 1962 regulates the cost to be applied to capital assets. If a partner’s interest increases as a result of a value-shifting arrangement, the increase is taken to base cost by virtue of paragraphs 11(1)(g) and 23 of the Eighth Schedule to the Act.

*“Subject to subparagraph (2), a disposal is any event, forbearance or operation of law which results in the creation, variation, transfer or extinction of an asset, and includes -*

*(g) the decrease in value of a person’s interest in a company, trust or partnership as a result of a value shifting arrangement.”*

In the above example, the profit-sharing ratios have been varied by the reduction from 40% to 25% of the one partner, with a corresponding increase in the profit-sharing ratios of the other three partners. Value has shifted from the one shareholder to the other three. This constitutes a disposal but, with reference to the partner’s capital account which continues to reflect the value of the farm contributed, the proceeds remain to be determined.

Paragraph 13(1)(f) of the Eighth Schedule to the Act determines the time of disposal pursuant to a value shifting arrangement to be “... *the date on which the value of that partner’s interest decreases.*”

Paragraph 35(2) of the Eighth Schedule to the Act provides that the proceeds from such a disposal are equal to the difference between the market values of the interest before and after the disposal.

Paragraph 36 of the Eighth Schedule to the Act determines the proceeds to accrue to the disposing partner at the time of that disposal. This provision was enacted in order to amend the pre-existing common law position, as confirmed by the Appellate Division in *Sacks v CIR*<sup>71</sup>, whereby partnership profits only accrued to the partners on the date agreed by the partners to take account of those profits (CGT Guide, 2018:337).

- In *Sacks’* case *supra*, the court gave effect to the legal ability of a partnership to retain the value of its accrual until such time as the partners resolved to attribute same *inter se*. The partnership could suspend the accrual of an amount to a partner and hold a receipt, effectively, in trust for the benefit of the partners *pro rata* in accordance with their profit and loss sharing ratios, until a future date. It is submitted that while the purpose of paragraph 36 is described as being to “... *provide certainty as to when capital gains and losses accrue*” (CGT Guide, 2018:377), the wording goes further and serves as an example of both the legislature’s as well as SARS’ attempts at reconciling the legal recognition of partnerships with the taxation thereof; that being, as a “*transparent entity*” (Hattingh et al., 2015:132).
- It is worth mentioning that sections 66(13A) and 66(13B) of the Income Tax Act 58 of 1962 enable a taxpayer (including a partnership of individuals) to apply to the Commissioner to draw up the relevant financial accounts to a date other than the last

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<sup>71</sup> *Sacks v CIR 1946 AD 31*

day of February, subject to any conditions as the Commissioner may impose; the former section dealing with income and the latter, capital.

Thus, the proceeds are considered to have been received by the 40% partner at the moment of the disposal by virtue of paragraph 36 *supra*, at a value equal to the difference between the market value of the interest prior to and after the value was shifted per paragraph 35 *supra*. The 40% interest is reduced to a 25% interest, which is a 15% reduction. Thus, the proceeds deemed to have been received by the 40% partner on reduction of her interest to 25%, is 15% of the market value of the farm over and above the amount of capital created by the introduction of the farm. It is submitted, therefore, that the cost of such a reduction in partnership interest should be born by the partners in the acquisition by them of an increased fractional interest. *Res ipsa loquitur*, the respective interest cannot increase without compensation, at least to the extent of the tax liability suffered by, in this example, the 40% partner on reduction of her interest.

It is submitted that it is possible to avoid any value shifting, however, by preserving the value of a partner's interest by the incurral of inter-partner loans to neutralise any potential value diminution. The amount so credited to the 25% partner's loan account will be the proceeds on the disposal of her interest.

### 5.3. Conclusions regarding variation of partnerships

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Any change to the profit-sharing ratios of the partners to a partnership amounts to a variation of the interests of the partners in the partnership. From a legal point of view, no actual transfer of ownership in the underlying assets of the partnership will have occurred, and only upon termination of the partnership will each partner receive his or her *pro rata* share thereof. For tax, however, the fractional approach determines that the partner whose interest decreases is making a disposal of part of his or her interest in the underlying assets to the partner whose interest increases, at the time of the variation. To the extent that the one partner does not compensate the other for this change, paragraph 38 of the Eighth Schedule to the Act would apply to subject the full disposal to tax.

