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The taxation of private equity carried interest in South Africa

A research report submitted to the Faculty of Commerce, Law
and Management in partial fulfilment of the requirements for the degree of
Master of Commerce
(Specialising in Taxation)

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Degree	Master of Commerce (Taxation) (75% coursework)
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ABSTRACT

In this research report the South African taxation of carried interest in a private equity context is examined. The extent to which reform of that taxation should be considered is also presented in this report.

The nature of carried interest in the South African private equity context is initially examined. Thereafter, a discussion of the relevant provisions of the Income Tax Act and related South African case law that would likely apply to the taxation of carried interest is set out.

An analysis and determination of how appropriate and adequate the taxing provisions and relevant principles from case law are in the taxation of carried interest is provided. A recommendation for new legislation to deal with the taxation of carried interest has also been made.

KEY WORDS:

Carried Interest, Private Equity, Private Equity Fund, Private Equity Management Company, Management Fee, Portfolio Company, En Commandite Partnership, Fund Manager, General Partner, Limited Partner, Capital Contribution, Hurdle Rate, Realisation Proceeds.

DECLARATION

I declare that this research report is my own unaided work. It is submitted in partial fulfillment of the requirements for the degree of Master of Commerce (Specialising in Taxation) at the University of the Witwatersrand, Johannesburg. It has not been submitted before for any other degree or examination at any other university.

RKraut

Ryan Kraut

24 th day of August, 2016

DEDICATION

To my parents, and to my girlfriend
with sincere thanks
for their love, support and encouragement
during the writing of this research report

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I am grateful to my supervisor, Professor Maeve Kolitz, for her practical insights as well as for her support and encouragement.

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1 Introduction

1.1 Background and motivation

According to Hale (2007: 5), private equity can be defined as:

> 'equity financing of unquoted companies at many stages in the life of the company, from start-up to expansion, to management buy-outs and buy-ins of established companies.'

What sets private equity investments apart from other types of investments is the focus on unlisted or unquoted companies, the nature of capital used (that is, equity), the investment horizon or period (that is, medium to long term) as well as the types of companies it targets (that is, companies with high growth potential) (Hale, 2007: 5).

The private equity industry in South Africa is among the most established in emerging markets with fund types that vary by stage of investment, size and sector specialisation. With respect to the size of the South African industry, at the end of 2013 (the most recent year for which data is available), the industry employed 741 investment professionals who managed a total of R162,2 billion of assets. Further, the South African industry has achieved a compound annual growth rate of 11,8% of total funds under management since 1999 when the South African Venture Capital Association and KPMG survey began. (KPMG and SAVCA, 2014: 21.)

A private equity fund functions as an investment portfolio comprising a number of investee companies (Dyer, 2011: 7). More specifically, a private equity fund is normally constituted as a partnership which is managed by the fund's general partner. The general partner, amongst other things, identifies and evaluates investment opportunities and raises capital to create the fund. This capital is then deployed by the general partner to acquire investments in a portfolio of companies. Thereafter, the general partner is typically

responsible for monitoring and realising those investments on behalf of the fund. (Elson and Weld 2007: 46 and Dauds, 2007: 10.)

The bulk of the fund's capital is sourced from the limited partners (typically institutional investors such as pension funds and insurance companies, development finance institutions as well as charitable foundations with large endowments and high net worth individuals) who are typically passive investors in the fund (Elson and Weld, 2007: 46).

Most usually, the limited partners require the general partner to make a capital contribution as a co-investment into the fund – albeit a substantially smaller amount than that contributed by the limited partners. This co-investment is made to demonstrate the commitment and belief of the general partner to the success of the fund. In other words, the requirement for the general partner to put its own financial capital at risk, by co-investing in the fund, ensures that the interest of the general partner from an investment perspective is aligned with that of the limited partners. (Dauds, 2007: 10 and Horak, 2007: 3.)

Private equity investment is a transformational, value added, active investment strategy and to this end the general partner has as its strategic objective the achievement of a target return for the portfolio companies in which it invests within a certain risk level and within a certain investment time frame (Dyer, 2011: 7).

Carried interest is typically derived by the general partner in the form of a disproportionate share of the sales proceeds realised upon disposal of investments by the private equity fund (Modise et al, 2014: 281). More particularly, the general partner is typically entitled to 20% of the fund's realisation profits, notwithstanding that the general partner contributes only 1% to 2% of the fund's investment capital (Dauds, 2008: 10-11). It is important to note, however, that the distribution of carried interest is only made once all the fund

investors' capital has been returned to them and a minimum return on the fund investment(s) disposed of has been achieved (Missankov, Van Dyk , Van Biljon, Hayes , Van der Veen, 2006: 24-25).

For some years now, the tax treatment of carried interest has been the focus of significant attention from tax authorities, market players and the media in several countries such as the US and the UK (Garcia, 2008: 209). The argument advanced by a number of commentators in these jurisdictions – where carried interest has always been taxed as a capital gain – is that carried interest is in substance a form of deferred compensation / remuneration for services rendered by private equity fund managers that should be subject to the same (a greater) tax burden as other types of service fees / remuneration (Braeken, 2012: 3).

In South Africa, this argument is particularly relevant given the significant differential in effective tax rates that would apply to carried interest characterised as gross income for services rendered or to be rendered in terms of paragraph (*c*) of the gross income definition[1] in section 1 of the Income Tax Act 58 of 1962[2] as opposed to characterisation as a capital gain.

Further, in South Africa, establishing the appropriate timing of the taxation of private equity carried interest is an important consideration. This is because the right to carried interest, if shown to be in respect of services to be rendered by the general partner to the limited partners, could be taxed upfront, when the private equity fund is established, in terms of paragraph (*c*). More particularly, should the right to carried interest constitute an amount that accrues to the general partner at fund inception, in respect of services to be rendered, then paragraph (*c*) would apply thereto which would require inclusion of the market value of this right in gross income of the general partner, at fund inception.

[1] Hereafter referred to as 'paragraph (*c*)'

[2] Any references to sections, paragraphs and schedules in this report refer to the Income Tax Act unless otherwise indicated.

Upfront taxation of the right to carried interest could impose a significant tax burden on the general partner who would not have received the carried interest distribution to fund the tax due.

In National Treasury's 2008 *Budget Review* it was stated (at 70) that:

> '…the tax treatment of management carried interest (reward for fund managers in the form of shares/equity) will be investigated. Given the complexities involved, a discussion document will be developed to raise options and elicit public comment.'

Despite this statement, at the time of writing, no such discussion document has been issued. Further, as South African tax legislation contains no special provisions regulating the taxation of private equity carried interest, the tax consequences for private equity fund managers – both upon awarding of the right to carried interest when the private equity fund is formed and several years later upon its distribution to them – is unclear.

Accordingly, this report will seek to provide greater clarity and understanding of the South African tax implications of private equity carried interest in the hands of the general partner of a South African private equity fund by determining its appropriate characterisation and by assessing which provisions of the Act and which case law principles would likely apply to the taxation thereof. Further, in instances where the study identifies shortcomings in the South African taxation of private equity carried interest, appropriate recommendations for taxation reform will be made.

1.2 The research problem

1.2.1 The statement of the problem

This research will evaluate the appropriateness and adequacy of South African taxation of carried interest in the private equity context and examine in what respects reform thereof should be considered.

1.2.2 The sub-problems:

The first sub-problem

The first sub-problem is to examine the nature of carried interest in a private equity context**.**

The second sub-problem

The second sub-problem is to discuss and scrutinise the relevant provisions of the Income Tax Act and related South African case law that would likely apply to taxing private equity carried interest in South Africa.

The third sub-problem

The third sub-problem is to analyse and determine how appropriate and adequate these taxing provisions and relevant case law principles are in the South African taxation of

private equity carried interest[3] and to make recommendations for reform thereof where the law is found wanting

1.3 Research methodology

The research method to be followed will be a qualitative approach.

To this end, journal articles, academic working papers, books, theses, domestic tax legislation and cases pertaining to the subject will be reviewed in order to:

- Understand the private equity business model and the typical way in which private equity funds are structured in South Africa.
- Understand what carried interest is, how carried interest arrangements typically operate in the private equity context as well as the economic arrangement that exists among the parties to the carried interest arrangement.
- Establish the South African taxing provisions and related South African case law principles that would likely apply to taxing carried interest in South Africa.
- To determine how appropriate and adequate current South African law is in taxing carried interest.
- Provide possible recommendations for reform where current South African law is found to be deficient in taxing carried interest.

1.4 Scope and limitations

This research seeks, inter alia, to examine and discuss the likely income tax consequences of the right to carried interest and the distribution of carried interest with reference to the structure – as depicted in Figure 1 of Chapter 2 – of a typical South African tax resident

[3] Hereafter referred to as 'carried interest'

private equity fund, which has investments in portfolio companies that are tax resident in South Africa.

Further, this structure assumes that the private equity management company as well as the general partner are both South African tax resident companies with the related services being rendered in South Africa by South African tax resident key executives and employees of both these entities. In addition, it is assumed that the shares acquired by the private equity fund in portfolio companies are equity shares as defined in section 1 of the Act.

To this end, the following are considered outside the scope of the research report:

- Evaluating the Value-Added Tax effects of the management fee and the right to and distribution of carried interest; and
- Examining the income tax consequences for the limited partners of the private equity fund, arising from the carried interest arrangement entered into with the general partner.

Moreover, the possible application of the general anti-avoidance rules, contained in sections 80A-80L of the Act, to any of the transactions within the structure depicted in Figure 1 of Chapter 2, is considered beyond the scope of this report.

1.5 Organisation of report

An introduction to the report, a statement of the research problem, the scope and limitations of the report, as well as an overview of the report's organisation is provided in chapter 1.

By way of a diagram depicting a commonly used structure for a South African private equity fund and carried interest arrangement and explanation thereof, chapter 2 will provide an in depth analysis of what carried interest is, how carried interest arises and how carried interest arrangements operate in South Africa.

Chapter 3 will first determine the tax consequences for the general partner of the right to carried interest and the distribution of carried interest that flow from the legal form of a typical carried interest arrangement as depicted in Figure 1 of chapter 2. Thereafter, it will be determined to what extent, in legal substance, a carried interest arrangement, as depicted in Figure 1 of chapter 2, is a fee arrangement in which the general partner is compensated for fund management services rendered / to be rendered to the limited partners by being awarded the right to, and the distribution of carried interest. The chapter will conclude by discussing and analysing, based on the legal substance of a carried interest arrangement, as depicted in Figure 1 of chapter 2, the applicable case law and the relevant provisions of the Act that will apply both to the taxation of the right and to the taxation of the distribution of carried interest.

Chapter 4 will first analyse how appropriate and adequate the South African income tax provisions and related case law principles are – as discussed in chapter 3 – for the purposes of taxing private equity carried interest, based on the legal substance of a carried interest arrangement, as depicted in Figure 1 of Chapter 2. Thereafter, having identified any shortcomings in the law, a recommendation for reform thereof will be made.

Chapter 5 will provide a summary of the findings in relation to the research problem.

2 An examination of a private equity carried interest arrangement

2.1 Introduction

In order to be able to examine the South African tax legislation and related case law that would likely apply to carried interest, as is done in chapter 3 of this report, it is important to have a comprehensive understanding of carried interest in the context of South African private equity.

To this end, by way of a diagram depicting a commonly used structure for a South African private equity fund and carried interest arrangement and explanation thereof, this chapter will provide an in depth analysis of what carried interest is, how carried interest arises and how carried interest arrangements operate in South Africa.

More particularly, in this chapter:

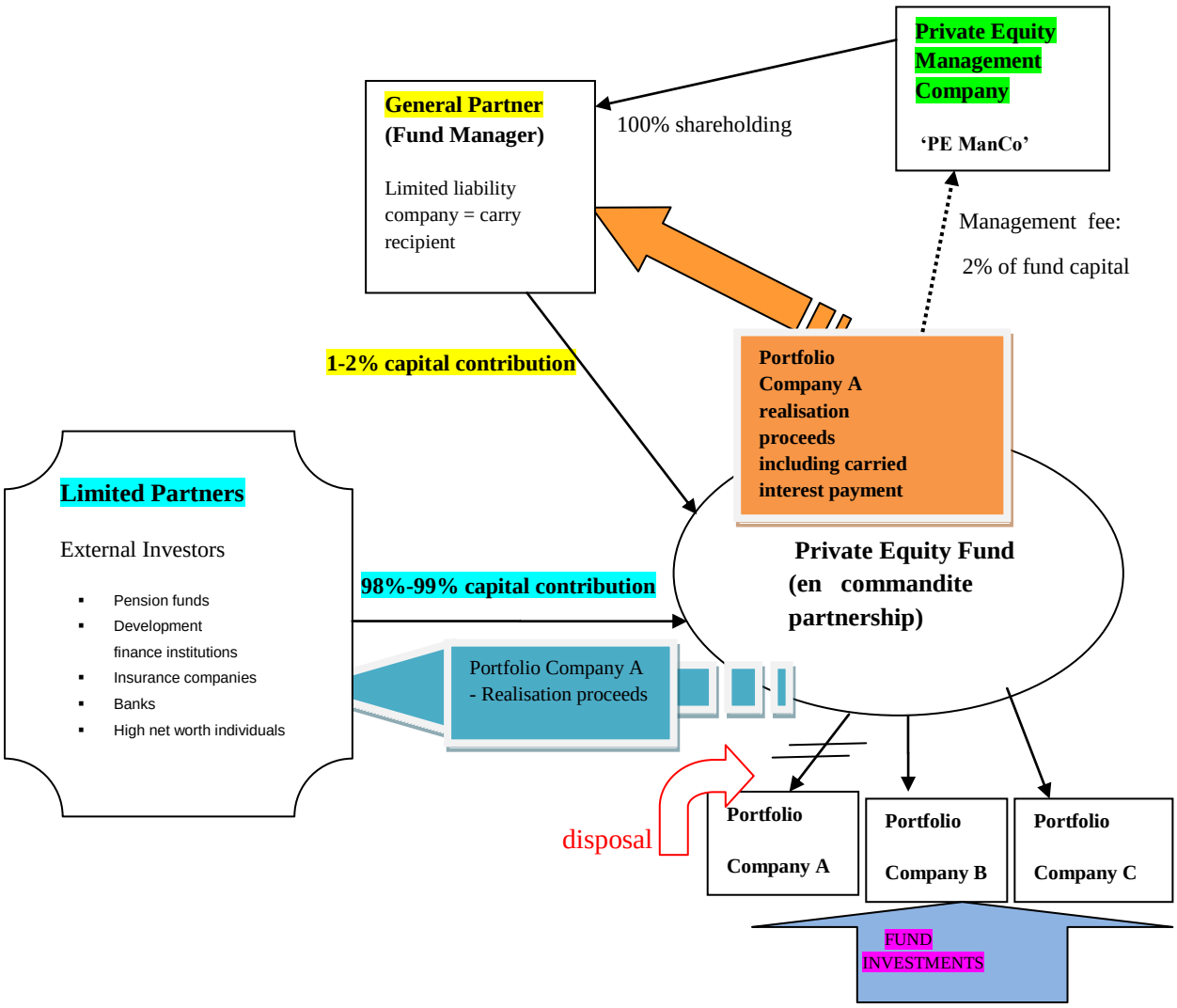
- the legal structures typically used for a South African private equity fund will be examined;
- the major private equity participants and in broad terms what their respective roles are in the formation and operation of a South African private equity fund will be discussed; and
- a typical fee and carried interest arrangement in a South African private equity fund will be scrutinised.

2.2 A typical South African private equity fund structure and carried interest arrangement

2.2.1 Diagrammatic illustration of fund structure and carried interest arrangement

Based on discussions with several persons active in the South African private equity industry, a review of a private equity fund partnership agreement and a private equity structure memorandum obtained from a large South African commercial law firm, a typical structure for a private equity fund, private equity transaction and carried interest arrangement in South Africa is as depicted in Figure 1[4] and as discussed below in 2.2.2 .

FIGURE 1 – PRIVATE EQUITY FUND STRUCTURE



[4] Further corroboration for certain elements of the Figure 1 structure was obtained from various literature reviewed. Reference to the specific literature reviewed has been made in the explanation of the **Figure 1** structure below.

2.2.2 Explanation of Figure 1 Structure

A private equity fund serves as a vehicle to pool large amounts of capital from various investors to be invested in several target investee companies, known as portfolio companies (refer Figure 1). In South Africa, a private equity fund is usually organised as a limited partnership (Hayes et al, 2006: 16). More precisely, an en commandite partnership fund structure (as illustrated in Figure 1) is used; where a partnership is created between various limited partners (the external investors in Figure 1) and a general partner (refer Figure 1).

The general partner acts as the disclosed partner for the en commandite partnership and as such, notably has unlimited liability for the obligations of the en commandite partnership to third parties. In contrast to the general partner, the liability of the limited partners for the debts of the en commandite partnership is limited to their capital contributions, provided that their identities are not disclosed and they remain passive investors in the private equity fund (SAVCA, 2015: 39.)

Furthermore, the general partner serves as the private equity fund manager (Missankov et al, 2006: 16) and is responsible for the identification, evaluation and negotiation of investment opportunities and the monitoring and realisation of those investments for the private equity fund (Dauds, 2008: 10). The general partner is also responsible for administrative tasks of the fund such as preparing and approving investment agreements, maintaining the fund's accounting records, preparing the annual financial statements of the fund and preparing periodic reports and valuations of the fund's assets which are furnished to the limited partners. It is understood from discussions with various private equity fund managers as well as tax practitioners that deal extensively with private equity transactions that most often, no fee would be paid to the general partner for fund management services performed.

