Volume 10 Issue 4 December 2019

BUSINESS TAX & COMPANY LAW

QUARTERLY

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VOLUME 10, ISSUE 4 — DECEMBER 2019

Published in 2019
by

Siber Ink

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Tokai 7966
Cape Town
SOUTH AFRICA

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ISSN 2219–1585

Set in 9/13 pt ITC Stone Serif by GJ du Toit

Cover design by James Berrangé

Printed and bound by
Digital Action, Paarden Eiland, Cape Town

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BUSINESS TAX & COMPANY LAW QUARTERLY

ISSN 2219–1585

VOLUME 10
ISSUE 4
DECEMBER 2019

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Siber Ink CC

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Editorial

MILTON SELIGSON SC*

This issue of the *BTCLQ* features an important contribution to tax jurisprudence by Professor Fareed Moosa, Head of the Department of Mercantile and Labour Law at the University of the Western Cape, entitled 'Democratic Principles Underpinning Tax Administration in South Africa'. The article deals with the impact of constitutionalism under the South African Constitution on tax law and administration, and seeks to demonstrate that taxpayers are included among the beneficiaries of the fundamental rights incorporated in the Bill of Rights of the Constitution.

The author highlights that this constitutional protection includes the right to just administrative action by the South African Revenue Service and its officials when executing their duties and functions under the Tax Administration Act 28 of 2011, as well as under the plethora of tax legislation enacted in this country. This right entitles taxpayers to tax administration that is lawful, reasonable and procedurally fair. Additionally, taxpayers are entitled to written reasons for administrative decisions taken that adversely affect their interests.

Furthermore, the Constitution subjects all fiscal legislation and conduct in the administration thereof to constitutional control. The effect of this is that taxation and tax administration must conform to the rule of law and the values, principles and spirit that infuse the Constitution. The author points out, with ample reference to ground-breaking decisions of the Constitutional Court and other authorities, that the rule of law seeks to establish a legal regime that is underpinned by the principles of legality, equality, clarity, consistency and fairness and the advancement of human rights and freedoms for all citizens, including taxpayers. He contrasts this with the public administration that characterised the pre-constitutional, apartheid era.

Tax advisors and practitioners should find the comprehensive analysis of the operation of the rule of law in tax law and administration and the application of the principle of legality in those spheres, as well as the copious source references, helpful in dealing with the thorny problems that often arise at the intersection of constitutional and tax issues. For, in an era when taxpayers are often confronted by an increasingly aggressive tax administration seeking to exercise the broadly intrusive powers conferred on SARS, the protections afforded by the Constitution afford a significant and effective counterpoise. It should never be forgotten, either by taxpayers or by SARS and it's functionaries that, as the author reminds

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us in his conclusion, the Constitution envisages a public administration which is '… efficient, equitable, ethical, caring, accountable and respectful of fundamental rights …'.[1]

* * *

The second article in this issue, by Michael Rudnicki, also deals with an important, if somewhat esoteric issue—The Taxation of Carried Interest. Carried interest has nothing to do with interest in its usual tax connotation. It is a concept well known in the private equity industry and refers to the super profit that a private equity professional will earn if a private equity fund generates a profit for the general partner that manages the fund, in excess of what is known as 'the hurdle rate'. Such private equity professionals are employed by the fund manager and typically acquire their carried interests as beneficiaries in a vested trust.

The article delves into the private equity industry to explore the meaning of 'carried interest' and illustrates a typical private equity structure which usually has a limited partnership (partnership *en commandite*) at its centre, with a general partner that manages the private equity fund and its investments and is itself a separate partnership that becomes entitled to the 'carry'. The article discusses the general partner partnership and its entitlement to earn a disproportionate share of the surplus profits when a partnership return 'hurdle' of between 8% and 11% has been achieved by the private equity fund.