In many partnerships, goodwill is a valuable asset which could lead to significant liability for tax for the "*disposing partner*" even though in law no true disposal has occurred. It is submitted that the Income Tax Act does not provide clear guidelines in this case.

A variation could also lead to the result that the underlying assets have different base costs for each of the partners, making the calculation of future capital gains burdensome.

It is suggested that the tax on such notional disposal be deferred until the assets are actually sold or the partnership is actually terminated, because it is only at that time that the partners (depending on the circumstances) will be cash competent to satisfy the tax liability arising, and it is only at that time that an actual change in the holding of the asset takes place in law. Termination of partnership is dealt with below.

## 6. TERMINATION OF PARTNERSHIP

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On final termination and dissolution of a partnership, or on disposal of the asset(s) of a partnership as discussed in **Chapter 4**, the partners realise proceeds in accordance with their profit-sharing ratios. The partners will be repaid their capital accounts (either in cash or *in specie*) and they will divide the assets of the partnership up between themselves in accordance with their profit-sharing ratios<sup>72</sup>. This is known as the dissolution and liquidation of a partnership and which forms the basis of the ensuing discussion.

### 6.1. Disposal of joint and undivided shares or fractional interest?

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In law, a disposal occurs of the assets from the partnership to the partners; i.e. a disposal by all partners of their joint and undivided shares in the underlying assets in exchange for full ownership of assets equal in value to the respective erstwhile interests.

For tax, however, on the basis that a partnership is meant to be transparent, hence the fractional approach, each partner is disposing of a fractional interest in certain assets and acquiring a full interest in others. The application of the current legislation, as well as the practise and reasoning by SARS is submitted to be faulty in certain instances.

In describing the tax effects of the above, SARS state the following (CGT Guide, 2018:390-391):

*“Upon dissolution of a partnership it needs to be determined whether a disposal will result when the partnership assets are divided among the partners.*

*For example, assume that the partnership assets comprise 100 shares in a single company and there are two partners A and B sharing profits equally. On dissolution partner A takes 50 shares and partner B takes 50 shares. Before dissolution each partner had a fractional interest in 50 shares<sup>73</sup> and after dissolution each partner still holds 50 shares. While it could be argued that the 50 shares taken over by partner A consist of 25 shares formerly held by partner B and 25 shares formerly held by partner A it is not considered appropriate to trigger a disposal in these circumstances because each partner’s bundle of rights in the shares<sup>74</sup> has remained unchanged.*

*The position would be different if the partnership assets comprised 50 shares in Company X and 50 shares in Company Y and partner A took over the 50 shares in*

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<sup>72</sup> *Isaacs v Issace 1949 (1) SA 952 (C) at 961.*

<sup>73</sup> Legally, however, each partner holds a joint and undivided interest in 100 shares. For tax, it may also be argued that the *fractional interest* of each partner is to the 100 shares. The reasoning by SARS here is therefore submitted to be incorrect.

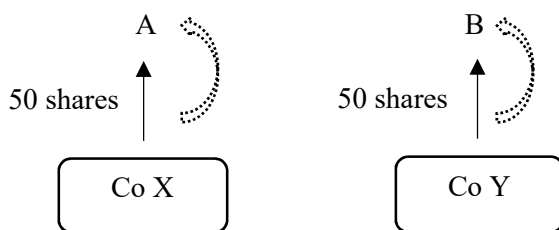
<sup>74</sup> It is submitted that this sentence erroneously refers to a partner’s bundle of rights in “*shares*” where the intention is to refer to a partner’s bundle of right in a “*company*”.