The general partner ordinarily – on behalf of the private equity fund[5] – appoints a private equity management company (PE ManCo in Figure 1), of which the general partner is a wholly owned subsidiary, and to which the general partner delegates / outsources certain of its functions, tasks and duties. In this regard, PE ManCo usually provides various investment, advisory and administrative services to the private equity fund, for which PE ManCo – as illustrated in Figure 1 – receives an arm's length management fee of typically 2% of the private equity fund's annual value (Field 2007: 27).

It is important to note that the general partner, as opposed to PE ManCo, will always be responsible and accountable for the overall management and control of the business activities and affairs of the fund. As part of its remit, PE ManCo may research possible investment opportunities for the fund and may make recommendations to the general partner regarding investment acquisitions and disposals. In this regard, however, invariably it is the general partner's prerogative as the fund manager to act on and execute any such recommendations.

The limited partners ordinarily provide 98% to 99% (as per Figure 1) of the total capital contributed to the private equity fund and typically require the general partner (refer Figure 1) to contribute the remaining 1% to 2% of capital to the private equity fund. The rationale for the aforementioned capital co-investment by the general partner is to ensure that the interests of the general partners from an investment perspective are aligned with those of the limited partners. (Dauds, 2008: 10-11.)

When a fund disposes of an investment in a portfolio company, (refer portfolio company A in Figure 1) the realisation proceeds from such disposal are ordinarily not paid to the general and limited partners in proportion to each party's respective capital contribution made to the fund. This is because, at the time of launch of the fund[6], when fund terms are negotiated, typically, the general partner is contractually entitled, upon the future disposal

[5] Hereafter referred to as 'the fund'
[6] Hereafter referred to as 'the fund's inception'

of a portfolio company by the fund, to receive a disproportionately larger share of the portfolio company disposal proceeds, most frequently 20% (Missankov et al, 2006: 25) despite having contributed only 1% to 2% of the capital of the fund (Refer Figure 1). It is this share of realisation proceeds i.e. 20% of realisation proceeds received by the general partner which is disproportionate to the 1% to 2% capital contribution that that the general partner makes, that represents the general partner's carried interest (Dauds, 2008: 10-11).[7]

It is important to note, however, that the distribution of carried interest will typically only be received by the general partner provided that:

- first, all the capital contributions made have been returned to all the private equity fund investors, being both the general and limited partners, and;
- second, a specified return on investment has been achieved for all the fund investors, being both the general and limited partners; this preferred return is known as 'the hurdle'. (Missankov et al, 2006: 24-25.)

The distribution of carried interest is shown in the following illustrative example:

Illustrative example 1: Distribution of carried interest

Suppose the general partner and limited partners in Figure 1 make capital contributions of R2 and R98 respectively to the fund in Figure 1. This R100 is in turn used by the fund to acquire a 100% shareholding in year 1 in portfolio company A in Figure 1.

[7] For purposes of this report, the general partner's entitlement, at the inception of the private equity fund, to receive carried interest distributions in the future will be referred to as the general partner's 'right to carried interest'. When carried interest is paid to the general partner, this will be referred to as 'the distribution of carried interest'. Further when reference in the report is only made to 'carried interest' this is a collective term that refers both to the 'right to carried interest' and 'the distribution of carried interest'.

In terms of the partnership agreement, the general partner shares in 20% percent of the proceeds realised on disposal of portfolio company A only once:

- the R100 of capital contributions made have been repaid to all the fund investors; and
- all the fund investors have achieved a compound annual growth rate on capital invested in portfolio company A of 12% −the hurdle rate of return.

Further, suppose that the private equity fund in Figure 1 disposes of its entire shareholding in portfolio company A in Figure 1 at the end of year 5 for R300.

Based on the above facts, at the end of year 5, the realisation proceeds will be allocated and distributed by the private equity fund in Figure 1 to its general and limited partners as tabulated below:

TABLE 1 – ALLOCATION AND DISTRIBUTION OF REALISATION PROCEEDS TO FUND INVESTORS

Allocation and distribution type	General partner	Limited partners	TOTAL
Return of capital contributions	R2	R98	R100
Hurdle return	R2[8]	R75[9]	R77
Residual realisation proceeds allocated	R25[10] (R123 x 20%)	R98[11] (R123 x 80%)	R123 (R300 – R177)
Total realisation proceeds allocated	R29 (R2+ R2 +R25)	R271 (R98 +R75+ R98)	R300
Allocation of residual realisation proceeds in proportion to capital contributed to fund	R2,50 (rounded) [12]	R120,50 (R123- R2,50)	R123
Distribution of carried interest	**R22,5** (R25- R2.5)	N/A	R22,5

[8] Calculated as follows on financial calculator: -2 PV; 5 n; 12 i, COMP FV = R4 (rounded) – R2 = R2
[9] Calculated as follows on financial calculator: -98 PV; 5 n; 12 i, COMP FV = R173 (rounded) – R98= R75
[10] Rounded
[11] Rounded
[12] Calculated as follows: 123 x 2/100

As tabulated above, **R22,5** constitutes the **distribution of carried interest**, at the end of year 5, received by the general partner. Put differently, of the total residual realisation proceeds of the fund, 18% (22,5/123) is allocated to the general partner as the distribution of carried interest

2.2.3 Conclusion

In this chapter, it was evident based on discussions with several persons active in the South African private equity industry, a review of a private equity fund partnership agreement and a private equity structure memorandum obtained from a large South African commercial law firm that private equity funds in South Africa most often take the form of an en commandite partnership, which partnership acquires investments in various portfolio companies (refer Figure 1). It was further discussed that there are two types of investor in South African private equity funds, each with very different economic roles; namely:

- the limited partners who contribute the bulk, that is, 98% - 99% (as per Figure 1) of the fund's capital (Dauds, 2008: 10-11). The liability of these limited partners for debts of the fund is capped at their capital contributions, provided that they remain passive investors and their identities are not disclosed (SAVCA, 2015: 39); and
- the general partner, a company, which serves as the fund manager and which contributes significantly less capital, typically only 1% - 2%, (refer Figure 1) to the fund (Missankov et al, 2006: 16 and Dauds, 2008: 10-11). In sharp contrast to the limited partners, the general partner is the disclosed partner, and therefore bears unlimited liability risk in respect of fund debts (SAVCA, 2015: 39). Moreover, unlike the limited partners, the general partner takes an active role in managing the fund and is typically responsible for the identification, evaluation and negotiation of investment opportunities and the monitoring and realisation of those investments for the fund (Dauds, 2008: 10). Notably, based on discussions with various private equity fund managers as well as tax practitioners that deal extensively with private

equity transactions, most often, no fee is paid to the general partner for any fund management services performed.

It was further discussed that a typical South African private equity fund will also have a fund management company, (PE ManCo in Figure 1), which owns 100% of the general partner and which is appointed by the general partner to perform for the fund, various investment, advisory and administrative services delegated to it by the general partner. Notably, the fund management company, unlike the general partner, is remunerated for its services rendered to the fund, by way of an annual management fee, typically 2% of the fund's annual value (Field 2007: 27).

Furthermore, it was shown that a typical private equity carried interest arrangement in South Africa operates on the basis that the general partner receives, as the distribution of carried interest, a disproportionate share of the portfolio company realisation proceeds (typically 20%), despite having contributed only 1% - 2% of the fund's capital, provided certain performance conditions have been met (Dauds, 2008: 10-11 and Missankov et al, 2006: 24-25).

In conclusion the detailed examination in this chapter of a private equity carried interest arrangement in South Africa reveals an arrangement in which the general partner performs a multitude of fund management services yet receives no remuneration therefor. At the same time, the general partner receives an enhanced return on its investment in the fund by receiving a disproportionate share of fund realisation proceeds, namely the distribution of carried interest. The pertinent question to ask then is why such a disproportionate share of fund proceeds is awarded to the general partner, if not as a reward (that is, a fee) for services rendered. This question is examined in detail in the following chapter.

3 The analysis of South African tax legislation and case law applicable to private equity carried interest

3.1 Introduction

This chapter addresses the second sub-problem of this research, namely to discuss and analyse the provisions of the Act and associated case law that would likely apply to the taxation of carried interest in South Africa.

To this end, the chapter will first discuss the legal form of a carried interest arrangement as depicted in Figure 1 of chapter 2 and the tax consequences that flow from the legal form of a carried interest arrangement. In this respect, the applicability of the following taxation provisions will be discussed and analysed:

- Section 9C read with the Eighth Schedule;
- Paragraph 36 of the Eighth Schedule; and
- Paragraph 20 of the Eighth Schedule.

Thereafter, the chapter will determine whether, the legal substance of a carried interest arrangement, as depicted in Figure 1 of chapter 2, is a fee arrangement between the general partner and the limited partners. That is, whether, in legal substance, both the right to carried interest acquired by the general partner at fund commencement, and the distribution of carried interest received by the general partner, represent rewards made to the general partner by the limited partners for services rendered / to be rendered by the former to the latter.

In order to make this determination, the chapter will discuss and critically evaluate the merits of arguments advanced by various commentators, industry players and tax policy

makers, arguing both for and against carried interest being, in legal substance, service related compensation of the general partner.

The chapter will then discuss and examine the applicability of paragraph (*c*) and related case law principles to the taxation of both the right to, and the distribution of, carried interest, based on the legal substance of a carried interest arrangement, this being a fee arrangement between the general partner and the limited partners. The chapter will conclude by considering the tax implications, both of the right to, and the distribution of, carried interest, where paragraph (*c*) is found to apply to the taxation thereof, based on the legal substance of a carried interest arrangement.

3.2 Tax consequences of the legal form of a carried interest arrangement

3.2.1 Overview

Based on discussions with several persons active in the South African private equity industry as well as a review of a private equity partnership agreement, a typical carried interest arrangement in South Africa takes a legal form such that:

- The right to carried interest, in legal form, is the right of the general partner to share disproportionately, in partnership profits made by the fund upon disposal of a portfolio company.
- The distribution of carried interest, in legal form, is the disproportionate share of proceeds realised by the fund partnership upon disposal of a portfolio company, which is allocated to the general partner, as part of its fund partnership profit share, provided certain conditions are met.[13.]

[13] As discussed in section 2.2.2, the disproportionate allocation of portfolio company realisation proceeds is only made once the original fund capital has been returned to all the fund investors and the hurdle rate of return has been achieved for all the fund investors.

Furthermore, it is understood from discussions with various private equity fund managers as well as tax practitioners that deal extensively with private equity transactions, that almost invariably, fund partnership agreements regulating the payment and allocation of carried interest are silent as to why the right to carried interest is awarded and why the distribution of carried interest is made. More particularly, in these agreements, there is **no link** between the services required to be rendered by the general partner – as described in the agreement – and the right to carried interest acquired, as well as the subsequent distribution of carried interest received, by the general partner.

The tax consequences, both in respect of the right to carried interest and the distribution of carried interest, which flow from the legal form of a typical carried interest arrangement in South Africa, are discussed in sections 3.2.2 and 3.2.3 below.

3.2.2 Tax implications of the right to carried interest based on the legal form of a carried interest arrangement

The right to carried interest is the right to share – albeit disproportionately – in the future profits of the fund, which fund, as was explained in Chapter 2, is most often a partnership. In the private equity context, the future profits of the fund partnership are primarily the realisation gains that arise upon disposal of a portfolio company[14]. According to De Koker and Williams (2015: para 3.31), provided it is clear that the taxpayer is not a dealer in such rights, an incorporeal right such as the right to share in partnership profits, is of a capital nature.

Accordingly, if the general partner is not a dealer in carried interest rights, it is submitted, that the right to carried interest will then be of a capital nature, provided that the right is

[14] Investors in private equity funds will generally derive the following types of income: profits from the sale of portfolio companies, dividends and interest. Invariably, however, the main form of income derived by private equity investors will be the realisation gains on disposal of portfolio companies by the fund. (Horak, 2007: 3.)

not acquired in respect of services rendered / to be rendered in which case, it is submitted that the right would be of a revenue nature. This is because receipts and accruals arising from services rendered are inherently revenue in nature, being the product of one's wit and labour (Singleton, 2004: 1). In this respect, it is submitted that the right to carried interest is not acquired because of services rendered / to be rendered by the general partner, because, as was noted above, in terms of the legal form of a typical carried interest arrangement, there is no apparent nexus in the fund partnership agreement between the award of the right to carried interest and any services undertaken to be rendered by the general partner.

It follows, therefore, that the right to carried interest – based on the legal form of a carried interest arrangement – is of a capital nature, being the acquisition of an incorporeal right to share in the future partnership profits of the fund. It is further submitted that the acquisition of a right of a capital nature in such circumstances does not constitute the disposal of an asset in terms of paragraph 11 of the Eighth Schedule. It follows that there can then be no capital gain or capital loss as there has been no disposal of an asset in terms of paragraph 11 of the Eighth Schedule, which would trigger capital gains tax consequences.

Moreover, it is submitted that the acquisition of the right to carried interest does not constitute gross income of the general partner because paragraph (*c*) does not apply to the taxation thereof. Broadly stated, paragraph (*c*) requires the inclusion in gross income of any amount received or accrued in respect of services rendered or to be rendered, even if such amount would otherwise be of a capital nature. In this respect, it would appear that paragraph (*c*) does not apply to the taxation of the right to carried interest as it would seem that, prima facie, the right to carried interest is not awarded to the general partner in respect of services to be rendered by the general partner to the limited partners for the reasons discussed in the paragraphs above.

Consequently, it is submitted that, based on the legal form of the right to carried interest, there will be no tax consequences upon the awarding of the right to carried interest to the general partner as:

- the acquisition of the right does not constitute gross income, being an amount received or accrued that is of a capital nature and to which paragraph (*c*) does not apply; and
- the acquisition of a right of a capital nature in such circumstances is not a disposal of an asset for capital gains tax purposes.

3.2.3 Tax implications of the distribution of carried interest based on the legal form of a carried interest arrangement

Private equity funds in South Africa typically have a life of 10 years, and investments within these funds tend to be held for 5 to 8 years before being disposed of (Financial Mail, 2014: 50). In terms of section 9C(2), any amount received or accrued (other than a dividend or a foreign dividend) in respect of the disposal of an equity share,[15] must be deemed to be of a capital nature if that equity share had, at the time of the receipt or accrual of that amount, been held for a period of at least three years[16].

It therefore follows that the proceeds received on disposal of a portfolio company shareholding by a fund partnership, will almost invariably be qualifying shares; being equity shares held by the fund partnership for a continuous period of at least three years prior to disposal. Consequently, section 9C(2) will deem the proceeds realised on the disposal of a portfolio company by a fund partnership to be of a capital nature.

[15] In terms of section 1 of the Act, an equity share is defined as any share in a company, excluding any share that, neither as respects dividends, nor as respects returns of capital, carries any right to participate beyond a specified amount in a distribution.

[16] Shares, that meet the requirements of section 9C(2), will hereafter be referred to as 'qualifying shares' even through the Act no longer uses the term qualifying share.

In this regard, although the fund partnership disposes of the shares in the portfolio company, the Act does not recognise a partnership as a distinct taxable entity. It is rendered fiscally transparent and has no existence as a taxable entity apart from the individual partners who comprise the partnership. For capital gains tax purposes, it is expressly provided that the proceeds from the disposal of a partner's interest in an asset of the partnership, are deemed to have accrued to that partner at the time of the disposal, in terms of paragraph 36 of the Eighth Schedule (De Koker and Williams, 2015: para 24.51.). Further, where a partnership asset has been disposed of to a third party, (as is the case here with the disposal of the shares in the portfolio company to an external party), the proceeds must be allocated among the partners according to the partnership agreement (Stiglingh, Koekemoer, Van Zyl, Wilcocks, De Swart, 2015: 949).

In the light of what was discussed in the previous paragraph, it is submitted that the general partner holds an interest in the shares in the portfolio company through the fund partnership, rather than in its own name. Because the fund partnership is fiscally transparent, however, it is further submitted that these shares must be treated for the purposes of section 9C(2) as if held by the general partner itself. Consequently, it is submitted that section 9C(2) will apply in deeming the portfolio company realisation proceeds, allocated to the general partner, to be of a capital nature. This is because such proceeds are received by the general partner in respect of the disposal of its interest in the qualifying shares in the portfolio company, held by the fiscally transparent fund partnership[17]. It is important to note, that the aforementioned portfolio company realisation proceeds, received by the general partner, **include the distribution of carried interest**, which, in legal form, as discussed above, represents a partnership profit share, and therefore simply forms part of the general partner's share of the proceeds realised by the fund partnership upon disposal of a portfolio company.

Thus, based on the legal form of a carried interest arrangement, the distribution of carried interest, along with the other portfolio company realisation proceeds received by the general partner, will be deemed to be of a capital nature in terms of section 9C(2). As

[17] Hereafter referred to as 'the general partner's interest in the qualifying portfolio company shares'

noted in section 3.2.1 above, in legal form, there is typically no link in the partnership agreement between the distribution of carried interest and the services performed by the general partner. Consequently, based on the legal form of the distribution of carried interest, it is submitted that paragraph (*c*) does not apply to the taxation of the distribution of carried interest. Thus, it is submitted, that the treatment of the distribution of carried interest on capital account, in terms of section 9C(2), will not be superseded by the requirement to include the distribution in gross income of the general partner, in terms of paragraph (*c*).

For the purposes of paragraph 20 of the Eighth Schedule[18], the base cost of each partner's interest in a partnership asset disposed of, will comprise the amount paid for that interest (De Koker and Williams, 2015: para 24.51). Accordingly, it is submitted that the base cost of the general partner's interest in the qualifying portfolio company shares will, in terms of paragraph 20, be the capital contributed by the general partner to the fund partnership, which capital was utilised to acquire the general partner's interest in these qualifying shares in the portfolio company.