The article then discusses the tax treatment of a partnership and its partners in terms of section 24H of the Income Tax Act. It investigates various definitions of the term 'carried interest'. The author points out that, given the uncertainties in valuing the units which will be issued up front by the Trust to the executives of the general partner (fund manager) to reflect their share of the 'carried interest', it is commonly accepted by most valuation experts, as well as by Her Majesty's Revenue and Customs ('HMRC') in the United Kingdom, that the value of the carried interest on acquisition is nil. The article explores the *causa* for the acquisition of carried interest in the context of a private equity fund in South Africa and concludes that the benefit acquired up front is acquired 'by virtue of employment' and is therefore taxable as income in terms pf section 8C of the Act.

The author further submits that when, at a later stage, the Trust receives its proportionate share of the carried interest, the beneficiaries will acquire personal rights against the Trust to the agreed proportion of the relevant amount. This right will be distinct from the vested contractual right acquired up front by virtue of employment. The personal right will be acquired as a beneficiary of the Trust and will not be imbued with the character of

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[1] *Per* Mokgoro J—majority judgment—in *Van der Merwe and Another v Taylor NO and Others* 2008 (1) SA 1 (CC) at para [72].

employment, and will, so the author argues, be taxed in accordance with the normal trust conduit principles and not under section 8C.

This article should be of considerable interest to tax practitioners as it sheds light on tax issues in the private equity industry, a topic of growing importance.

* * *

The third article in this issue, by Advocate Kevin Burt of the Johannesburg Bar, discusses the recent unanimous judgment of the Supreme Court of Appeal in *BMW South Africa (Pty) Ltd v The Commissioner for the South African Revenue Service*[1]. In that case, the Supreme Court of Appeal rejected the appeal brought by the taxpayer to establish the deductibility of fees paid by it to tax consultancy firms to ensure compliance with local tax laws by expatriate employees from abroad while they were seconded by their overseas employers to work for BMW in South Africa. BMW South Africa had agreed to pay the income tax due by the expatriate employees and had engaged and paid the tax consultancy firms. SARS had decided that the payment of such fees represented taxable fringe benefits in the hands of the expatriate employees.

The article considers the judgment of the Court (written by Navsa JA), in which it was held that the statement in Davis et al, *Juta's Income Tax* that, if the service provided by the employer was used partially for the business or affairs of the employer, it would fall outside the fringe benefit provision, was 'too strongly worded'. The Court found that the taxpayer's reliance on the tax consultancy firms' services being 'at least in part' utilised by BMW South Africa was misplaced—while there might have been 'some peripheral advantage' to the employer, that was irrelevant as the service had been utilised by the employees for private or domestic purposes, and SARS had correctly applied paragraph 2(*e*) of the Seventh Schedule in treating the services as taxable benefits in their hands.

The author is critical of the decision of the Supreme Court of Appeal and considers that the conclusion reached that the consultancy firms' services had only some 'peripheral advantage' is open to question for three reasons: *First*, the Court probably did not appreciate the full extent of BMW South Africa's reliance on the services in question on the basis discussed in the article. *Second*, the Court overlooked the fact that the expatriate employees were not given the option of choosing their own tax consultancies, because, as was common cause, the employer had made the payments to protect it's own and the BMW Group's interests, which the author points out would have included financial and reputational risk arising from the potential mis-statement of the expatriate employees' income tax liabilities. *Third*, the Court's conclusion that the services rendered were services

[1] 1156/18 [2019] ZASCA 6 September 2019.

for which the expatriate employees would otherwise have had to pay for personally was unrealistic, bearing in mind that they would have had to continue to pay for similar services in their home countries.

Finally, the author points out that in the circumstances the case does not settle the question as to what the position is, if on the particular facts the benefit to the employer is not peripheral or marginal.