*Company X and partner B took over the 50 shares in Company Y. In that event partner A has disposed of 25 shares in Company Y to partner B in return for 25 shares in Company X. Likewise, partner B has disposed of 25 shares in Company X in return for 25 shares in Company Y.”*

In the first example given by the CGT Guide (2018:390) *supra*, taking a fractional interest approach, each share is a separate asset because it can be dealt with independently of the others. This is recognised in the Eighth Schedule to the Act in, for example, paragraph 32 which defines “*identical assets*”. By regarding each share in a company as an identical asset in relation to the other shares, the legislature clearly considered that each share is a separate asset. Therefore, when partner A disposes of his interest in his shares in the single company (s)he is, under the fractional interest approach, disposing of half of his or her interest in each of the 100 shares held by the partnership, and in exchange acquiring a full interest in 50 of the shares. It is understood that it may not be appropriate to trigger a disposal or a gain in these circumstances, but it is submitted that the Income Tax Act does not cater for it. It is further to be noted that the explanation provided by the CGT Guide (2018:390) *supra* is merely the view of the author and is not binding either on SARS or on the taxpayer.

In the second example (CGT Guide, 2018:391) partner A has not disposed of 25 shares in Company Y to partner B in return for 25 shares in Company X. Partner A has disposed of half of his or her interest in the 50 shares in Company Y and acquired a further half interest in the 50 shares in Company X. This distinction is important because the base cost of the shares in company Y may be different from the base cost of the shares in Company X. As such, following this approach could result in an inequitable distribution of a latent capital gain inherent in unequal base costs. It is likely that a partnership agreement would not intend this as a consequence, and as such the approach suggested in the CGT Guide (2018:391) would likely be in conflict with the partnership agreement.

Illustration of the above discussion



|                     |      |      |
|---------------------|------|------|
| Cost to partnership | R2   | R100 |
| Market Value        | R100 | R100 |

|          |                      |   |            |
|----------|----------------------|---|------------|
| <b>A</b> | Disposal of 50% of Y | = | R50        |
|          | Base cost            | = | (50)       |
|          | Gain                 | = | <u>nil</u> |

|          |                      |   |            |
|----------|----------------------|---|------------|
| <b>B</b> | Disposal of 50% of X | = | R50        |
|          | Base cost            | = | (1)        |
|          | Gain                 | = | <u>R49</u> |

New Base Costs

|          |                            |            |
|----------|----------------------------|------------|
| <b>A</b> | Base cost of ½ of Co. X    | R1         |
|          | Acquired other half from B | 50         |
|          | New base cost of X shares  | <u>R51</u> |

|          |                            |             |
|----------|----------------------------|-------------|
| <b>B</b> | Base cost of ½ Co. Y       | R50         |
|          | Acquired other half from A | 50          |
|          | New base cost of Y shares  | <u>R100</u> |

The partnership agreement states, however, that they share 50/50. The result is clearly not 50/50. Paragraph 36 of the Eighth Schedule to the Act, as discussed above, imputes capital gains of the partnership to the individual partners. In the above example, one partner is inheriting a latent capital gain which exceeds that of the other partner. As such, it is submitted that this fractional treatment

disregards the intention behind paragraph 36 to a large extent. It is up to the partners to deal with this in their partnership agreement. Legislative intervention may provide much needed clarity in this area.

The above approach by SARS, as explained in the CGT Guide (2018:390) *supra*, is submitted to result in a pragmatic application of the taxing principles, but it is not what the Income Tax Act says. The CGT Guide (2018:390) begins its explanation by requiring a determination as to whether a disposal has occurred. It is submitted that the wording of the Act does not enable this determination to occur; but rather requires that a disposal must be considered to have occurred.

## 6.2. Disposal in terms of the Income Tax Act 58 of 1962 versus SARS practice

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The definition of “*disposal*” in paragraph 11 of the Eighth Schedule to the Act states that if any partner, for any reason, no longer has any claim to any of the underlying assets then, subparagraph (1) of the definition must apply and the relevant partner must be considered to have “*disposed*” of their claim or interest. Further, as partners hold joint and undivided interests in the underlying assets of a partnership, their interest is their individual asset. If the partners decide to sell an underlying asset, each partner must include the nett amount realised in their individual income for tax purposes, because of paragraph 36 of the Eighth Schedule to the Act discussed above.