In the result, it is submitted, that the general partner will be subject to capital gains tax at the effective tax rate of 18,67%[19] for a company[20], on a capital gain determined by deducting from the above-mentioned portfolio company realisation proceeds received by the general partner − which proceeds include the distribution of carried interest − the base cost, determined in accordance with paragraph 20, of the general partner's interest in the qualifying portfolio company shares. Thus, the distribution of carried interest is subject to capital gains tax at the effective tax rate of 18,67%.

[18] Hereafter referred to as 'paragraph 20'

[19] Calculated as follows: 100 x 66,6% CGT inclusion rate [Paragraph 10 of the Eighth Schedule] x 28% company tax rate. It is noted that a new CGT inclusion rate of 80% has been proposed for companies, because of the proposed amendment to paragraph 10 of the Eighth Schedule ('paragraph 10'), as per the Draft Rates and Monetary Amounts and Amendment of Revenue Laws Bill of 2016 (at page 8). As this Bill is draft legislation that has not yet been promulgated into law at the time of writing, the aforementioned 66,6% CGT inclusion rate for companies as per paragraph 10 has been used in this report as opposed to the 80% proposed inclusion rate as per the proposed revised paragraph 10.

[20] The company tax rate is used, given that for the purposes of this report, the tax consequences of the right to carried interest and the distribution of carried interest are discussed and analysed with reference to the structure – as depicted in Figure 1 of Chapter 2 – where the general partner is a company.

The abovementioned tax implications are shown in the following illustrative example:

Illustrative example 2: Tax implications of the distribution of carried interest based on the legal form of a carried interest arrangement

Assume that the facts are the same as the illustrative example in section 2.2.2 of Chapter 2. In this regard, it will be recalled that portfolio company A was acquired by the fund in year one, for R100 and was subsequently disposed of by the fund in year 5 for R300. In year 5, the general partner was allocated, and received, R29 of the R300 realisation proceeds that arose upon disposal of portfolio Company A by the fund. Furthermore, the general partner had contributed R2 as its co-investment to the fund, which amount was used to acquire a 2% shareholding in portfolio company A (that is, the general partner, has an interest (equal to 2%) which cost R2, in the shareholding of the fund partnership, in portfolio company A). The first two columns of Table 1 in section 2.2.2 of Chapter 2, showing the allocation and distribution of the realisation proceeds to the general partner, are reproduced below:

TABLE 2 – ALLOCATION AND DISTRIBUTION OF REALISATION PROCEEDS TO THE GENERAL PARTNER

Allocation and distribution type	**General partner**
Return of capital contributions (base cost of shareholding)	R2
Hurdle return	R2
Residual realisation proceeds allocated	R25
Total realisation proceeds allocated	R29 (R2+ R2 +R25)
Allocation of residual realisation proceeds in proportion to capital contribution of general partner	R2,50
Distribution of carried interest	R22,5 (R25- R2,5)

In year 5, when portfolio company A is disposed of by the fund and R29 of the total realisation proceeds of R300 is distributed to the general partner:

- The full R29 realisation proceeds received by the general partner, which include the distribution of carried interest of R22,5 (refer Table 2 above) will, in terms of section 9C(2), be deemed to be of a capital nature. This is because these realisation proceeds are an amount received by the general partner in respect of its interest in the qualifying shares in portfolio company A, held by the tax transparent fund partnership. That is, the general partner, will have disposed of an interest in an equity shareholding in portfolio company A, which immediately prior to its disposal, the general partner will have owned, through the tax transparent fund partnership, for at least three continuous years (in this scenario five continuous years, from fund commencement date, to disposal date).
- The base cost of the general partner's interest in the qualifying shares in portfolio company A will, in terms of paragraph 20, be the R2 that the general partner contributed to the fund partnership, which was used to acquire its interest in the qualifying shares in portfolio company A (refer Table 2 above).
- The capital gain of the general partner in year 5 will be R27 (R29 proceeds – R2 base cost) which will be subject to capital gains tax of R5 (Rounded) (R27 x 18,67% effective tax rate) in year 5. Notably, the distribution of carried interest, which, as discussed previously, forms part of the portfolio company realisation proceeds received by the general partner, will be included in the amount deemed to be of a capital nature in terms of section 9C(2), and will therefore also be included in the amount taxed at the effective tax rate of 18,67%.

The tax implications discussed above follow from the assumption that that the legal form of a carried interest arrangement is matched by the legal substance of a carried interest arrangement. In section 3.3 below, it will be determined whether the legal substance of a carried interest arrangement is more appropriately characterised as a service arrangement. That is, whether, in legal substance, the right to carried interest acquired, and the distribution of carried interest received, by the general partner, constitute remuneration for services rendered / to be rendered by the general partner to the limited partners.

3.3 Determining the legal substance of a carried interest arrangement

3.3.1 Overview

According to Clegg and Stretch (2015: para 26.6.3), when there is genuine uncertainty or disagreement as to the nature of a transaction, the legal substance (that is, the legal reality) of the transaction and / or the agreement regulating the transaction must be examined. In this regard, it is submitted that the legal form of a carried interest arrangement casts doubt and results in uncertainty, as to whether the right to carried interest acquired by the general partner, and the distribution of carried interest received by the general partner, truly represent, respectively, a right to, and a subsequent allocation of, **profit of the fund partnership** resulting from the disposal of its shares in a portfolio company, to the general partner.

It is submitted that this is because in legal form, the general partner contributes a nominal amount of capital to the fund partnership, yet acquires the right to a significantly disproportionate share in, and is later allocated, a significantly disproportionate share of, fund partnership profits, arising on the disposal by the fund, of a portfolio company. Moreover, as already discussed, the fund partnership agreement is ordinarily silent as to why the right to carried interest is granted and the distribution of carried interest is made, while at the same time requiring the general partner to perform a number of services in managing the fund, for which it receives no remuneration.

Consequently, it is submitted, that the legal form of a carried interest arrangement appears to differ from its legal substance. In this regard, it is submitted, that, prima facie, the legal substance of a carried interest arrangement appears to be a fee arrangement in which the general partner is remunerated for services rendered / to be rendered to the limited partners by acquiring the right to carried interest and receiving the distribution of carried interest. Thus, it needs to be determined whether, and to what extent, the legal substance of a carried interest arrangement is indeed a service arrangement between the general partner and the limited partners. This determination is made in sections 3.3.2 and 3.3.3 below, by presenting and analysing arguments, advanced by various commentators, tax policy makers

and industry players, both for and against carried interest, being, in legal substance, service related compensation.

3.3.2 Analysis of arguments that support carried interest as being, in legal substance, service related compensation

Arguments put forward

According to Dauds (2007: 11) the general partner does not receive the carried interest in return for any corresponding capital contribution; instead, the carried interest is based solely on the general partner's performance. Dauds (2007: 11) further submits that, as the limited partners grant the general partner the right to and thereafter transfer to the general partner, such a significant portion of the fund's realisation profits as carried interest, the motive for forgoing such a large and disproportionate share of fund profits must surely be as a reward for the latter's performance, that is, for services rendered and to be rendered. Put differently, why else, it is submitted, would the limited partners, who are dealing with the general partner at arm's length, in a commercial transaction, forgo such a material share of fund realisation profits that they are otherwise entitled to, based on their significant capital contributions, if not to remunerate the general partner for services rendered or to be rendered.

In this regard, the limited partners waive a portion of their profits to incentivise the general partner to work actively to create value in the private equity fund (Bergkvist, Nilsson, Hagbard Beyer, 2014: 143). It follows that the carried interest actually represents compensation for services rendered by the general partner, more particularly performance fees earned (Dauds, 2007: 11 and Horak, 2007: 5).

Aron-Dine (2007: 5) asserts that the general partner does not put enough of its own financial capital at risk and that the basic standard for establishing whether the carried interest represents a capital gain would seem to be whether the general partner has a material amount of financial capital at stake. In this regard, Aron-Dine (2007: 5) quotes Bloomberg News columnist John Berry who states that:

> 'The general partner obtains the 20% carried interest in return for management services, not because [it] contributes 20% of the capital in the pot [the private equity fund].'

Aron-Dine (2007: 6) further argues that the general partner is performing a service, for which the carried interest is clearly compensating it. This is because, unlike the fund's limited partners, the general partner is responsible for making investment decisions and for managing investments. The general partner often appoints its key executives to the boards of the portfolio companies and is frequently involved in the day to day decisions of these companies, not unlike corporate Chief Executive Officers. (Aron-Dine, 2007: 6.)

In addition, Aron-Dine (2007: 6) contends that the general partner in essence provides long term consulting services to the limited partners, quoting, in support of this view, the following statement made by a United States private equity representative at the Senate Finance Committee hearing on carried interest:

> 'What we do, Senator, is to help build a company… we take a technologist, as an example, who knows a lot about how to build a chip but has never hired a salesperson, a marketing person – never even put together a HR person – and we will advise them on how to take that technology idea.. be a catalyst to help pull that technology through the process to ultimately get it commercialised.'

Moreover, the Blackstone Group[21], in a filing with the United States Securities and Exchange Commission, is quoted as follows:

[21] The Blackstone Group is a global leader in private equity, with $94 billion in assets under management. [http://www.blackstone.com/the-firm/asset-management/private-equity] (accessed 7 January 2016.)

> ‘We also believe that the primary source of income from each of our [private equity] businesses is properly characterised as income earned in exchange for the provision of services.’ (Aron-Dine, 2007: 6.)

In addition, it is submitted, that strong support for the argument that carried interest is service related compensation which is performance based is to be found in the glossary to the KPMG and SAVCA *Venture Capital and Private Equity Industry Performance Survey of South Africa covering the 2014 calendar year*, where it is stated:

> ‘[That carried interest] represents a **fee enhancement** for a private equity **fund manager** for achieving a **benchmark return or hurdle rate**.’ (Emphasis Added)

Analysis of the arguments

It is submitted that the arguments presented above support the view that the legal substance of a carried interest arrangement is that of a service arrangement between the general partner and the limited partners. More precisely, it is further submitted that in legal substance, it appears that the limited partners reward the general partner for various fund management services rendered / to be rendered by the general partner to them by first granting the general partner the right to carried interest and thereafter paying the general partner a performance based fee, which is the distribution of carried interest.

3.3.3 Analysis of arguments that support carried interest as being other than service related compensation of the general partner

Argument 1

The enhanced return obtained by the general partner as the distribution of carried interest is commensurate with the greater risk the general partner is exposed to compared to the limited partners who invest in the private equity fund, given that receipt of the distribution

of carried interest is subordinate to all other investment proceeds received by the fund investors (that is, the distribution of carried interest is received only after repayment of the cost of the fund investments initially made and the payment of the hurdle return to all the fund investors). Further, the distribution of carried interest is only received when the fund investments perform well. In light of this different risk profile, there is a need for a differential return between the limited partners and the general partner. This is delivered through the requirement of the general partner to invest typically 1% - 2% of the capital of the fund, whilst sharing 20% of the fund's top slice profits. (British Venture Capital Association, 2007: 6 and Fournier and O'Hara, 2006: 24.). The concept of differential returns is not unique to private equity funds and is a conventional way of reflecting the economic circumstances of different types of investor acting together in a shared investment (British Venture Capital Association, 2007: 6).

Analysis of argument 1

It is submitted that this argument does not hold up to scrutiny. This is so, it is submitted, because although the general partner may be exposed to the risk of not receiving a distribution of carried interest given the requirements first to return initial investment capital and then to pay the hurdle return, this in no way impacts on the risk of it losing its 1% - 2% capital co-invested in the fund.

As was discussed in chapter 2, before the distribution of carried interest is made, the initial capital of **all** the fund investors, **including the general partner** is repaid. Moreover, the general partner, along with the limited partners, **also receives** the hurdle return on its investment. On this basis, it is submitted that the **investment risk** and the **economic characteristics** of the general partner's 1% - 2% capital contributed to the fund[22] are the same as that of the 98% - 99% capital contributed to the fund by the limited partners[23]. Consequently, it is further submitted, that the right to a disproportionate return on the co-investment of the general partner, namely the right to carried interest, and the

[22] Hereafter referred to as the 'co-investment of the general partner'
[23] Hereafter referred to as the 'investment of the limited partners'

disproportionate return on the co-investment, namely the distribution of carried interest, must be for services rendered / to be rendered by the general partner to the limited partners, rather than being attributable to the greater investment risk attached to the general partner's co-investment when compared to the investment of the limited partners.

In this regard, Aron-Dine (2007: 8) argues that while the requirement first to repay the initial capital contributed as well as to achieve the hurdle return makes the distribution of the carried interest subject to performance conditions, which conditions make the receipt of the distribution more risky, risky compensation is still compensation for services rendered. Differently put, characterisation of the distribution of carried interest as service based compensation should not be affected by the fact that receipt of the distribution is contingent upon performance conditions being met, which performance conditions make receipt of the distribution more risky. A wide variety of performance based compensation arrangements, including arrangements in which service providers accept the entire risk of success or failure of an enterprise, is effectively compensation for services rendered. Examples include contingent fees based on movie revenues paid to actors, lawyer contingency fees, performance bonuses paid to employees and directors, share options, royalties and incentive fees paid to managers of other people's money (Aron-Dine, 2007: 9-10.)

Argument 2

Given that the general partner has unlimited liability to third parties for the debts of the fund, it could may be argued that this exposes the general partner to significantly more risk than that of the limited partners, for which the general partner is rewarded by being granted the right to and thereafter receiving the distribution of carried interest.

Analysis of argument 2

It is submitted that this argument in no way supports the contention that the right to and distribution of carried interest is not for services rendered by the general partner to the limited partners. This is because the undertaking by the general partner to accept additional risk (of unlimited liability) does not impact in any way on the risk of its underlying co-investment. It follows then that the right to carried interest and the distribution of carried interest cannot be **investment rewards** for the greater **investment risk** to which the general partner is exposed compared to the limited partners.

Consequently, it is further submitted, that both the right to and the distribution of carried interest are quid pro quo for the service to be rendered / rendered by the general partner to the limited partners, which service is the undertaking by the general partner to accept third party unlimited liability risk for the debts of the partnership[24].

That an undertaking by a taxpayer to accept risk on behalf of other parties is a service rendered by that taxpayer is further supported, it is submitted, by the case *of H v COT* 1957 (4), SA 478 (SR), 21 SATC 346 ('*H v COT'*). In *H v COT*, the taxpayer, a director, received shares in a company as consideration for an undertaking to guarantee the payment of the company's debts. The issues to be decided in this case were whether the undertaking to give the guarantee (that is, the undertaking to take on the risk of the company defaulting on its debts) was a service rendered and whether the receipt of the shares was in respect of such a service rendered. It was held (at 347) that the undertaking to give the guarantee was a personal act of service performed by the taxpayer, that is, the rendering of a service by the taxpayer. It was held further (at 347) that the shares which the taxpayer had received for a nominal payment were a receipt in respect of such a service and therefore formed part of his gross income.

[24] Hereafter referred to as 'the risk undertaking by the general partner'

Argument 3

The services provided to the limited partners of the fund are performed not by the general partner, but rather by the key executives of the private equity management company[25], which company is fully remunerated for such services on an arm's length basis by charging a management fee which is fully taxable. The carried interest is divorced from and has entirely different economic characteristics compared to these management fees, as the carried interest is the investment reward pertaining to the co-investment by the general partner. (British Venture Capital Association, 2007: 8 and Garcia: 2008: 40-41.)

Analysis of argument 3

In response to this argument it is submitted that because the general partner is the fund manager – as was discussed in detail in chapter 2 – it will invariably be required to perform fund management services in respect of which the right to and the distribution of carried interest is clearly compensating it. Consequently, it is submitted that the argument that the general partner performs no fund management services cannot be correct. Moreover, as has already been discussed, because the co-investment of the general partner is subject to the same degree of risk and has the same economic characteristics as that of the investment of the limited partners, it is submitted that the carried interest cannot be the **investment reward** in respect of the general partner's **co-investment***;* rather, it is the reward for services rendered / to be rendered by the general partner to the limited partners.

3.3.4 Conclusion: Determining the legal substance of a carried interest arrangement

Based on the analysis conducted in sections 3.3.2 and 3.3.3 above, of the arguments both for and against carried interest being service related compensation, it may be concluded

[25] The private equity management company corresponds to PE ManCo in Figure 1 per section 2.2.1 of chapter 2, which receives a management fee of 2% of fund capital.

that in legal substance, a carried interest arrangement entails the general partner undertaking to render and thereafter rendering to the limited partners, in the capacity of **service provider**, various fund management services as well as performing the additional service of assuming the risk of unlimited liability in respect of third party debts of the fund. Furthermore, in legal substance, it is submitted that the general partner acquires the right to and receives the distribution of, carried interest as a reward for the aforementioned **services rendered / to be rendered** rather than as an enhanced investment reward / return based on the ostensibly higher risk exposures of its co-investment in the fund compared to the limited partners' investments.

Consequently, it is submitted that the legal substance of a carried interest arrangement does not accord with its legal form. This is because in legal substance, a carried interest arrangement is a fee arrangement in which the general partner is remunerated for services rendered / to be rendered to the limited partners. This applies even though in legal form a carried interest arrangement entails the acquisition of the right to, and the subsequent receipt by, the general partner, of a disproportionate share of fund partnership profits, in its capacity as partner and not as service provider to the limited partners.