The Taxation of Carried Interest

MICHAEL RUDNICKI*

ABSTRACT

'Carried interest' is a term that is defined as the super profit that a private equity professional will earn if a private equity fund generates a profit in excess of its 'hurdle rate'. Carried interest forms part of the general partner's interest (the general partner bears the risk of loss of the partnership to the extent that it exceeds the limited partners' contribution to the partnership) in an *en commandite partnership* (silent partnership) and is disproportionate to its co-ownership in the underlying partnership assets. Partnerships are attractive from a tax perspective, as they are see-through vehicles that allow income and capital proceeds to flow directly to the partners of the partnership. Private equity professionals are employed by a fund manager and acquire their interests in the 'carry', typically in the form of a beneficiary interest in a vested trust. The vested rights to income are awarded to private equity professionals based on their seniority and experience.

The award of carried interest is usually characterized by a direct link to employment and, because the legal mechanism to acquire the benefit of the carry is in the form of a beneficiary interest in a trust, the acquisition is likely to constitute an equity instrument for purposes of section 8C of the Income Tax Act, 1962. The equity instrument is acquired up front and is unconditional, and therefore if the instrument is not restricted in terms of section 8C, the tax event from an employees' tax perspective arises at acquisition. There is a dichotomy, though, in the disparity between the value of carry acquired up front (regarded internationally as being nominal given the various probability variables in determining the future super-profit) and the potential gainful outcome which private equity professionals may generate, to the extent that the partnership assets perform favourably.

As the employment benefit is acquired and taxed up front (on the basis that the equity instrument is unrestricted), future benefits acquired by beneficiaries, in the form of income or capital proceeds derived by the trust, will retain their tax character in terms of legislated *conduit pipe* principles. The disparate tax treatment has caused a number of international legislators to apply particular tax rates, or to remove inflationary benefits to capital gains generated by the carried interest, which passes though the private equity structures, ultimately to the private professionals. Emphasis on this analysis suggests that the beneficiary interest is unrestricted for section 8C purposes. However, forms of disposal restrictions and so-called 'leaver' provisions are often required by various stakeholders, such as the remuneration committee and the limited partners, which may not achieve the same tax result.

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Introduction

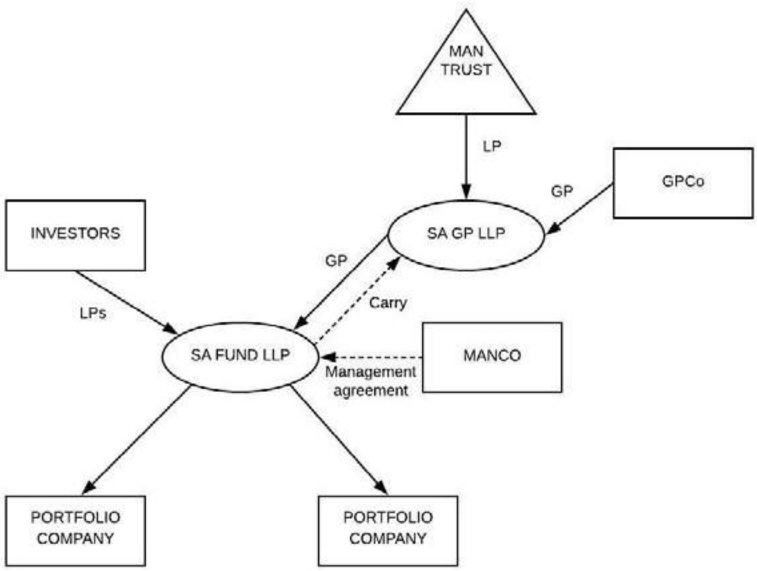
The taxation of carried interest has often been written about without a clear explanation of what the concept actually is. As is often the case when analysing the tax implications of complex transactions and terminologies, the trick really is to ignore the confusing labels and delve into the rights and obligations of the product or transaction. That is the precise intention of this article. The term 'carried interest' is synonymous with the private equity industry. Little has been written in this journal about this industry and the related tax consequences, and so besides this article, it may be useful, in an economy where growth is dismal and investment opportunities often appear below the surface, that many more articles covering the private equity industry are written.

The article starts with an illustration of a typical private equity legal structure and a brief description of its components and their purpose. The article then considers the salient tax principles associated with partnerships. The discussion up to this point is important in order to establish how and where carried interest fits into a private equity structure and what its purpose is. The article then deals with the fundamental tax principles associated with carried interest.