If the fractional approach is introduced into the Income Tax Act to clearly deal with how a partner’s interest in an underlying asset must be dealt with, it follows that on the termination of a partnership a partner will be disposing only of that partner’s fractional interest in the underlying asset; notwithstanding that in law it is a joint and undivided share that is being disposed of. On termination, a partner is normally compensated for the disposal of that fractional interest and it follows that any tax arising on this disposal would be equitable in such circumstances.

In the case where a partner leaves a partnership or the partnership is terminated for all the partners and the underlying assets of the partnership are merely transferred to the partners in accordance with their fractional interests, it is submitted that the tax law should provide for a roll-over of the cost of the fractional interest until the partner actually disposes of the asset or his share of the asset.

In the case of a partnership in which the major asset is goodwill, it is usual to compensate an exiting partner in cash for his share of the goodwill. It is equitable that such partner would have a capital gain on that disposal. However, in the case of the termination of a partnership, the goodwill merely be extinguished unless the business of the partnership and the goodwill are sold to a third party prior to the termination, in which case the gains arising would be adequately dealt with in terms of paragraph 36 of the Eighth Schedule to the Act.

The problem arises when a partnership is terminated, and the assets of the partnership are “*transferred*” to the partners based on the value of their fractional interests but not necessarily taking into account that each partner has a fractional interest in each asset. In other words, if two equal partners owned two

assets in partnership which were equal in value, two things could happen at the time of the termination of the partnership:

- Each partner could receive a 50% interest in each asset; or
- One partner could receive the one asset and the other partner could receive the other.

### 6.3. Conclusions regarding termination of partnerships

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The fractional interest approach effectively allows a roll-over if each partner receives his fractional interest in each asset of the partnership; notwithstanding that, in law, the position is changed with regard to the full ownership of the assets. Under the fractional interest approach, however, if one partner receives the one asset and the other partner receives the other asset, each partner has a disposal of half of the asset that they no longer own, in return for proceeds equal to half of the asset that they retain.

It is submitted that the Tax Act make it clear how each situation is deal with and it would be fair to allow a tax roll-over in both cases. Allowing a tax roll-over when assets are taken out of a partnership (with specific cash consideration) is consistent with the principle of allowing a roll-over when assets are brought into a partnership.

## 7. CONCLUSION

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It is submitted that further research be done to consider the approach taken by other similar common law foreign jurisdictions in their regulation of the taxation of those mechanics inherent in the ordinary commercial partnership which are submitted to be ambiguously dealt with, if at all, in South Africa's current legislation.

In considering the elements thereof highlighted in this dissertation, the answer to the question initially posed in the title will have to be answered in the negative; namely, South Africa's current fiscal legislation does not deal clearly with the taxation of the ordinary commercial partnership. Specific elements remain ambiguous or unclear and are submitted to require additional legislative intervention.

With a shared aggregate approach to the taxation of partnerships, the United Kingdom's extensive partnership legislation is a useful tool to draw from, being perhaps the closest approach to South Africa in its recognition and taxation of partnerships.

Should South Africa consider that more drastic legislative intervention is required and opt for a rigid departure from the aggregate approach in favour of the entity approach, the interaction between the United States of America's legal recognition of partnership and the taxation thereof provides another extensively codified legislative tool.

As noted, a partnership is a recognised entity for the purposes of the Value-Added Tax Act<sup>75</sup> (“VAT Act”). Notwithstanding a change in the composition of the partners, the partnership remains a separate person for Value-Added Tax (“VAT”) purposes. Section 51(1) of the VAT Act provides that the partnership is deemed to carry on its enterprise as a person separate from its members as the registration of the partnership is effected separately from any of its members. Section 51(2) of the VAT Act provides that where a partnership is dissolved in consequence the withdrawal of one or more but not all of its members, or the admission of a new member, the “*new partnership*” and the “*dissolved partnership*” are deemed to be one and the same partnership. It would be useful, therefore, if to some extent the income tax provisions could be aligned with the VAT provisions keeping in mind the comments and suggestions made in the body of this dissertation.

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<sup>75</sup> Act 89 of 1991

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