Accordingly, it needs to be established which taxing provision(s) and which case law principles will likely apply to the taxation of carried interest based on the legal substance of a carried interest arrangement. As already discussed, broadly stated, paragraph (*c*) taxes amounts received or accrued attributable to services rendered, as gross income, irrespective of whether the amount is of a capital nature. In this regard, as in legal substance both the right to and distribution of carried interest are rewards for services rendered / to be rendered, prima facie, this would point to paragraph (*c*) applying to the taxation thereof. Whether, and to what extent, paragraph (*c*) does in fact apply to the taxation of carried interest, based on the legal substance of a carried interest arrangement, is examined in section 3.4 below.

3.4 Determining the application of paragraph (*c*) to the taxation of carried interest based on the legal substance of a carried interest arrangement

3.4.1 Overview

Section 1 of the Act contains a definition of 'gross income', the introductory portion of which, in so far as is relevant for this report, reads as follows[26]:

> 'Gross income in relation to any year or period of assessment, means –
>
> (i) in the case of any resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such resident…
>
> during such year of assessment, excluding receipts or accruals of a capital nature, but including, without in any way limiting the scope of this definition, such amounts (whether of a capital nature or not) so received or accrued as described hereunder,…'.

Paragraphs (*a*) to (*n*)[27] extend the scope of the definition of 'gross income' by including certain amounts in a taxpayer's gross income, irrespective of whether these amounts may otherwise be of a capital nature.

Of the special inclusions in gross income, as already noted, paragraph (*c*) is of particular relevance in this report. Paragraph (*c*) includes in gross income

> 'any amount… received or accrued in respect of services rendered or to be rendered…'.

Both the terms 'services rendered' and 'in respect of' in paragraph (*c*) are not defined in the Act and give rise to several questions of interpretation. These terms have however received judicial interpretation and an analysis of some of these decisions follows to provide clarity and understanding of the meaning of these terms as used in the context of paragraph (*c*) and as a basis for assessing the application of paragraph (*c*) to the taxation of carried interest, based on the legal substance of a carried interest arrangement.

[26] Hereafter referred to as the opening words of the definition of 'gross income'.
[27] Hereafter referred to as 'the special inclusions in gross income'

3.4.2 Establishing the meaning of the term 'services rendered'

In ITC 1692, 62 SATC 508, two cases with insightful findings in relation to the meaning of 'services rendered' were cited (Singleton, 2004: 10).

In the first case, *Maseti v Key NO & others*, 1951 (2) SA 187 (C), Herbstein J said the following at 192D: (Singleton, 2004: 12)

> 'The phrase for services rendered is in common use and its ordinary meaning is that something has been done for the benefit of some person, e.g. supplying of a particular need. When one speaks of a fee for services rendered one means the payment of a sum of money as compensation for an act which has been performed, or a need which has been provided.'

The second case cited was *H v COT* 1957 (4), SA 478 (SR), 21 SATC 346 where Young J attributed a very wide meaning to the words 'services rendered' when he said the following at 482E-G: (Singleton, 2004: 12)

> 'As to the first question, the term "services rendered" is an ordinary English one and not a technical expression. It should I think, therefore be given its ordinary connotation unless there is something in the context to justify another meaning. The expression ordinarily suggests work and labour done, i.e. personal acts: cf, *Sowerby & Co v GN Railway*, 7 TLR 392; and I find nothing in the context to justify a departure from that meaning; rather the contrary, because the reference in sec.8(b) to amounts accrued whether "payable under any contract of employment or service or not" supports, I think, the above conclusion,'.

According to Singleton (2004: 12), the broad scope of what comprises 'services rendered' can be encapsulated in the words of Meyerowitz (Meyerowitz, 2001-2002: para 9.1.2.)

> 'services are not confined to employment as such, but include any form of service, e.g. professional services such as medical, legal, architectural, or as a director and so on, and casual services. e.g. passing on some information'.

As stated in chapter 1 as well as chapter 2, at inception of the fund, the general partner undertakes to provide and thereafter typically renders a range of services, namely the identification, evaluation and negotiation of investment opportunities and the monitoring and realisation of those investments for the private equity fund, and by extension for the limited partners. Thus, it is submitted, that the fund management services rendered or to be rendered by the general partner to the limited partners, would constitute services rendered or to be rendered for the purposes of paragraph (*c*). Moreover, as already discussed in section 3.3.3, on the authority of *H v COT*, it is further submitted that the undertaking by the general partner to accept third party unlimited liability risk for the debts of the partnership, is a service rendered / to be rendered as contemplated by paragraph (*c*).

3.4.3 Establishing the meaning of the term 'in respect of'

It is submitted that the critical enquiry is whether the amount accrued to and thereafter received by the general partner, namely the right to carried interest and the distribution of carried interest respectively, is 'in respect of' services rendered or to be rendered by the general partner to the fund's limited partners, in the context of paragraph (*c*).

The meaning of the term 'in respect of' in the context of paragraph (*c*) was considered in *Stander v CIR* 1997 (3) SA 617 (C), 59 SATC 21, where it was given a narrow interpretation. In this respect, the court held (at 219), that for an amount to be derived 'in respect of services rendered', there must be a direct causal link between the amount received and the services rendered.

Further, in *De Villiers v CIR* 1929 AD 227, 4 SATC 86, (at 87) Stratford JA stated that:

> '[t]he words "in respect of" had received judicial interpretation in the case of *Commissioner for Inland Revenue v Crown Mines Ltd* (1923 AD 121) in which Innes CJ said that a tax could not be imposed "in respect of" a particular subject –matter unless it "had direct relationship to that matter'', by which was meant, his Lordship thought, "causal relationship.'' '

It is submitted, that the application of the test of causation as applied in the Appellate Division case of *Tuck v CIR* 1988 (3) SA 819 (A), 50 SATC 98 ('the *Tuck* case'), where the determination of the capital or revenue nature of a single amount received was considered, is most appropriate for purposes of determining whether, and to what extent, the right to and the distribution of carried interest are 'in respect of' services rendered / to be rendered. In this regard, the judgment in the *Tuck* case is discussed and analysed and the application of its principles of causation and apportionment to the taxation of carried interest is considered below.

Tuck v CIR

The Judgment of the Appellate Division

In the *Tuck* case, Corbett JA, for the purpose of characterising a receipt or accrual as being of a capital or income nature for tax purposes, formulated the test to be applied as follows: (at 113)

> 'In a case such as the present, however, it seems to me that most problems of characterisation could appropriately be dealt with by applying the simple test as indicated by Watermeyer CJ in the passage quoted from his judgment in the *Lever Bros* case viz by asking what work if any, did the taxpayer do in order to earn the receipt in question, what was the quid pro quo which he gave for the receipt?'

In this respect, Corbett JA concluded (at 114) that there were two main elements giving rise to the receipt of the shares: the services rendered to the company and the element of restraint and that neither of these could be regarded as the sole quid pro quo given by the appellant.

Corbett JA, citing both South African and foreign cases which expressed support for the notion of apportionment, and noting that there was no authority in South African case law

for the apportionment of a receipt which contained an income element as well as an element of a capital nature, made the following pronouncement (at 114 and 115):

> 'It seems to me that in a proper case apportionment provides a sensible and practical solution to the problem which arises when a taxpayer receives a single receipt and the quid pro quo contains two or more separate elements, one or more of which would characterise it as capital. It could hardly have been the intention of the legislature that in such circumstances the receipt be regarded wholly as an income receipt, to the disadvantage of the taxpayer, or wholly as a capital receipt to the detriment of the fiscus.'

Corbett JA proceeded to make the following apportionment (at 115):

> 'It is not possible to infer that one element is more important than the other and in all circumstances I consider that a 50/50 apportionment would be fair and reasonable.'

Corbett JA held (at 116) that only 50% of the receipt in respect of the holding company shares – that represented the quid pro quo for services rendered by the taxpayer – constituted taxable income.

Analysis of the judgment

In the *Tuck* case, the Appellate Division expressly approved the use of the originating cause, or quid pro quo test for the purpose of characterising the receipt of the shares as being of a capital or revenue nature (Emslie and Jooste, 1989: 295). In this regard, Emslie and Jooste (1989: 299) assert that in determining the causa for the purposes of ascertaining the capital or revenue nature of an amount received or accrued, one must enquire what is the originating cause, or quid pro quo, giving rise to it.

It is therefore submitted that when the quid pro quo for any single receipt or accrual contains two or more separate elements, one or more of which would characterise it as

capital, an apportionment on a fair and reasonable basis is always required (the *Tuck* case at 114 and 115 and Emslie and Jooste, 1989: 304).

Application of the Tuck Case to the taxation of carried interest

Causation

As discussed above, the test of causation in the *Tuck* case enquires what work, if any, did the taxpayer do in order to earn the receipt or accrual; what was the quid pro quo that the taxpayer gave for the receipt or accrual. Applied in the context of carried interest, it is submitted that the work done, being the various fund management services undertaken to be rendered and thereafter rendered – as discussed in section 2.2.2 above – by the general partner to the limited partners, as well as the risk undertaking of the general partner, discussed in section 3.3.3 above, is clearly the quid pro quo for the right to carried interest and, thereafter, for the distribution of carried interest.

That this is the case is supported by the conclusion in section 3.3.4 above that in legal substance, the general partner acquires the right to carried interest and receives the distribution of carried interest **as a reward for**, that is, as **quid pro quo**, for the services rendered / to be rendered to the limited partners. It may therefore be concluded that there is a direct causal link between the services rendered or to be rendered by the general partner to the limited partners and the right to carried interest awarded as well as the distribution of carried interest. Consequently, it is submitted that the right to carried interest is an amount acquired by the general partner, and the distribution of carried interest is an amount received by the general partner **in respect of** services rendered or to be rendered, as envisaged in paragraph (*c*), by the general partner to the limited partners.

Apportionment

It is submitted, on the authority of the *Tuck* case, that if it were evident that the quid pro quo for the award of the right to carried interest and the distribution of carried interest consisted of two or more separate elements, one or more of which would characterise it as capital, then apportionment between its revenue and capital components, on an equitable and reasonable basis, would be required.

In section 3.3.4 above, however, after having examined arguments both for and against carried interest being, in legal substance, service related compensation, it was concluded that it was only services rendered / to be rendered that was the quid pro quo, both for the right to and the distribution of carried interest. As already discussed in section 3.2.2, according to Singleton (2004: 1) receipts and accruals from services rendered are inherently of a revenue nature, being the product of one's wit and labour. Consequently, the quid pro quo both for the right to and the distribution of carried interest comprise only one element, namely services rendered / to be rendered, which is of a revenue nature. It follows then that no apportionment is required as there is no capital element included in the quid pro quo for either the right to or the distribution of carried interest.

3.4.4 Determining the application of paragraph (*c*) to the taxation of the right to carried interest based on the legal substance of a carried interest arrangement

In section 3.4.3 above, it was established that in legal substance the right to carried interest is acquired by the general partner 'in respect of' services to be rendered as contemplated by paragraph (*c*), by the general partner to the limited partners. It must be stressed, however, that in order for paragraph (*c*) to apply **at all** to the taxation of the right to carried interest, certain additional criteria in paragraph (*c*) also need to be met, namely, that that there must be an 'amount' which 'accrues' to the taxpayer in respect of the services to be rendered.

Consequently, in order to establish if paragraph (*c*) applies to the taxation of the right to carried interest, based on the legal substance of a carried interest arrangement, it needs to be determined if this right constitutes an 'amount' that has 'accrued' to the general partner at the inception of the fund. This is considered below.

Meaning of an 'amount'

Singleton (2004: 4) explains that the word 'amount' also appears in the opening words of the definition of 'gross income' when it refers to amounts received or accrued, whether in cash or otherwise. In this respect, Singleton (2004: 5) submits that because of the relationship between paragraph (*c*) and the opening words of the definition of 'gross income', the amount received or accrued under paragraph (*c*) is an 'amount in cash or otherwise' as used in the opening words of the gross income definition.

In this regard, the courts have held that an 'amount' includes not only money, but also the value of every form of property earned by the taxpayer, whether corporeal or incorporeal, which has a monetary value (*Lategan v CIR* 1926 CPD 203, 2 SATC 16 at 19, ('the *Lategan* case') and *CIR v People's Stores (Walvis Bay) (Pty Ltd)* 1990 (2) SA 353 (A), 52 SATC 9 at 21 ('the *People's Stores* case').

In the context of fiscal legislation, property has been described as meaning rights which have a monetary value in the hands of the holder. Such rights include real rights and personal rights. (Singleton, 2004: 5.). A real right (jus in rem) is a right in a thing, which is enforceable against all persons, or differently put, against the whole world, for example, ownership in both movable and immovable property. A personal right (jus in personam) is a right against a particular person or group of persons, for example, rights of action to claim delivery of a thing or to claim performance of an act. (Singleton, 2004: 5 and McAllister, 2015: 43-44.)

The general principle is that, should a non-cash amount accrue to or be received by a taxpayer, then the market value of such property, as valued on the date of receipt or accrual, should be included in the taxpayer's gross income (*Lace Proprietary Mines Ltd v CIR* 1938 AD 267, 9 SATC 349 at 362).

This property, whether corporeal or incorporeal, must however, have an ascertainable money value. In addition, the onus of establishing that an 'amount' has been received or accrued rests upon the Commissioner. (Stiglingh et al, 2015: 16.)

The leading authority that if a receipt or accrual has no ascertainable monetary value, then it cannot fall into gross income, is *CIR v Butcher Bros (Pty) Ltd* 1945 AD 301, 13 SATC 21 ('the *Butcher Bothers* case'). This case concerned the owner of a building who, at the end of a lease, of considerable duration, would obtain the benefit of certain improvements effected by the lessee to the lease premises. The question was whether an 'amount' had accrued to the lessor in the current tax year, and if so, what its value was. It was held that the lessor would not get the benefit of the improvements until the expiry of the lease 30 years into the future and that it was therefore impossible for purposes of the current tax year to estimate the value of that benefit. The value of the benefit was so conjectural, given the duration of the lease and the uncertainty as to the value of the improvements at the expiry of the lease, that it had no ascertainable money value in the present tax year. Consequently, no 'amount' had accrued to the taxpayer in that tax year in respect of those improvements. (Clegg and Stretch, 2015: para 4.10 and Williams, 2009: 82 - 83.)

In summary, for an 'amount' to be included in paragraph (*c*), it must be an amount in cash, or if it is a non-cash award, it must constitute 'property' which has an 'ascertainable money value'. Furthermore, where a non-cash award qualifies as an amount received or accrued, it must be valued at its market value at the date of receipt or accrual.

Determining if the right to carried interest constitutes an 'amount'

The right to carried interest, awarded to the general partner at the inception of the fund, is a non-cash award. Consequently, in order to be an 'amount' for the purposes of paragraph (*c*), it needs to be determined, as discussed in the paragraph immediately above, if this right constitutes 'property' and if the right has an 'ascertainable money value'.

The right to carried interest is a contractual right of the general partner to a disproportionate share of future fund realisation proceeds, which proceeds constitute the distribution of carried interest. Accordingly, this right represents a right of action by the general partner to claim delivery from the limited partners of the distribution of carried interest. This means that the right to carried interest is a personal right. Thus, it is submitted, that this right constitutes property.

It then remains to determine if this property has an ascertainable money value at the inception of the fund. In this respect, the value of an asset such as the right to carried interest, is derived from its expected future cash flows, taking into account the risk in realising these expected cash flows. To this end, a discounted cash flow method or an option pricing method is typically used to estimate the value of the right to carried interest at the fund's inception. (Fournier and O'Hara, 2006: 24.)

The discounted cash flow method projects the expected future cash flows arising upon the distribution of the carried interest and discounts them at a rate of return commensurate with the risk involved in realising those cash flows. An alternative to the discounted cash flow method is to value the right to carried interest using standard option pricing theory, that is to say, using an option pricing model. Similar to a call option[28], the right to carried interest represents the right to the 20% share of the disposal value of an investment (the portfolio company) above a predetermined level (that is, the exercise price). In this case,

[28] A call option is defined as an agreement that gives the purchaser the right, but not the obligation, to buy a fixed quantity of a commodity, financial instrument or some other underlying asset, at a given price at or before a specified date (Arnold, 2005: 638).

the ‘exercise price’ is the contributed capital of the private equity fund, plus the accumulated preferred return (that is, the hurdle return) at the termination of the fund, when the portfolio company is disposed of (Fournier and O’Hara 2006: 24.). Given the aforementioned similarity of the right to carried interest and a call option, Fournier and O’Hara (2006: 24) advise that option pricing models such as Black Scholes, or the binomial model may be used to calculate the value of the right to carried interest, which is a financial asset, by analysing the volatility and opportunity cost of investing in this asset.

It should be noted, however, that both of the valuation methodologies (that is, discounted cash flow method and the option pricing method) discussed above, rely on a number of estimates, assumptions and subjective judgements in determining the value of the right to carried interest at the fund’s inception. Accordingly, there may well be a fairly sizeable difference in the value determined for the right to carried interest, at the fund’s inception, using either of these valuation methods and the value of the distribution of carried interest ultimately received by the general partner. (Fournier and O’Hara 2006: 24-25.)

Based on the discussion above, it is submitted that the right to carried interest, awarded at the inception of the fund, has an ascertainable money value. This is because, as noted above, recognised valuation methodologies may be used to determine a value for this right at the commencement of the fund. It is further submitted that although these valuation models require a degree of subjective judgement as well as the use of estimates and assumptions, employing either of these valuation methods, still yields a value for the right to carried interest. Thus, it is submitted, that the monetary value of the right to carried interest at the fund’s inception is ascertainable. This position may be contrasted with the *Butcher Bothers* case, cited above, where, given the significant magnitude of the uncertainties that existed in attempting to value leasehold improvements, 30 years subsequent to the year of assessment, it was held by the court (at 42) that it appeared **impossible** that **any trustworthy estimate for the value** of such improvements could ever be obtained.