A private equity partnership structure

Before dealing with the meaning of 'carried interest', it is important to understand how a typical Private Equity Fund is structured from a legal perspective.

The diagram below illustrates a typical Private Equity Fund Structure:



A typical Private Equity Fund is constituted by an *en commandite* partnership. The partners consist of limited liability partners, or partners *en commandite*, and a general partner who is also the managing partner of the partnership. The LPs comprise the investors in the fund. The GP typically takes the form of a partnership itself. Its partners are usually a vehicle such as a trust that houses the carried interest that accrues to management together with a partner that is exposed to the creditors' obligations outside the ring-fenced liability of the LPs.

> 'In a partnership en commandite, the partners en commandite are not liable to the partnership's creditors for partnership debts, but are liable only to the principal or disclosed partners, while a partner en commandite is liable only to the amount of his or her contribution to the partnership and is not disclosed to the public as being a partner.'[1]

Each partner contributes to the partnership and the contributions are collectively applied to invest in the underlying portfolio or investee companies. This type of partnership is common internationally in the Private Equity industry, as well as in South Africa, as it constitutes a see-through vehicle for tax purposes (discussed below).

The Limited Partners are protected in relation to their liability towards creditors in an amount equal to their contribution to the partnership, but are not held out to the world as partners—hence the term 'silent partners'. The General Partner ('GP') assumes unlimited liability.

Partnership law in South Africa is dealt with in terms of common law. The law is complex but two key *essentialia* of a partnership in a private equity context are:

- the entitlement to share profits; and
- co-ownership.

Profit sharing

> 'One of the essentialia is that each partner must be entitled to share in the net profits of the partnership….The proportion in which partners share the profit is one of the naturalia and can be agreed to by the partners.'[2]

This is an important aspect in a Private Equity partnership model. Partners in a private equity context will share profits in a complex manner, often in a manner that is disproportionate to their partnership contributions, particularly the GP. In the diagram above, the GP Partnership will generate income commensurate with its capital contribution to the main partnership, but will generate a share of the profits disproportionate to its capital contribution when a partnership return hurdle is achieved.

The so-called super profit, or carried interest, is usually triggered once a specific profit hurdle is achieved (in South Africa usually between 8% and

[1] Silke, electronic version, paragraph 11.9.
[2] *The New Companies Act Manual* 2 ed LexisNexis at 193.

11%). Income is distributed to partners in a Private Equity Fund in terms of a tiered payment system or waterfall.

A typical income distribution waterfall is the following:

- Return of capital
- Return of management fees
- Preferred return or hurdle
- Super-profit (80% distributed to limited partners and 20% (carried interest) to the fund management, usually held by a trust).

Co-ownership

> 'One of the naturalia of a partnership is that partners are co-owners of the assets of the partnership in joint undivided shares, because a partnership is not a legal entity……The partnership fund comprises all the assets and rights which are jointly owned by the partners or to which they are jointly entitled …'[3]

The co-ownership element of a partnership interest is an important consideration for the taxation of partners. The distinction between the cost to a partner of a partnership interest and the cost to a partnership of acquiring an interest in the undivided property has been judicially considered.[4]

> 'That distinction was made by this court in Rane Investments Trust v Commissioner, South African Revenue Service 2003 (6) SA 332 (SCA) … at para 35:
>
> "The Commissioner argued further, however, that Ranes's expenditure was in respect of its acquisition of its partnership share, not in the acquisition of the film. That argument loses sight of the principle that in acquiring the share, Rane was also acquiring, as part of the business of the former partnership, a share in the film—already an asset. It was the expenditure on the film as an asset taken over by the new partnership that was deductible, and not the amount of R90 000 paid to become a partner."'[5]

Tax treatment of a partnership and its partners

The tax treatment of a partnership *en commandite* per se is ignored (a partnership is not a person at common law or under section 24H of the Act)[6] and each partner will deal with income and expenditure derived in common in their respective capacities as partners.[7] The income of the partnership shall be apportioned among the partners and:

> '… determined in accordance with any agreement between such members as to the ratio in which the profits or losses of the partnership are to be shared …

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[3] *The New Companies Act Manual* 2 ed LexisNexis, page 194.
[4] In *Chipkin (Natal) (Pty Limited v Commissioner, South African Revenue Service* 2005 (5) SA 566 (SCA)]..
[5] *Chipkin supra*, at at para [9].
[6] *Chipkin supra,* at at para [11].
[7] Section 24H of the Income Tax Act 58 of 1962 ('the Act').

> such income shall, notwithstanding anything to the contrary contained in any law or the relevant agreement of partnership, be deemed to have been received by or to have accrued to each such member individually on the date upon which such income was received by or accrued to them in common.'[8]

Section 24H of the Act specifically defines a 'limited partner' as:

> 'any member of a partnership en commandite, an anonymous partnership, or any similar partnership or foreign partnership, if such member's liability towards a creditor of the partnership is limited to the amount which the member has contributed or undertaken to contribute to the partnership or is in any other way limited'.

A partnership, for tax purposes, is a see-through vehicle which is an attractive legal vehicle for private equity purposes, as multiple corporate layers between investors and portfolio companies, which may result in possible tax leakage, are avoided. Accordingly, limited partners' and the general partner's interest from a tax perspective are determined solely with reference to the underlying assets (or portfolio companies) and the profit-sharing ratio contained in the partnership agreement.

What is carried interest?

The discussion above establishes the legal and tax principles applied to interests in an *en commandite* partnership. These principles look through the various structures starting from the respective partners to the underlying portfolio companies. The carry return is reflected in the diagram above which flows from the main partnership to the GP partnership.

The term 'carried interest' is well known in the private equity industry. The term possesses a mystery, often in the minds of those who do not participate in the industry, as to its purpose and effect and legal meaning. It is often thought of as super profits for private equity professionals: it is why they are 'in the game'.

Various definitions are contained in different sources around the world, but the definitions are usually consistent from an international perspective.

> 'Carried interest—an interest in a partnership which provides that the holder is entitled to participate in the "super profit" made by the fund which is allocated to the carried interest holders.'
>
> 'Carried interest holders—individuals who are partners in the fund partnerships ... who are employees or directors of the general partner or an associated company, who normally provide only capital to the partnership and who are entitled to share in the "super profit" made by the fund.'[9]

[8] Section 24H(5) of the Act.
[9] Memorandum of Understanding between the BVCA and the UK Department of Inland Revenue on the income tax treatment of Venture Capital and Private Equity Limited Partnerships and Carried Interest, 25 July 2003.

> 'The sponsor of a private equity fund is entitled to a profit participation (also known as carried interest, carry or success fee) that is usually a set percentage of profits (typically 20%, but can be higher or lower).'[10]

The carried-interest holder, usually structured via a partnership (refer above diagram), houses management's interest in the carry vehicle. The 20% carried interest is attributed to the GP partnership, and usually the bulk of the GP partnership's distribution of the carry is to management and the remainder to the GP Company which acts as the general partner of the GP partnership, and is usually the entity that bears the risk of loss of any amount above the LP's contribution

Management's share of the carry is usually held in a vesting trust. The Trust will issue units or vested rights to income and capital to the fund manager's executives. Given the various degrees of uncertainty and probabilities inherent in these units' value up front, it is commonly accepted by most valuation experts as well as HM Revenue and Customs ('HMRC') in the United Kingdom, that the value of carried interest upon its acquisition is zero. Therefore, by implication, the value of the trust units must be negligible too.

What is the *causa* for the acquisition of carried interest?

The discussion above, echoed by many international tax authorities, suggests that the securities (in whatever form, but in South Africa, commonly constituting beneficial interests in a vesting trust) are employment related, if the right to acquire them is made available by the employer or a person related to the employer.[11] HMRC in the UK also regards the carried-interest value to be equal to the amount actually paid for it, if a number of conditions are satisfied, viz:

> 'the only restrictions applying to carried interest are leaver, vesting restrictions, and general transfer restrictions'.