In conclusion, as argued above, because the right to carried interest constitutes 'property' and because it has an 'ascertainable money value', it is submitted that this right is an 'amount' within the meaning of paragraph (c) of the definition of 'gross income'.

Meaning of 'accrued to'

After years of debate as to the meaning of the term 'accrued to', the matter was finally settled in the *People's Stores* case, where the court (at 22) upheld the judgment in the *Lategan* case that the meaning of the words 'accrued to', was 'entitled to'. In the *Lategan* case, the court was called upon to decide the date of accrual of the proceeds from the sale of wine by a farmer in a particular year of assessment. Part of the price was received in that year, while the balance was payable in instalments after the end of that year. The taxpayer argued that the debt receivable in the future had not accrued to him, but the court held that he became entitled to a right to claim future receipts on the date of the sale and therefore had to include the total value of the sale in his gross income in the year during which the sale took place. (Haupt, 2012: 23 and Stiglingh et al, 2015: 20.)

According to Stiglingh et al (2015: 20-21) the meaning of the term 'accrued to' therefore implies that the taxpayer must be entitled to an amount. The physical receipt thereof in the year of assessment, as well as the enforceability thereof, is irrelevant for the purposes of the concept of an accrual. For instance, in the case where goods are sold on credit in year one, but are only due and payable in year two, the seller has already obtained a vested right in year one, namely a right to future payment – he has a right in year one to claim payment in year two. This right to future payment will result in an inclusion in gross income in year one, provided that the right has a monetary value. (Stiglingh et al, 2015: 21.)

Stiglingh et al (2015: 21.) explain that there is, however, an important qualification, namely that the taxpayer must be **unconditionally entitled** to the amount. According to

Stiglingh et al (2015: 21) this principle has, inter alia, been confirmed in *Ochberg v CIR* 1933 CPD 256, 6 SATC 1 (at 264) and in *Mooi v CIR* 1972 (1) SA 675 (A), 34 SATC 1 (at 684). If the right of the taxpayer to claim future payments is conditional, for example, subject to the approval of a third party, there can be no accrual. Accrual can take place only **after the conditions have been fulfilled**, as the taxpayer is not entitled to the amount until this has taken place. (Stiglingh et al, 2015: 21.)

Determining if the right to carried interest accrues to the general partner

It will be recalled from chapter 2 that the distribution of carried interest will only be received by the general partner provided that:

- first, all the capital contributions made have been returned to all the private equity fund investors, being both the general and limited partners; and
- second, the hurdle rate of return on investment has been achieved for all the fund investors, being both the general and limited partners.

It is therefore clear from the above bullet points that various conditions need to be met before the general partner receives its distribution of carried interest. Consequently, it is submitted, that the right to carried interest, acquired by the general partner, is a contingent right, which does not give the general partner an unconditional entitlement, at fund inception, to claim payment of the distribution of carried interest in a future year. For these reasons, it is further submitted, that the right to carried interest does not accrue to the general partner at fund inception; rather it accrues when the general partner becomes unconditionally entitled to claim payment of the carried interest, which occurs once all the carried interest conditions have been satisfied. Consequently, it is submitted, that the accrual of the right to carried interest occurs contemporaneously with the receipt by the general partner of the distribution of carried interest.

That the right to carried interest is a contingent right, which accrues to the general partner, not at fund inception, but rather once all the carried interest conditions have been satisfied,

is supported, it is submitted, by the Appellate Division case of Mooi v CIR, 1972 (1) SA 675 (A), 34 SATC 1 ('the Mooi case') which is discussed below.

Mooi v CIR

Factual Background

The taxpayer, an employee of the Phalaborwa Mining Co Ltd accepted his employer's offer, on 27 July 1963, of an option to subscribe, at R1,25 per share, for 500 of the company's R1 shares, subject to various conditions, inter alia: (a) the option was not exercisable until six months after completion of the company's mine at Phalaborwa: (b) the option could be exercised only if the taxpayer was still employed by the company. It was common cause that the option was in respect of services rendered and to induce him to render future services to the company. In October 1966, the taxpayer exercised the option and acquired 500 shares for R1,25 each. Their market value at that time was R6,40 each. The total market value of the shares acquired by the taxpayer therefore exceeded the option price paid by him by R2 575. (Williams, 2009: 105.)

The Commissioner included the sum of R2 575 in the taxpayer's gross income for the tax year ended 28 February 1967, as an amount which had accrued to him in respect of services rendered or to be rendered when the option became exercisable, that is, 1 September 1966 (Williams, 2009: 105).

The taxpayer objected on the basis that what had accrued to him in respect of services rendered or to be rendered was the right he acquired on 27 July 1963 (when he accepted his employer's offer to grant him the option) to exercise an option at a later date when certain conditions had been fulfilled. More particularly, the taxpayer asserted that the right had accrued on 27 July 1963 as that was the date that there came into existence an enforceable contract of option between the taxpayer and his employer, that is, from this date the taxpayer was able to take legal action, in terms of the contract of option, against

his employer to protect his rights in terms of the option granted. Furthermore, the taxpayer argued that the option accrued on this date as it was capable of being valued in money on this date. (The *Mooi* case at 650 and Williams, 2009: 105.)

The Judgment of the Appellate Division

In deciding precisely what it was that accrued to the taxpayer, and when such accrual took place, Ogilvie Thompson CJ held the following (at 684D-F):

> 'In the present case, as already emphasised, services still needed to be rendered by appellant after July 1963, and there can be no doubt that the true and real benefit contemplated by the letter of 25 July 1963 was the right, upon due fulfilment of all the conditions stated in that letter, to obtain shares at the price of R1.25 per share … In my view, the contingent right which appellant acquired on 23 July 1963, did no more than – to borrow a phrase used by Sellers LJ in the court of appeal in *Abbot's* case and subsequently adopted by Lord Keith in the House of Lords – "set up the machinery for creating a benefit'', which said benefit only accrued when the option became exercisable. Accordingly, I am of the opinion that no accrual within the meaning of the definition of "gross income" occurred in July 1963 (cf *Ochberg v CIR* and *Hersov's* case, but that the relevant accrual occurred when the option became exercisable on 1 September 1966. The real benefit conferred upon appellant, which was at all material times in the contemplation of all concerned, was the right to apply for the shares at R1,25 per share and that right arose when upon fulfilment of the conditions of the option, the latter became exercisable.'

Application of the Mooi Case in determining the time of accrual of the right to carried interest

Based on the judgment in the *Mooi* case, Williams (2009: 122) asserts that a right is conditional / contingent, when its enforceability is suspended until the occurrence of an uncertain future event. Furthermore, on the authority of the *Mooi* case, where a taxpayer acquires a contingent right, such a right does no more than 'set up the machinery for creating a benefit' and the benefit accrues on the date when all the conditions attaching to the right are fulfilled. This is the case even if such a contingent right possesses a money value at the time of its acquisition and notwithstanding that such a right is enforceable

insofar as the taxpayer is able to take legal action to protect it. (De Koker and Williams, 2015: para 2.11 and Williams, 2009: 122.)

Applying the judgment in the Mooi case to determine the time of accrual of the right to carried interest, it is submitted that this right, acquired by the general partner at the fund's inception, is contingent. This is because its enforceability, to claim payment of the carried interest, is suspended, until the fulfilment of the carried interest conditions. It follows then that the right to carried interest, acquired at fund commencement, does no more than 'set up the machinery for creating a benefit' and that the benefit accrues on the date when all the carried interest conditions are fulfilled. This is despite the fact that the right to carried interest is capable of being valued − as discussed above − at the time of its acquisition, and notwithstanding that this right is enforceable insofar as the general partner is able to take legal action to protect its right to carried interest in terms of the partnership agreement (for example, by suing the limited partners for damages were the limited partners to revoke its right to carried interest prior to it exercising such right).

In conclusion, on the authority of the Mooi case, it is submitted that the right to carried interest, acquired by the general partner at the fund's inception, is a contingent right, to which the general partner is **not** unconditionally entitled, and which therefore does **not accrue** to the general partner in terms of paragraph (c).

Conclusion: Determining the application of paragraph (*c*) to the taxation of the right to carried interest based on the legal substance of a carried interest arrangement

The right to carried interest acquired by the general partner at fund inception, meets a number of the paragraph (*c*) criteria, namely:

- it is an amount, meaning that it constitutes 'property' and it has an 'ascertainable money value'; and

- it is acquired ‘in respect of services’ to be rendered as contemplated by paragraph (*c*).

Given, however, as discussed above, the existence of the carried interest conditions, the right to carried interest is **not** an amount to which the general partner is **unconditionally** entitled. Consequently, the right to carried interest does **not** constitute an amount that **accrues** to the general partner in respect of services to be rendered to the limited partners at fund inception. It follows then that because the **accrual requirement** of paragraph (*c*) is **not met**, paragraph (*c*) does not apply to taxing the right to carried interest. As previously discussed, paragraph (*c*) includes in gross income, inter alia, any amount **accrued** in respect of services rendered / to be rendered. As the right to carried interest does not constitute an amount accrued, no amount falls to be included in the gross income of the general partner in respect of this right acquired at fund inception. Consequently, there is no amount that can be subject to tax, with the result that the general partner will not be taxed on the right to carried interest at fund inception.

3.4.5 Determining the application of paragraph (*c*) to the taxation of the distribution of carried interest based on the legal substance of a carried interest arrangement

Paragraph (*c*) applies to include in gross income, inter alia, any amount received in respect of services rendered. In section 3.4.3 above, it was determined that in legal substance the distribution of carried interest is an amount received by the general partner in respect of services rendered, as contemplated by paragraph (*c*). Consequently, paragraph (*c*) will apply to the taxation of the distribution of carried interest and will include the distribution received in the gross income of the general partner. Further, paragraph (*c*), will supersede the application of section 9C(2) to the taxation of the distribution of carried interest because paragraph (*c*) includes amounts received in gross income in respect of services rendered irrespective of whether such amounts are otherwise of a capital nature.

3.5 Tax implications of the distribution of carried interest based on the legal substance of a carried interest arrangement

The proceeds that arise upon disposal of a portfolio company by the fund, which are allocated to the general partner, in terms of the fund partnership agreement will consist of the following:

a) the return of the initial capital contributed to the fund by the general partner, which capital was used to acquire the general partner's interest in the qualifying shares in the portfolio company[29];
b) proceeds which provide the general partner with a return on its investment capital sufficient to meet the pre-determined rate of return, that is, the hurdle rate of return;
c) proceeds that are proportionate to the investment capital of the general partner; and
d) the distribution of carried interest, that is, proceeds received which are disproportionate to the investment capital of the general partner.

Of the total proceeds arising on disposal of a portfolio company by the fund, which are allocated to the general partner,[30] the sum of the items described in points (a) – (c) above, represent the portion of such proceeds which do not constitute the distribution of carried interest. It is submitted that section 9C(2) will apply to deem such proceeds (which do not constitute the distribution of carried interest) received by the general partner to be of a capital nature. This is so, it is submitted, because such proceeds are, in terms of section 9C(2), an amount received by the general partner in respect of its interest in the qualifying portfolio company shares.

Moreover, as discussed in section 3.2.3, the base cost of the general partner's interest in the qualifying portfolio company shares will, in terms of paragraph 20, be the capital contributed to the fund by the general partner, which capital was used to acquire the general partner's interest in the qualifying portfolio company shares.

[29] Hereafter referred to as 'the investment capital of the general partner'
[30] Hereafter referred to as 'realisation proceeds'

Consequently, it is submitted that the general partner will be subject to capital gains tax at the effective rate of 18,67%, on a capital gain determined by deducting from the above-mentioned portion of the realisation proceeds, which do not constitute the distribution of carried interest, the base cost, determined in terms of paragraph 20, of the general partner's interest in the qualifying portfolio company shares. Furthermore, as this portion of the realisation proceeds, which excludes the distribution of carried interest, does not constitute an amount received by the general partner in respect of services rendered to the limited partners, it is submitted that paragraph (*c*) will not apply to the taxation thereof. Consequently, it is further submitted, that treatment of these realisation proceeds on capital account in accordance with section 9C(2) will remain undisturbed.

As already noted in section 3.4.5 above, paragraph (*c*) will apply to tax the distribution of carried interest received by the general partner, this being an amount received in respect of services rendered. Moreover, as previously noted, paragraph (*c*) will supersede the application of section 9C, as paragraph (*c*) includes in gross income, amounts that would otherwise be of a capital nature. Consequently, the distribution of carried interest received by the general partner will be included in its gross income in terms of paragraph (*c*) and will be subject to normal tax at the rate of 28%.

The abovementioned tax implications are shown in the following illustrative example:

Illustrative example 3: Tax implications of the distribution of carried interest based on the legal substance of a carried interest arrangement

Assume that the same facts apply as illustrative example 2 in section 3.2.3 above. That is, portfolio company A was acquired by the fund in year one, for R100 and was subsequently disposed of by the fund in year 5 for R300. Furthermore, the general partner contributed R2 as its co-investment to the fund, which amount was used to acquire a 2% shareholding in portfolio company A (that is, the general partner, has an interest (equal to 2%) which cost R2, in the shareholding of the fund partnership, in portfolio company A). Table 2,

from illustrative example 2, which shows the allocation and distribution of the realisation proceeds to the general partner, in year 5 is presented again below.

Table 2 – ALLOCATION AND DISTRIBUTION OF REALISATION PROCEEDS TO GENERAL PARTNER

Allocation and distribution type	**General partner**
Return of capital contributions	R2
Hurdle return	R2
Residual realisation proceeds allocated	R25
Total realisation proceeds allocated	R29 (R2+ R2 +R25)
Allocation of residual realisation proceeds in proportion to capital contribution of general partner	R2,50
Distribution of carried interest	R22,5 (R25- R2,5)

Assume further that the market value of the right to carried interest was determined to be R12 at fund inception.

It is submitted that the tax implications for the general partner will then be as follows:

At fund inception, as discussed in section 3.4.4 above, because the general partner is not unconditionally entitled to the right to carried interest, this right does not constitute an amount accrued to the general partner. In terms of the definition of gross income in section 1 of the Act, for an amount to be included in gross income, among other things, it must be an amount **received by or accrued to** the taxpayer. Because the acquisition of the right to carried interest by the general partner constitutes **neither a receipt nor an accrual** of an amount, because entitlement to the amount is not unconditional, no amount falls to be included in the general partner's gross income in respect of the right, notwithstanding that the right may have an ascertainable money value (R12 market value in this example) at

fund inception. In the result, the general partner will not be subject to taxation in respect of the right to carried interest, at fund inception.

Thereafter, in year 5, when portfolio company A is disposed of and the realisation proceeds are distributed to the general partner:

- The amount to be included in the gross income of the general partner in terms of paragraph (*c*) will be the R22,5 distribution of carried interest, this being in legal substance, an amount received by the general partner for services rendered[31] by it to the limited partners. This will result in the general partner being subject to normal tax of R6,30 (R22,5 x 28%) in year 5.
- The amount of realisation proceeds received by the general partner, deemed to be of a capital nature in terms of section 9C(2), in respect of its interest in the qualifying shares in portfolio company A, held by the tax transparent fund partnership, will be R6,50 (R29 total realisation proceeds – R22,5 distribution of carried interest). Furthermore, in terms of paragraph 20, the general partner will deduct R2, being the base cost of its interest in the qualifying shares in portfolio company A, from the proceeds of R6,50. This will result in a capital gain of R4,50 (R6,50 – R2) for the general partner in year 5, which will be subject to capital gains tax of R1 (Rounded) (R4,50 x 18,67%) in year 5.

3.6 Conclusion

In this chapter, it was determined that the legal form and associated tax implications of a carried interest arrangement do not accord with the arrangement's legal substance and related tax implications.

[31] Such services comprise the fund management services rendered and the service of the general partner undertaking unlimited 3rd party liability risk

With respect to the nature of the right to carried interest and the taxation thereof, it was explained that:

- In legal form, the right to carried interest is the right of the general partner to share disproportionately, relative to its capital contributed to the fund, in fund partnership profits. Further, it was noted, based on discussions with various private equity fund managers as well as tax practitioners that deal extensively with private equity transactions that almost invariably, the fund partnership agreement is silent as to why the general partner acquires the right to carried interest, and that there is no link between this right and the fund management services that are required to be performed by the general partner, as per this agreement.

  Based on its legal form, it was submitted that the right to carried interest is of a capital nature since it represents the right to future partnership profits, where the general partner is neither a dealer in carried interest rights, nor is the right to carried interest acquired by the general partner in respect of services rendered / to be rendered by the general partner to the limited partners.

  It was explained that consequently, no tax liability arises in the hands of the general partner at fund inception, upon acquisition of the right to carried interest. This is because, in legal form, the right to carried interest is the acquisition of a right of a capital nature by the general partner which constitutes neither gross income of the general partner, nor a disposal event for capital gains tax purposes as per the Eighth Schedule

- In legal substance, the right to carried interest is a reward acquired by the general partner at fund inception from the limited partners for services to be rendered by the former to the latter. It was established, however, that paragraph (c) does not apply to tax the right to carried interest as the right does not constitute an amount that accrues to the general partner at fund inception. It was noted that this is because the general partner is not unconditionally entitled to the right at fund inception. It was explained further that because no amount accrues in respect of the acquisition of the right to carried interest, in terms of paragraph (c), no amount falls to be included in the gross income of the general partner. Consequently, it

was explained that the general partner is not subject to tax in respect of the acquisition of the right to carried interest, at fund inception.

With respect to the nature of the distribution of carried interest and the taxation thereof, it was explained that:

- In legal form, the distribution of carried interest is the receipt by the general partner, subject to certain conditions being met, of a disproportionate share[32] of the proceeds realised by the fund partnership upon disposal of a portfolio company, which proceeds are received by it in its capacity as a partner. As with the right to carried interest, almost invariably there is no link in the fund partnership agreement between the distribution received and the fund management services to be performed by the general partner, in terms of the fund partnership agreement.

It was explained that in terms of section 9C(2), amounts received by a taxpayer in respect of the disposal of equity shares, held for a continuous period of at least three years, are deemed to be of a capital nature. On the basis that the investments of private equity funds tend to be held for 5 to 8 years before being disposed (Financial Mail, 2014: 50), it was noted that proceeds received on disposal of a portfolio company shareholding by a fund partnership, will, almost invariably, be deemed to be of a capital nature in terms of section 9C(2).

In this regard, based on the legal form of a carried interest arrangement, it was further explained that section 9C(2) read with paragraph 36 of Eighth Schedule will apply in deeming the **full portfolio company realisation proceeds**, allocated to the general partner in terms of the fund partnership agreement, to be of a capital nature. It was noted that this is because such realisation proceeds are received by the general partner in respect of its interest in the qualifying shares in the portfolio company, held by the tax transparent fund partnership. It was discussed that in terms of paragraph 20, the base cost of the general partner's interest in the qualifying shares in the portfolio company, is the capital contributed by the general

[32] Relative to the capital that it contributed to the fund

partner to the fund, which capital was used to acquire the general partner's interest in these qualifying shares.

It was further discussed that as a result, the general partner will be subject to capital gains tax at the effective rate of 18,67%, on a capital gain determined as the difference between the portfolio company realisation proceeds received and the base cost, in terms of paragraph 20, of the general partner's interest in the qualifying shares in the portfolio company. It was noted that because the distribution of carried interest forms part of the portfolio company realisation proceeds received by the general partner, the distribution will be included in the amount deemed to be of a capital nature in terms of section 9C(2) and will therefore also be included in the amount taxed at the effective rate of 18,67%. Moreover, it was discussed, that because in legal form, the distribution of carried interest, is received in the capacity as partner, and not for services rendered, paragraph (*c*) does not apply to override the capital gains tax treatment afforded to the distribution of carried interest received by the general partner.

- In legal substance, the distribution of carried interest is the receipt by the general partner of a fee from the limited partners for fund management services rendered by the former to the latter as well as for the service rendered to the limited partners of undertaking to accept third party unlimited liability risk for the debts of the fund partnership.

  It was further explained that paragraph (*c*) applies to the taxation of the distribution of carried interest received by the general partner. This is because the distribution is an amount received in respect of services rendered, in terms of paragraph (*c*), by the general partner to the limited partners. Further, it was noted that paragraph (*c*), overrides section 9C(2) in taxing the distribution of carried interest because paragraph (*c*) includes in gross income amounts that are of a capital nature. It was discussed that upon receipt of the portfolio company realisation proceeds by the general partner, the portion that comprises the distribution of carried interest will

be included in the gross income of the general partner in terms of paragraph (*c*) and will be subject to normal tax at the rate of 28%.

To conclude, where a carried interest arrangement is taxed in accordance with its legal form, the right to carried interest, acquired by the general partner at fund inception, will not be taxed, while the distribution of carried interest received by the general partner will be taxed upon receipt, at the effective capital gains tax rate of 18,67%. Conversely, where a carried interest arrangement is taxed in accordance with its legal substance, there will be no taxation of the right to carried interest acquired by the general partner at fund inception, while the distribution of carried interest received by the general partner will subject to normal tax upon receipt, at the higher tax rate of 28%.

4 The analysis of the appropriateness and adequacy of South African tax law in respect of private equity carried interest and recommendation for taxation reform

4.1 Introduction

In chapter 3, it was determined that in legal substance, a carried interest arrangement is a fee arrangement in which the general partner is remunerated for services rendered / to be rendered to the limited partners by acquiring the right to and receiving the distribution of carried interest. In the light of this **legal substance** of a carried interest arrangement, this chapter will analyse and determine how appropriate and adequate the existing South African law is in taxing carried interest.

The appropriateness of paragraph (*c*) and of section 9C, as discussed in chapter 3, in taxing carried interest, based on the legal substance of a carried interest arrangement, will first be determined. Thereafter, how adequate paragraph (*c*) and case law dealing with the interpretation and application of paragraph (*c*) [33], as discussed in chapter 3, are, for the purposes of taxing carried interest will be evaluated, based on the legal substance of a carried interest arrangement. In order to facilitate this evaluation, the common law remedies available to the Commissioner for the South African Revenue Service[34] to challenge the legal form of a carried interest arrangement in court so as to ensure that carried interest is taxed in terms of paragraph (*c*), will be examined.

The chapter will conclude by providing a recommendation for specific carried interest legislation where the law is found wanting.

[33] Hereafter referred to as 'paragraph (*c*) and case law'
[34] Hereafter referred to as 'the Commissioner'

4.2 Determining the appropriateness of paragraph (*c)* and section 9C in taxing carried interest

Overview

It is submitted that the criterion to determine the appropriateness of paragraph (*c*) and section 9C respectively, in taxing carried interest, is whether the application of each provision, respectively, enables the correct taxing result to be achieved, based on the **legal substance** of a carried interest distribution. As discussed previously, in legal substance, a carried interest distribution is a performance fee received by the general partner from the limited partners for services rendered by the former to the latter. In this regard, it is submitted that the correct taxing result for the distribution of carried interest is for the distribution to be subject to normal tax at the rate of 28%[35], as would apply to other forms of compensation received for services rendered.

Determining the appropriateness of section 9C in taxing carried interest

In this regard, as discussed previously, section 9C determines the tax consequences based on the **legal form** of the distribution of carried interest. To reiterate, in legal form, the distribution of carried interest represents the general partner's disproportionate share of the proceeds realised by the fund partnership upon disposal of a portfolio company. As previously noted, section 9C deems the full portfolio company realisation proceeds allocated to the general partner in terms of the fund partnership agreement, which include the distribution of carried interest, to be of a capital nature. Consequently, section 9C seeks to tax the distribution of carried interest as a **capital gain** in the hands of the general partner, in accordance with its **legal form**. This will result in the distribution being subject to capital gains tax at the effective capital gains tax rate of 18,67%.

[35] As previously noted, 28% is the tax rate applicable where the general partner is a company, assuming the structure – as depicted in Figure 1 of Chapter 2 – applies.

Accordingly, it is submitted that section 9C is inappropriate in taxing the distribution of carried interest as this provision seeks to tax the distribution of carried interest on capital account in accordance with its **legal form** and not in accordance with its legal substance. Thus, taxation of the distribution of carried interest in accordance with section 9C does not achieve the correct taxing result. That is, the distribution of carried interest is taxed as a capital gain at the lower effective capital gains tax rate of 18,67% rather than being subject to normal tax at the higher rate of 28%.

Determining the appropriateness of paragraph (*c*) in taxing carried interest

It is submitted that the distribution of carried interest is taxed appropriately in terms of paragraph (*c*). This is so, it is submitted, because paragraph (*c*) taxes the distribution of carried interest in accordance with its legal substance as a fee received from the limited partners. In this regard, paragraph (*c*) includes in the gross income of the general partner, as service based compensation, the distribution of carried interest, which is then subject to normal tax at the rate of 28% in the hands of the general partner. This will be the tax result, notwithstanding, as discussed above, that in legal form, the distribution of carried interest will be deemed to be of a capital nature in terms of section 9C. This is because paragraph (*c)* includes in gross income, inter alia, any amount received in respect of services rendered, irrespective of whether such amount is of a capital nature.

Thus, it is submitted, that paragraph (*c*) achieves the correct and appropriate taxing result for the distribution of carried interest, based on its legal substance. That is, taxation of the carried interest distribution as a fee received by the general partner from the limited partners, subject to normal tax at the rate of 28%.

4.3 Determining the adequacy of paragraph (*c*) and case law in taxing carried interest based on the legal substance of a carried interest arrangement

4.3.1 Establishing the criteria to determine the adequacy of paragraph (*c)* and case law for taxing carried interest based on the legal substance of a carried interest arrangement

It is submitted that how adequately paragraph (*c*) and case law taxes carried interest, based on the legal substance of a carried interest arrangement[36], may be assessed by benchmarking it against certain of the commonly accepted principles of a good tax system. It was Adam Smith who penned the maxims (or principles) of taxation in his book *The Wealth of Nations: Volume 2*, which have subsequently influenced tax policy design (Stiglingh et al, 2015: 1157).

In this regard, it is further submitted that the following principles of a good tax system, serve as appropriate criteria to assess the adequacy of paragraph (c) and case law in the taxation of carried interest, based on the legal substance of the arrangement:

- The certainty principle: The timing and amount of tax payments should be certain.
- The convenience principle: Taxes should be imposed in a manner or at a time that is convenient for taxpayers.
- The administrative efficiency principle: The tax system should be designed in such a manner as not to impose an unreasonable administrative burden on the taxpayer and the Revenue Authorities. (Stiglingh et al, 2015: 1157.)

[36] Hereafter referred to as 'the arrangement'

4.3.2 Determining the adequacy of paragraph (*c*) in taxing carried interest based on the legal substance of a carried interest arrangement

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Criterion: Does the existing law satisfy the certainty principle criterion

Certainty of timing of taxation

As regards the timing of the taxation of the right to carried interest, as was discussed in section 3.4.4 above, case law, in particular the *Mooi* case, clearly lays down the principle that when a right is acquired, the enforcement of which is subject to conditions, the right is contingent and no accrual thereof occurs until the condition is satisfied. Because of the carried interest conditions, it was determined in section 3.4.4, that the right to carried interest is such a contingent right, with the result that this right clearly does not accrue to the general partner at fund inception.

Consequently, in section 3.4.4, it was concluded that paragraph (*c*), does not apply to the taxation of the right to carried interest, acquired by the general partner at fund inception, because this right acquired does not constitute an **amount accrued** in respect of services rendered / to be rendered in terms of paragraph (*c*). As a result, as discussed in section 3.4.4, the general partner is not subject to taxation in respect of the right to carried interest, acquired at fund inception.

As regards the timing of the taxation of the distribution of carried interest, as discussed in section 3.4.5, the distribution of carried interest is taxed upon receipt by the general partner in terms of paragraph (*c*), being an amount received in respect of services rendered.

It may therefore be concluded that based on the legal substance of the arrangement, there is certainty as to the timing of the taxation of carried interest in terms of paragraph (*c*). This is because no taxation is levied in respect of the right to carried interest in terms of

paragraph (*c*), at fund inception, while the distribution of carried interest is taxed upon receipt thereof by the general partner, in terms of paragraph (*c)*.

Certainty as to amount of taxation

For the reasons discussed in the paragraphs above, paragraph (*c*) does not apply to the taxation of the right to carried interest, with the result that no tax is leviable in respect of this right acquired by the general partner at fund inception. Consequently, based on the legal substance of the arrangement, there is certainty as to the amount of tax leviable (that is, no tax is leviable) in respect of the acquisition of the right to carried interest, in terms of paragraph (*c*).

Furthermore, in terms of paragraph (*c*), based on the legal substance of the arrangement, as regards the taxation of the distribution of carried interest received, it is submitted that there is certainty as to the amount of tax leviable on the general partner. This is because the tax levied on the distribution of carried interest is calculated by applying a single rate of tax of 28% to a taxable amount which is a cash sum received by the general partner.

Criterion: Does the existing law satisfy the convenience principle criterion

Because paragraph (*c*) does not apply in taxing the general partner's right to carried interest at fund inception, the general partner is not placed in the inconvenient and inequitable position of having to fund a potentially large tax debt in a cashless transaction, that is, prior to having received the distribution of carried interest.

Moreover, because the general partner's right to carried interest is not taxed at fund inception, the general partner will not be placed in the inconvenient and inequitable position of:

- being taxed on the market value of the right to carried interest and then subsequently receiving, as a distribution of carried interest, an amount which is less than the aforementioned market value of the right to carried interest; or

- being taxed on the market value of the right to carried interest and then receiving no distribution of carried interest if the carried interest conditions are not satisfied.

The tax position described in the two bullet points immediately above would be especially problematic for the general partner given, that in such cases, it is submitted, there would be no mechanism in the Act:

- which would ensure that the amount ultimately taxed in the hands of the general partner would be the distribution of carried interest, in circumstances where this distribution was less than the value of the right to carried interest taxed at fund inception; or
- which would ensure that no amount is ultimately taxed in the hands of the general partner, where no distribution of carried interest was received by the general partner.

To conclude, when dealing with the legal substance of the arrangement, because the application of paragraph (*c*) results in the taxation of carried interest being levied such that the incidence of the taxation follows the cash flow, that is, the distribution of carried interest, taxation is imposed at a time that is convenient for the general partner to make payment thereof, which results in the general partner being taxed on an equitable basis. Thus, it is submitted, that taxation of carried interest in terms of paragraph (*c*), satisfies the convenience criterion.

Criterion: Does the existing law satisfy the administrative efficiency principle criterion

Given, as discussed above, that paragraph (*c*) does not apply in taxing the right to carried interest, at fund inception; the following administrative burdens do not arise when taxing carried interest in terms of paragraph (*c*):

- The Commissioner is relieved of the complex, time consuming and expensive task of valuing the right to carried interest at fund inception:

- before an assessment can be raised to tax the general partner on the estimated market value of the right to carried interest, should the general partner neglect to include the right to carried interest as an accrual in its tax return, or
- where the Commissioner disagrees with the value of the right to carried interest as determined by the general partner and reflected in its tax return.

- The taxpayer, that is, the general partner, is relieved of the onerous and expensive task of having to determine a market value for the right to carried interest at fund inception, to be included as an accrual in its tax return.

It may therefore be concluded that taxation of carried interest in terms of paragraph (*c*), based on the legal substance of the arrangement, satisfies the administrative efficiency principle criterion.

4.3.3 Conclusion: Determining the adequacy of paragraph (*c*) and case law in taxing carried interest based on the legal substance of a carried interest arrangement

It may be concluded that paragraph (*c*) and case law are adequate in taxing both the right to and the distribution of carried interest, **when applied to the legal substance** of the arrangement. This is because − as was established in section 4.3.2 − application of paragraph (*c*) and case law, based on the arrangement's **legal substance**, satisfies the following criteria: the certainty principle criterion; the convenience principle criterion and the administrative efficiency criterion.

4.4 Examination of the common law remedies for challenging the legal form of a carried interest arrangement

4.4.1 Overview

It is important to note that the conclusion reached, in 4.3.3, that paragraph (*c*) and case law, are adequate for the purposes of taxing carried interest was made on the basis that paragraph (*c*) **automatically applied** to the taxation of carried interest. That is, on the basis that effect would **automatically be given** to the legal substance of a carried interest arrangement rather than its legal form.

It is submitted, however, that where the Commissioner taxes the general partner on the distribution of carried interest in terms of paragraph (*c*) and the general partner objects to and appeals the assessment of the Commissioner, the Commissioner will need to resort to litigation in order for a court to confirm the assessment, thus ensuring that the distribution is indeed taxed in terms of paragraph (*c*). More particularly, a court, in confirming the Commissioner's assessment, will need to be satisfied that in legal substance, a carried interest arrangement constitutes a fee arrangement between the general partner and the limited partners, and that this legal substance differs from the legal form of the carried interest arrangement.

Only then, it is submitted, will a court overrule the legal form and give effect to the legal substance of the carried interest arrangement and its associated paragraph (c) tax consequences. In this regard, the Commissioner has two 'substance over form' common law remedies available to it, to tax carried interest based on the legal substance of a carried interest arrangement. These remedies, namely: the 'simulation test' and 'the label test' are discussed hereunder.

4.4.2 The simulation test

What is the simulation test?

The simulation test seeks to determine whether the transaction under scrutiny is a sham or simulated transaction: one whose true nature the parties deliberately conceal. Such a transaction is a dishonest one and the courts will give effect to it by analysing the true intention of the parties, rending aside its disguise and assessing the transaction accordingly. (Surtees and Millard, 2004: 15.) More precisely, the court will determine the nature of the real transaction and will attach the tax consequences to it (De Koker and Williams, 2015: para 24.51).

It is submitted that successful application of the simulation test to a carried interest arrangement, requires that a court be satisfied that the legal form of the carried interest arrangement is a deliberate disguise by the general partner and limited partners in order to conceal the true nature of their transaction. The court will then give effect to the real transaction between the parties, and will implement the tax consequences that flow from the real transaction.

Consequently, if the Commissioner is able successfully to apply the simulation test to a carried interest arrangement, it is submitted that the court will give effect to the true transaction between the general partner and the limited partners, that is, the legal substance of the arrangement, which is a fee arrangement, and will overrule the simulated legal form of the transaction. Therefore, the court will confirm the assessment of the Commissioner, in terms of which the Commissioner taxed the general partner on the distribution of carried interest received in terms of paragraph (*c*).

What are the criteria for determining whether a particular transaction is simulated?

It was held in *Zandberg v Van Zyl* 1910 AD 302 (at 309) that the criterion for simulation is whether the parties to the agreement in question intended that it was to have 'effect according to its tenor' and that if they did so intend, then the agreement was not 'simulated' or 'disguised'. Moreover, when faced with an alleged simulated transaction, it was stated (at 309) that :

> ' The Court must be satisfied that there is a real intention, definitely ascertainable, which differs from the simulated intention.'