From a South African tax perspective, the question is whether the vested rights acquired by beneficiaries of the trust (a personal right to the income of the trust) are acquired by virtue of employment. And if these units meet the 'by virtue of employment' test, consideration would need to be given to the provisions of section 8C of the Act. This article focuses specifically on the *causa* of the trust unit acquisition and not on a detailed analysis of the provisions of section 8C.

The 'by virtue of employment' concept has been examined in various decided cases. The phrase contemplates a causal link between the rights

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[10] *Private Equity Fund Formation*, Scott W. Naidech, Chadbourne & Park LLP, Practical Law Company, 2011, page 6, http://us.practicallaw.com/3-509-1324

[11] See also Employment Related Securities Manual, HM Revenue & Customs, published 18 May 2016, updated 19 February 2018.?

acquired and employment and services rendered.[12] The determining cause or *causa causans* is a defining test in establishing the link with employment or services rendered.[13]

In the context of Private Equity, the determining reason and a causal relationship between joining a Private Equity organization and the acquisition of trust units that are acquired to generate carried interest must be established.

Private Equity professionals are employed by a Fund Manager whereby they earn their salary and often a bonus. The Fund Manager funds its operation expenses from fees it charges to the Limited Partners. The main reason an individual would take up employment with a Private Equity manager is the possibility of generating super profits from the Private Equity Fund. It is highly unlikely that a Private Equity professional would take up employment without this potential benefit.

The carry benefit award (ie the vested right acquired) is determined based on the seniority of the particular professional and is awarded up front. In other words, performance conditions do not determine the ultimate super profit quantum. The right to the super-profit is determined up front and no further conditions need to be met in order to ultimately benefit from this right. It may happen that the professional is promoted within the fund manager over time and in this instance, the individual concerned may be awarded additional vested rights.

The beneficiary rights are usually capable of transfer within a restricted market and at market value and often 'leaver' terms will be regulated in the trust deed.

Accordingly, it is submitted that if the up-front benefit acquired by an employee of the fund manager is a benefit with a determinative employment *causa,* then that benefit must be acquired 'by virtue of employment' and taxed accordingly in terms of the provisions of section 8C of the Act. As the value of the right acquired up front is nominal, and if the right is unrestricted, as contemplated in section 8C of the Act, the employment benefit, vis-à-vis the carry, will be taxed upon acquisition and on its nominal value at the time. These rights are usually unrestricted in terms of section 8C. Super profits are generated by effluxion of time, which achieves an implied employeeretention objective. In other words, given the fact that typically, the rights only produce value towards the end of the holding period of the portfolio company/ies (usually around 7 to 10 years), the decision to leave the employ of the fund manager before the end of the holding period is by implication curtailed. This feature often supports the objective of not imposing restrictions on the vesting rights.

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[12] *Stevens v Commissioner, South African Revenue Service* 2007 (2) SA 554 (SCA) at para 20.
[13] *Stander v Commissioner for Inland Revenue* 1997 (3) SA 617 (C), 59 (1997) SATC 212 (C).

Upon receipt by the Trust of its proportionate share of the carried interest, the beneficiary (employee) will acquire a personal right to the agreed proportion of the trust's income. This personal right is distinct from the vested, contractual right acquired up front, acquired by virtue of employment. This personal right, it is submitted, is acquired *qua* beneficiary and therefore is not imbued with an employment characteristic. The personal right is the potential enjoyment feature acquired up front and is distinct from the right acquired up front *by virtue of* employment. Accordingly, while the right acquired up front is acquired by virtue of employment (which is likely to be taxed in terms of section 8C of the Act albeit at a nominal or zero value) the personal right acquired as a beneficiary of the trust is likely to be taxed in terms of the normal trust *conduit pipe* principles.

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ISSN 2219-1585

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