In *Commissioner of Customs and Excise v Randles Brothers and Hudson Ltd* 1941 AD 369, it was held (at 395 -396) that a disguised transaction:

> ' … is a dishonest transaction: dishonest in as much as the parties to it do not really intend it to have inter partes, the legal effect which its terms convey to the outside world. The parties wish to hide the fact that their agreement or transaction falls within the prohibition or is subject to the tax, and so they dress it up in a guise which conveys the impression that it is outside the prohibition or not subject to the tax. Such a transaction is said to be in fraudem legis, and is interpreted by the Courts in accordance with what is found to be the real agreement or transaction between the parties. Of course before the Court can find that a transaction is in fraudem legis in the above sense, it must be satisfied that there is some unexpressed agreement or tacit understanding between the parties.'

In *Erf 3183/1, Ladysmith (Pty) Ltd and Another v CIR* 1996 (3) SA 942 (A), 58 SATC 229, ('the *Ladysmith* case'), counsel for the appellant had argued that the parties in question had actually intended the agreements to have effect according to their tenor and this was the end of the matter, since effect must be given to the agreements as intended (Hutchison and Hutchison, 2014: 76).

The Judge of Appeal disagreed, holding (at 953B-C) that:

> 'This is plainly not so. That the parties did indeed cast their arrangement in the form mentioned, must of course be accepted; that after all, is what they had been advised to do. The real question is, however, whether they actually intended that each agreement would inter partes have effect according to its tenor. If not, effect must be given to what the transaction really is.'

In the *Ladysmith case*, Hefer JA reached the conclusion (at 956E-F) that the provisions of the contracts 'bore the stamp of simulation' and that a purpose of concealing what the parties truly intended could be inferred. Consequently, it was held (at 956F-G) that the appellants had not escaped liability for tax. According to Hutchison and Hutchison (2014: 77), in the *Ladysmith* case, although the motive or purpose of avoiding tax was permissible, the transaction by which it was effected was not genuine since there was no true intention in actual fact to create the rights its provisions purported to create.

Much confusion was, however, created as to the criteria for determining a simulated transaction in the Supreme Court of Appeal case of *C:SARS v NWK Ltd* 2011 (2) SA 67 (SCA),73 SATC 55 (the *NWK* case) where Lewis AJ apparently broadened the scope of the test for simulation in holding (at 55) that:

> '… the test to determine simulation cannot simply be whether there is an intention to give effect to a contract in accordance with its terms. … The test should thus go further and require an examination of the commercial sense of the transaction: of its real substance and purpose. **If the purpose of the transaction is only to achieve an object that allows the evasion of a peremptory law, then it will be regarded as simulated.**' (Emphasis Added)

Many commentators were critical of the judgment in the NWK case, arguing that in allowing the tax purpose of a contractual arrangement to trump the true intention of the parties, the court had gone well beyond the well established doctrine of substance over form, and had in fact created new law (Daniels, 2013: 14).

The fog of confusion that had prevailed in regard to what constitutes a simulated transaction, since the decision in the NWK case was subsequently cleared by the decision of the Supreme Court of Appeal in *Roshcon (Pty) Ltd v Anchor Auto Body Builders CC and others* 2014 All SA 654 (SCA) (the *Roshcon* case). The significance of Wallis JA's judgment in the *Roshcon* case was, firstly, that he rejected the proposition that the Supreme Court of Appeal in the *NWK* case had taken the law in a 'new direction', and secondly, that he affirmed the traditional view that the essence of a simulated transaction is that it involves a *disguise* (Williams and Wilson, 2014: 3).

In this regard, Wallis JA held (at para 22 – 36) that the reasoning of Lewis AJ in the *NWK* case cannot be read in isolation and should be read with reference to the entire judgment and the particular facts of that case. Furthermore, the fundamental principles laid down in previous cases, that there be an element of dishonesty or an intention to disguise the true nature of an agreement, in order for simulation to be present, remain undisturbed. In the light of this, Wallis JA concluded (at para 37) that:

> ' … the notion that NWK transforms our law in relation to simulated transactions, or requires more of a court faced with a contention that a transaction is simulated than a careful analysis of all matters surrounding the transaction, including its commercial purpose, if any, is incorrect. The position remains that the court examines the transaction as a whole, including all surrounding circumstances, any unusual features of the transaction and the manner in which the parties intend to implement it, before determining in any particular case whether a transaction is simulated'

Application of the simulation test to a carried interest arrangement

Based on the dicta of leading tax cases, as discussed above, dealing with the criteria for determining simulation, it is submitted that for the Commissioner successfully to apply the simulation test to a carried interest arrangement, a court would need to be satisfied that the general partner and the limited partners[37] did not truly intend that the terms of the fund partnership agreement, pertaining to carried interest, be given effect to according to their tenor.

More particularly, it is submitted that the court would need to be satisfied that the parties did not intend the distribution of carried interest to be a disproportionate partnership profit share received by the general partner. Differently put, it is submitted, that the court would need to be satisfied that the real intention of the parties in entering into the carried interest arrangement, which was purposely disguised by the parties, was for the general partner to

[37] Hereafter referred to as 'the parties'

receive the distribution of carried interest as a fee paid to it by the limited partners for services rendered to them.

It is clear from the paragraphs above that a faked (that is, a dishonest or fraudulent) intention is required to label a transaction a simulated transaction. In this regard, because the taxpayer, that is, the general partner, would be contesting the assessment of the Commissioner, the onus of proof[38] that its intention is not faked and that the transaction is not simulated, would rest with the general partner in terms of section 102 of the Tax Administration Act 28 of 2011[39] (Hutchison and Hutchison, 2014: 76).

In order to discharge this onus, it is submitted that the general partner would need to satisfy a court that the parties had genuinely intended that the fund partnership agreement, in so far as it dealt with carried interest, was to be given effect to in accordance with its tenor. It is further submitted that a court would be so satisfied, and the onus discharged, by the general partner simply providing evidence to the court that the parties to the carried interest arrangement, carried out their respective obligations and enforced their respective rights in accordance with the relevant contractual terms governing carried interest in the fund partnership agreement.

With the general partner having discharged this onus, it is further submitted that the onus of proving that the parties did not genuinely intend that the fund partnership agreement, in so far as it dealt with carried interest, was to be given effect to, in accordance with its terms, would then shift to the party alleging the simulation, that is the Commissioner. In this regard, it is submitted that the Commissioner would have considerable difficulty in successfully applying the simulation test to a carried interest arrangement. This is because the general partner, as discussed in the paragraph above, would already have satisfied the court, that the intention of the parties to the carried interest arrangement was genuine and

[38] Hereafter referred to as ' the onus'
[39] Hereafter referred to as 'the Tax Administration Act'

that each party actually intended that the fund partnership agreement, in so far as carried interest was concerned, would, inter partes, have effect according to its tenor.

4.4.3 The label test

What is the label test?

This refers to the situation where bona fide transactions must nevertheless still be construed in accordance with their legal substance, rather than their legal form, where parties have mistakenly applied the wrong label to their transaction. Unlike a simulated transaction, no dishonesty attaches to such a transaction, but the courts will nevertheless analyse its legal substance in applying the correct label to the transaction. (Hutchison and Hutchison, 2014: 70 and Surtees and Millard, 2004: 15.). Consequently, the court will enforce the tax consequences based on the correct label applied to the transaction (Brincker and De Koker, 2010: para 46.7).

In this regard, in ITC 1833 70 SATC 238, it was stated (at 249) that:

'The law on the subject of simulated transactions also includes the principle that notwithstanding that the parties may honestly intend to enter, and may bona fide think that they are entering into a contract of a particular nature and in no way are fraudulent or have an improper claim and the agreement is not designedly disguised, the court may nonetheless, on an analysis of the relevant facts conclude that in fact the agreement is not what it purports to be but that there is some other agreement.'

Moreover, in Tucker v Ginsberg 1962 (2) ALL SA 31 (W), it was stated (at 36) that:

'As each party has given the transaction a different label, I think that it is appropriate to add here that the label used is not decisive. Despite the label, the Court must look at the nature of the transaction, and in ascertaining its nature the Court must have regard mainly to its substance and not merely its form.'

Application of the label test to a carried interest arrangement

It is submitted that in order for the Commissioner successfully to apply the label test to a carried interest arrangement, a court will need to be satisfied that:

- The parties to the arrangement have mistakenly characterised / labelled the distribution of carried interest, in accordance with its legal form, as the **allocation to the general partner of a disproportionate share of gains** made by the fund partnership upon disposal of a portfolio company.
- In legal substance, the distribution of carried interest is a fee received by the general partner from the limited partners for **services rendered** by the former to the latter.

In other words, the court will need to be satisfied that the label attached to the carried interest arrangement, based on its legal form, is incorrect, because the legal substance of the arrangement strongly suggests that the carried interest arrangement is more appropriately characterised as a fee arrangement between the general partner and the limited partners.

It is submitted that the Commissioner will have strong grounds for arguing that in legal substance, a carried interest arrangement is a fee arrangement between the general partner and the limited partners, and that its characterisation, in terms of its legal form, as a partnership profit sharing arrangement is incorrect. This is because the Commissioner will, it is submitted, be able to raise a number of the cogent arguments supporting carried interest as service related compensation, which arguments were analysed in section 3.3.2 above; the most pertinent of which, are, to reiterate:

- That the general partner does not receive the carried interest in return for any corresponding capital contribution; instead, the carried interest is based solely on the general partner's performance (Dauds, 2007: 11).
- That the motive for the limited partners granting the general partner the right to and thereafter transferring to the general partner, such a significant portion of the fund's

realisation profits as carried interest, must surely be as a reward for the latter's performance, that is, for services rendered (Dauds, 2007: 11). Differently put why else, it is submitted, would the limited partners, who are dealing with the general partner at arm's length, in a commercial transaction, forgo such a material share of fund realisation profits that they are otherwise entitled to, based on their significant capital contributions, if not to remunerate the general partner for services rendered.

- That the limited partners waive a portion of their profits to incentivise the general partner to work actively to create value in the private equity fund (Bergkvist et al, 2014: 143). It follows that the carried interest actually represents compensation for services rendered by the general partner, more particularly performance fees earned (Dauds, 2007: 11 and Horak, 2007: 5).

- The description of carried interest in the glossary to the KPMG and SAVCA *Venture Capital and Private Equity Industry Performance Survey of South Africa covering the 2014 calendar year*, where it is described as:

  '… a **fee enhancement** for a **private equity fund manager** for achieving a benchmark return or hurdle rate.' (Emphasis Added)

Moreover, in section 3.3.3, the arguments advanced by various commentators and industry players as to why carried interest is not service related compensation of the general partner were discussed and analysed. To reiterate, these parties argued that carried interest is not remuneration of the general partner for services rendered to the limited partners because:

- it represents an enhanced **investment** reward / return to compensate the general partner for the higher risk to which its co-investment in the fund is exposed compared to that of the limited partners' investments in the fund;
- it represents the reward of the general partner for assuming the additional risk of unlimited liability to third parties for the debts of the fund, and
- the services provided to the limited partners of the fund are performed not by the general partner, but rather by the key executives of the private equity management compan (refer PE ManCo in Figure 1 of chapter 2), which company is fully

remunerated for such services on an arm's length basis by charging a management fee which is fully taxable

It will be recalled that, upon examination, in section 3.3.3, none of these arguments held up to scrutiny, which, it is submitted, lends further support to the Commissioner's contention that, in legal substance, the distribution of carried interest, represents service related compensation of the general partner. Because the general partner will be contesting the assessment of the Commissioner, and in accordance with section 102 of the Tax Administration Act, it is further submitted that the onus of proof that the Commissioner's assessment is incorrect will rest with the taxpayer, that is, the general partner.

It may therefore be concluded that the Commissioner will likely succeed in applying the label test to a carried interest arrangement. That is to say, a court will likely find in favour of the Commissioner and hold that the parties to the carried interest arrangement have mistakenly characterised the distribution of carried interest in accordance with its legal form as a partnership profit sharing arrangement, and that the distribution must be characterised based on its legal substance as a fee arrangement.

Consequently, it is submitted, that a court will overrule the legal form of the carried interest arrangement and give effect to the legal substance thereof such that the correct label / categorisation of the arrangement as a fee arrangement between the general partner and the limited partners will be applied with its attendant tax implications. Thus, the court will confirm the Commissioner's assessment, in terms of which, the distribution of carried interest, received by the general partner, is taxed in terms of paragraph (*c*).

4.4 Conclusion: Analysis of the appropriateness and adequacy of the taxation of carried interest

Appropriateness of the taxation of carried interest

It maybe concluded that paragraph (*c*) is an appropriate taxing provision for carried interest as it achieves the correct taxing result based on the legal substance of a carried interest arrangement. That is, paragraph (*c*) taxes the distribution of carried interest, in accordance with its legal substance, as service related compensation of the general partner, which is subject to normal tax at the rate of 28%.

Furthermore, it may be concluded that section 9C is an inappropriate taxing provision for carried interest as it applies to deem the distribution of carried interest received by the general partner to be proceeds of a capital nature based on the legal form, rather than the legal substance of a carried interest arrangement. Consequently, section 9C does not achieve the correct taxing result based on the legal substance of a carried interest arrangement.

Adequacy of the taxation of carried interest

It is submitted that paragraph (*c*) and associated case law are inadequate in taxing carried interest. Although, as was discussed in section 4.3.3, paragraph (*c*) and case law were found to be adequate in the taxation of carried interest, based on the **legal substance** of a carried interest arrangement, crucially, as was explained in section 4.4.1, the legal substance of a carried interest arrangement **does not automatically prevail** over its legal form.

This has the important consequence that paragraph (*c*) does **not automatically apply** to the taxation of carried interest. Instead, in circumstances where the general partner objects against and appeals the Commissioner's assessment, the Commissioner will be forced to litigate the matter in order for a court to confirm its assessment, thus ensuring that carried interest is taxed appropriately, in accordance with paragraph (*c*). More precisely, a court

will overrule the legal form of a carried interest arrangement where the Commissioner successfully applies the simulation test or the label test. In this regard, it was discussed in section 4.4.2, that the Commissioner will likely have considerable difficulty in successfully applying the simulation test to a carried interest arrangement, while in section 4.4.3, it was submitted that the Commissioner will likely succeed in applying the label test to a carried interest arrangement.

In conclusion, it is submitted that paragraph (c) and case law are inadequate in taxing carried interest because paragraph (c) and case law **do not apply** in taxing carried interest based on the **legal form** of a carried interest arrangement. Consequently, in order for the Commissioner to ensure that carried interest is taxed appropriately in terms of paragraph (c), where the general partner objects against and appeals the Commissioner's assessment, the Commissioner requires a **court to confirm its assessment** by overruling the legal form of a carried interest arrangement, which is **costly both in terms of time and money.** Moreover, even though, as discussed in section 4.4.3, it appears likely that the Commissioner will succeed in applying the label test to a carried interest arrangement, it is submitted, that any matter subject to litigation has some degree of uncertainty attached to it. Consequently, it is submitted that in instances where the general partner objects and appeals against its assessment, the Commissioner will never have absolute assurance of a favourable outcome, that is, that its assessment will be confirmed by a court.

4.5 Recommendation for reform of the taxation of carried interest

Overview

In section 4.4 it was concluded that paragraph (*c*) is **appropriate** as regards the taxation of carried interest, given that application of this paragraph (*c*), results in the distribution of carried interest being subject to normal tax at a rate of 28%, in accordance with its legal substance as a fee received. It was established, however, that paragraph (*c*) is **inadequate** for the purposes of taxing carried interest because expensive and time consuming litigation is necessary in order for the Commissioner to ensure its application when taxing carried

interest where the general partner objects and appeals against the Commissioner's assessment. It follows, therefore, that new legislation is required that would tax carried interest appropriately, that is, based on its legal substance, but **without having to resort to the courts to ensure its application**, as is currently the position with paragraph (*c*), where the general partner objects to and appeals the Commissioner's assessment.

Recommendation for new legislation

It is recommended that a new provision be inserted after section 8C, namely section 8D that, broadly stated, includes in the income of the general partner of a private equity fund, the distribution of carried interest received, which would then be subject to normal tax at the rate of 28% (assuming the general partner is a company).

More particularly it is recommended that:

- Section 8D apply to the general partner of a 'private equity fund', organised as an en commandite partnership, of which the general partner serves as the 'fund manager'.
- Both 'private equity fund' and 'fund manager' be defined terms in section 8D. In this regard, 'fund manager' could be defined with reference to a non–exhaustive list of typical functions, duties and responsibilities performed by the general partner of a private equity fund.
- In terms of section 8D, all amounts allocated to and received by the general partner, in terms of the fund partnership agreement, in respect of an interest held by the general partner in qualifying shares of the fund partnership, be **included in the income of the general partner**,

EXCEPT FOR:

so much of the amount allocated to and received by the general partner in respect of its interest in qualifying shares of the fund partnership which:

a) represents the return of capital contributed by the general partner to the fund, which capital was used to acquire the general partner's interest in the qualifying shares;

b) provides the general partner with a pre-determined rate of return on capital invested by it in the fund partnership (that is, the hurdle rate of return), as specified in the fund partnership agreement; and

c) provides the general partner with a share of proceeds from the disposal of qualifying shares which is proportionate to the capital contributed to the fund by the general partner.[40]

It is submitted that section 8D would be an appropriate taxing provision for carried interest as it would achieve the same taxing result for carried interest, as paragraph (*c*) currently does, based on the legal substance of a carried interest arrangement. This is because in terms of section 8D, the portfolio company realisation proceeds[41] received by the general partner which would be included in its income, would be the distribution of carried interest, which would then be subject to normal tax at the rate of 28%. Furthermore, in terms of section 8D, the realisation proceeds received, which do not constitute the distribution of carried interest, comprised of the sum of the items described in points a) – c) above; namely, the return of fund capital, the hurdle return, and the proportionate proceeds, would be excluded from the application of section 8D. Accordingly, these realisation proceeds would be deemed to be of a capital nature in terms of section 9C(2) and would be subject to capital gains tax, as explained in section 3.5 above.

Moreover, it is submitted that section 8D would also be an **adequate** provision for the purposes of taxing carried interest. This is because section 8D would **implicitly** recognise

[40] Hereafter referred to as 'the proportionate proceeds'
[41] Hereafter referred to as 'realisation proceeds'

the receipt by the general partner, of the distribution of carried interest, as being a fee received by the general partner for services rendered to the limited partners, which fee would automatically be included in the income of the general partner, and would therefore be subject to normal tax at the rate of 28%. Thus, by not explicitly requiring any link to exist between the receipt of the carried interest distribution and the services rendered by the general partner, as is required for paragraph (*c*) to apply, it is submitted that section 8D would apply directly in taxing carried interest in accordance with the legal substance of a carried interest arrangement, notwithstanding its legal form. Accordingly, if section 8D were to be included in the Act, it is submitted that the Commissioner would not need to resort to expensive and time consuming litigation to ensure that carried interest is taxed appropriately, in accordance with its legal substance, as is currently the case with paragraph (*c*), in instances where the general partner objects to and appeals the Commissioner's assessment.

4.6 Conclusion

In this chapter, the appropriateness and adequacy of the existing law as regards the taxation of carried interest was evaluated and a recommendation for reform of the law was made where the law was found wanting.

It was concluded that paragraph (*c*) is appropriate for the purposes of taxing carried interest. This is because it achieves the correct taxing result based on the legal substance of a carried interest arrangement. That is, paragraph (*c*) taxes the distribution of carried interest, in accordance with its legal substance, as service related compensation of the general partner, subject to normal tax at the rate of 28%. In contrast to paragraph (*c*), it was concluded that section 9C is an inappropriate provision for the purposes of taxing carried interest as it applies to deem the distribution of carried interest to be proceeds of a capital nature based on its legal form, and does not tax the distribution based on its legal substance.

It was discussed that, prima facie, paragraph (*c*) and related case law appear adequate in taxing carried interest based on its legal substance, this being a fee arrangement between the general partner and the limited partners. In this regard it was, however, noted that the legal substance of a carried interest arrangement does not automatically prevail over its legal form. For this reason, it was explained, that in order to ensure that carried interest is taxed appropriately, in terms of paragraph (*c*), where the general partner objects against and appeals the assessment of the Commissioner, the Commissioner will require a **court** to confirm its assessment by overruling the legal form of a carried interest arrangement and giving effect to its legal substance and related paragraph (*c*) tax effects.

In this respect, it was further explained, that for a court to overrule the legal form of a carried interest arrangement, the Commissioner would need to apply:

- The simulation test successfully. That is, the court would need to be satisfied that the legal form of the carried interest arrangement was a deliberate disguise by the general partner and limited partners, in order to conceal the true nature of their transaction. It was concluded that the Commissioner would likely have significant difficulty in successfully applying this test.
- The label test successfully. That is, the court would need to be satisfied that characterisation of a carried interest arrangement according to its legal form, as a partnership profit sharing arrangement, was incorrect, because its legal form differed from its legal substance, this being a fee arrangement between the general partner and the limited partners. It was concluded that the Commissioner would likely succeed in applying this test.

It was concluded that paragraph (*c*) and case law are inadequate for the purposes of taxing carried interest as paragraph (*c*) and case law **do not apply to the taxation of carried interest based on the legal form** of a carried interest arrangement. Thus, the Commissioner, in order to ensure that carried interest is taxed appropriately, in terms of

paragraph (*c*), where the general partner objects against and appeals the Commissioner's assessment, will be required to resort **to expensive and time consuming litigation** in order for a court to confirm its assessment, by overruling the legal form of a carried interest arrangement, and giving effect to its legal substance and attendant paragraph (*c*) tax implications.

Because paragraph (*c*) was identified as inadequate in the taxation of carried interest, it was recommended that a new provision, section 8D, be inserted into the Act to cater specifically for the taxation of carried interest. More particularly, it was recommended that section 8D include in the income of the general partner of a private equity fund, the distribution of carried interest received, **without** any requirement that there be a link between the distribution received and services rendered, as is the case for paragraph (*c*) to apply to the taxation of the distribution. It was explained that this would enable the distribution of carried interest, received by the general partner, to be taxed automatically in terms of section 8D, in accordance with its legal substance, as a fee received, notwithstanding the legal form of the carried interest arrangement. In this way, the Commissioner would not need to resort to costly and time consuming litigation to ensure that carried interest is taxed appropriately, in accordance with its legal substance, as is currently the case with paragraph (*c*), in instances where the general partner objects and appeals the Commissioner's assessment.

5 Conclusion

In Chapter 2, the report analysed what carried interest is, how carried interest arises and how carried interest arrangements operate in South Africa. Based on discussions with several persons active in the South African private equity industry, a review of a private equity fund partnership agreement and a private equity structure memorandum obtained from a large South African commercial law firm, it was found that private equity funds in South Africa most often take the form of an en commandite partnership, which partnership acquires investments in various portfolio companies. Furthermore, there are two types of investor in South African private equity funds, each with very different economic roles; namely:

- The limited partners which − as per Figure 1 of chapter 2 − contribute most (ordinarily 98% - 99%) of the fund's capital (Dauds, 2008: 10-11). The liability of these limited partners for debts of the fund is capped at their capital contributions, provided that they remain passive investors and their identities are not disclosed (SAVCA, 2015: 39).
- The general partner, a company, which serves as the fund manager, and which contributes significantly less capital, typically only 1% - 2%, (refer Figure 1 of Chapter 2) to the fund (Missankov et al, 2006: 16 and Dauds, 2008: 10-11). In sharp contrast to the limited partners, the general partner is the disclosed partner, and therefore bears unlimited liability risk in respect of fund debts (SAVCA, 2015: 39). Additionally, unlike the limited partners, the general partner takes an active role in managing the fund and is typically responsible for the identification, evaluation and negotiation of investment opportunities and the monitoring and realisation of those investments for the fund (Dauds, 2008: 10). Notably, based on discussions with various private equity fund managers as well as tax practitioners that deal extensively with private equity transactions, most often, no fee is paid to the general partner for any fund management services performed.

Additionally, it was found that a typical private equity carried interest arrangement in South Africa operates on the basis that the general partner receives, as the distribution of carried interest, a disproportionate share of the proceeds that arise on disposal by the fund of a portfolio company (typically 20%), despite having contributed only 1% - 2% of the fund's capital, provided certain performance conditions have been met (Dauds, 2008: 10-11 and Missankov et al, 2006: 24-25).

Chapter 3 discussed and scrutinised the relevant provisions in the Act and related case law that would likely apply to taxing both the right to carried interest, acquired by the general partner at fund inception, and the distribution of carried interest, received by the general partner.

It was found that the legal form and associated tax implications of a carried interest arrangement differ from the arrangement's legal substance and related tax implications.

As regards the nature of the right to carried interest and the taxation thereof, it was found that:

- In legal form, the right to carried interest is the right of the general partner to share disproportionately, relative to its capital contributed to the fund, in fund partnership profits. Further, typically there is no link in the fund partnership agreement between the acquisition of this right and the fund management services that are required to be performed by the general partner, as per the fund partnership agreement.

  Based on its legal form, it was established that the right to carried interest is of a capital nature; being the right to future partnership profits, where the general partner is neither a dealer in carried interest rights, nor is the right acquired by the general partner in respect of services rendered / to be rendered by the general partner to the limited partners. As a result, no tax liability arises in respect of the acquisition of the right because the general partner acquires, at fund inception, a right of a capital nature which constitutes neither gross income of the general

partner, nor a disposal event for capital gains tax purposes as per the Eighth Schedule.

- In legal substance, the right to carried interest is a reward acquired by the general partner, at fund inception, from the limited partners for services to be rendered by the former to the latter. It was established that because of the carried interest conditions, namely; the requirement to return to all fund investors their initial capital contributed to the fund and to achieve for all fund investors the hurdle rate of return on investment, before the distribution of carried interest is received, the general partner is not unconditionally entitled to the right at fund inception.

  Therefore, the right to carried interest does not accrue to the general partner at fund inception. This means that paragraph (*c*) does not apply to the taxation of this right, as the right acquired does not constitute an amount accrued in respect of services rendered / to be rendered as contemplated by paragraph (*c*). Consequently, it was determined that no tax liability arises in respect of the acquisition by the general partner, at fund inception, of the right to carried interest. This is because there is no accrual of an amount to the general partner; thus no amount falls to be included in the general partner's gross income, which would then be subject to tax.

With respect to the nature of the distribution of carried interest and the taxation thereof, it was found that:

- In legal form, the distribution of carried interest is the receipt by the general partner, subject to certain conditions being met, of a disproportionate share of portfolio company realisation proceeds, received in its capacity as partner. As with the right to carried interest, typically there is no link in the fund partnership agreement between the distribution received and the fund management services to be performed by the general partner, in terms of the fund partnership agreement. Consequently, paragraph (*c*), which includes in gross income, inter alia, any

amount received in respect of services rendered, does not apply to the taxation of the distribution, based on its legal form.

Furthermore, in terms of section 9C(2), amounts received by a taxpayer in respect of the disposal of equity shares, held for a continuous period of at least three years, are deemed to be of a capital nature. Because the investments of private equity funds tend to be held for 5 to 8 years before being disposed (Financial Mail, 2014: 50), it was established that proceeds received on disposal of a portfolio company shareholding by a fund partnership, will, almost invariably, be deemed to be of a capital nature in terms of section 9C(2).

In this regard, based on the legal form of a carried interest arrangement, it was further determined that section 9C(2) read with paragraph 36 of Eighth schedule will apply in deeming the **full portfolio company realisation proceeds**, allocated to the general partner in terms of the fund partnership agreement, to be of a capital nature. This is because such realisation proceeds are an amount received by the general partner in respect of its interest in the qualifying shares in a portfolio company, held by the tax transparent fund partnership[42]. Furthermore, it was established that in terms of paragraph 20, the base cost of the general partner's interest in the qualifying portfolio company shares, is the capital contributed by the general partner to the fund, which capital was used to acquire the general partner's interest in these qualifying shares.

As a result, it was found, in section 3.2.3, that the general partner is subject to capital gains tax at the effective capital gains tax rate of 18,67%, on a capital gain determined as the difference between the portfolio company realisation proceeds received and the paragraph 20 base cost, of the general partner's interest in the qualifying portfolio company shares. Notably, it was also found that because the

[42] Hereafter referred to as 'the general partner's interest in the qualifying portfolio company shares'

distribution of carried interest is included in the portfolio company realisation proceeds received by the general partner, the distribution is included in the gain that is subject to capital gains tax at the effective capital gains tax rate of **18,67%**. The tax implications of the distribution of carried interest, based on its legal form, are shown in Illustrative example 2 in section 3.2.3.

- In legal substance, the distribution of carried interest is the receipt by the general partner of a fee from the limited partners for fund management services rendered by the former to the latter as well as for the service rendered to the limited partners of undertaking to accept third party unlimited liability risk for the debts of the partnership. It was found that paragraph (*c*) applies to the taxation of the distribution of carried interest received by the general partner; the distribution being an amount received in respect of services rendered, in terms of paragraph (*c*), by the general partner to the limited partners. Further, it was established that paragraph (*c*), overrides section 9C in taxing the distribution of carried interest because paragraph (*c*) includes in gross income amounts that are of a capital nature.

  Consequently, it was found in section 3.2.5 that upon receipt of the portfolio company realisation proceeds by the general partner, the portion that comprises the distribution of carried interest will be included in the gross income of the general partner in terms of paragraph (*c*) and will be subject to normal tax at the rate of 28%. The tax implications of the distribution of carried interest, based on its legal substance, are shown in Illustrative example 3 in section 3.2.5.

The chapter concluded that where a carried interest arrangement is taxed in accordance with its legal form, there will be no taxation of the right to carried interest acquired, this being the acquisition of a right of a capital nature to which paragraph (*c*) does not apply, while the distribution of carried interest received will, in terms of section 9C(2), be deemed to be proceeds of a capital nature and will be taxed upon receipt, in the hands of the general partner, at the effective capital gains tax rate of 18,67%.

Alternatively, where a carried interest arrangement is taxed in accordance with its legal substance, there will be no taxation of the right to carried interest acquired as there is no accrual of an amount in respect of this right acquired while the distribution of carried interest received will be included in the gross income of the general partner upon receipt in terms of paragraph (*c*) and will then be subject to normal tax at the higher tax rate of 28% in the hands of the general partner.

Chapter 4 evaluated the appropriateness and adequacy of the existing taxing provisions in the Act and relevant case law principles for the purposes of taxing carried interest and made a recommendation for reform where the law was found wanting.

It was found that paragraph (*c*) is appropriate for the purposes of taxing carried interest because it achieves the correct taxing result based on the legal substance of a carried interest arrangement. That is, paragraph (*c*) taxes the distribution of carried interest, in accordance with its legal substance, as a fee received by the general partner, which is then subject to normal tax at the rate of 28% as is the case with any other form of compensation for services rendered. In contrast to paragraph (*c*), it was found that section 9C is an inappropriate taxing provision for carried interest since it applies to deem the distribution of carried interest to be proceeds of a capital nature based on its legal form, and fails to tax the distribution based on its legal substance.

It was also found that the Commissioner, in order to ensure that the distribution of carried interest is taxed in terms of paragraph (*c*) and thus appropriately, in the event that the general partner objects against and appeals the Commissioner's assessment, will require a court to confirm its assessment, by overruling the legal form of a carried interest arrangement, and giving effect to its legal substance and related paragraph (*c*) tax effects. It was established that for a court to overrule the legal form of a carried interest arrangement, the Commissioner will need to apply either of the following tests successfully:

- The simulation test. That is, the court will need to be satisfied that the legal form of the carried interest arrangement is a deliberate disguise by the general partner and limited partners, in order to conceal the true nature of their transaction. It was determined that the Commissioner will likely have significant difficulty in successfully applying this test.
- The label test. That is, the court will need to be satisfied that characterisation of a carried interest arrangement according to its legal form, as a partnership profit-sharing arrangement, is incorrect, because its legal form differs from its legal substance, this being a fee arrangement between the general partner and the limited partners.

It was found, that paragraph (*c*) is **inadequate** for the purposes of taxing carried interest because paragraph (*c*) cannot be applied to the taxation of carried interest based on the **legal form** of a carried interest arrangement. This implies that in instances where the Commissioner's assessment is objected to and appealed by the general partner, the Commissioner, to ensure that carried interest is taxed appropriately in terms of paragraph (*c*), is required to **resort to costly and time consuming litigation** in order for a court to confirm its assessment, by overruling the legal form of a carried interest arrangement and giving effect to its legal substance and associated paragraph (*c*) tax consequences.

Because paragraph (*c*) was found to be inadequate for the purposes of taxing carried interest, it was recommended that a new provision, section 8D be inserted into the Act to cater specifically for the taxation of carried interest. It was recommended that section 8D include in the income of the general partner of a private equity fund, the distribution of carried interest received, **without** any requirement that there be a link between the distribution of carried interest received and services rendered, as is the case for paragraph (*c*) to apply. It was explained that this would enable the distribution of carried interest received by the general partner to be taxed appropriately, in accordance with its legal substance as a fee received, subject to normal tax at the rate of 28%, notwithstanding the legal form of a carried interest arrangement. Consequently, the Commissioner would **not have to resort to expensive and time consuming litigation**, in order to ensure that carried interest was taxed appropriately, in accordance with its legal substance, as is

currently the case with paragraph (*c*) in circumstances where the general partner objects to and appeals the Commissioner's assessment.

In conclusion:

- The law is **appropriate** for the purposes of taxing carried interest in South Africa because paragraph (*c*) taxes the distribution of carried interest in accordance with its legal substance, as a fee received for services rendered, which amount is included in the gross income of the general partner. This means that the correct taxing result is obtained because the fee received is then subject to normal tax at the rate of 28% as is the case with any other type of remuneration for services rendered.
- The law is, however, **inadequate** for the purposes of taxing carried interest in South Africa because paragraph (*c*) and case law do not apply to the taxation of carried interest based on the legal form of a carried interest arrangement, where in legal form, both the right to carried interest and the distribution of carried interest are not acquired / received as remuneration for services rendered. As a result, in instances where the general partner objects to and appeals the Commissioner's assessment, the Commissioner is then required to litigate the matter, which is both costly and time consuming, in order for a court to confirm its assessment, which confirmation involves the court overruling the legal form of the carried interest arrangement and giving effect to the legal substance of the arrangement and its associated paragraph (*c*) tax implications.
- A recommendation has therefore been made to insert a new section 8D into the Act which, it is submitted, would address the inadequacy of existing law in taxing carried interest. This is because section 8D would tax the distribution of carried interest appropriately, in accordance with its legal substance as a fee received by the general partner, subject to normal tax at 28%, **notwithstanding the legal form** of the distribution. In this way, the Commissioner would not need to resort to costly and time consuming litigation to ensure that carried interest is taxed appropriately, in accordance with its legal substance, as is currently the case with

paragraph (*c*), in instances where the general partner objects to and appeals the Commissioner's assessment.

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