



A Research Report submitted to the Faculty of Commerce, Law and Management, University of the Witwatersrand, Johannesburg, in partial fulfilment of the requirements for the degree of Master of Commerce (specialising in Taxation)

**DOUBLE TAXATION BIAS IN THE TAXATION OF COMPANIES AND PARTNERSHIPS –
A COMPARATIVE STUDY**

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ABSTRACT

The decision to undertake domestic (onshore) or international (offshore) trade activity should be one primarily influenced by the perceived commercial viability and sustainability of the trade activity in a local or foreign jurisdiction. As with all investment decisions, the decision to trade onshore or offshore should not be a “tax decision”, i.e. a decision motivated primarily by the resultant tax outcome of such trade in the jurisdiction under consideration. ‘Tax is usually not a major factor in the initial decision of an enterprise to make a direct investment abroad. Other factors such as return on investment, political stability, labo[u]r costs and access to foreign markets, are much more important as far as the original investment is concerned. The tax “tail” should not wag the commercial “dog”.’¹

Similarly, the decision to trade onshore or offshore should never result from a “taxable person or taxable entity decision”, i.e. a decision to trade onshore or offshore based on the manipulation of the existing mismatch in tax treatment between different ‘persons’ as recognised (whether defined or not) in the relevant tax legislation. Persons typically recognised for the purpose of tax legislation include, *inter alia*, natural individuals, companies² and trusts. ‘A partnership, in South African law, is not a legal person distinct from the partners of whom it is composed, nor is a partnership a taxable *persona* for the purposes of the Income Tax Act 58 of 1962 (the ‘Act’).’³

The purpose of this research will be to reveal the creation of a bias in the matter of double taxation of companies, in comparison to, the avoidance of double taxation within partnerships, even where it is observed that the characteristics of a modern partnership are increasingly akin to those of a company. This is a phenomenon found to occur in many jurisdictions across the world. Essentially, the premise of this research is to assert that a company is subject to economic double taxation in South Africa and certain jurisdictions, whereas a partnership, although closely resembling a company (i.e. a ‘quasi-partnership’), is not.

Key words: taxable entity bias, taxable person, company double taxation, partnership taxation, traditional partnership, non – traditional partnership, quasi – partnership, modern partnership, double taxation, economic double taxation, section 24H, agency theory, aggregate theory, LLC, S Corp, LLP, GmbH & Co. KG, personal liability company, Inc., Van Wyk de Vries Commission, flow - through taxation, pass-through taxation, classical system of corporate taxation, unlimited liability company, incorporated partnership.

¹ Arnold, B J & McIntyre, M J, 2002: 10.

² Please refer to Scope Limitations.

³ Meyerowitz, 2008: 16-26.

DECLARATION

I declare that this Research Report is my own unaided work. It is submitted 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.

Refilwe Gloria Mashale

30 March 2016

1. CHAPTER 1:

1.1. INTRODUCTION

'Men may put on the habiliments of a partnership whenever it advantages them to be treated as partners underneath, although in fact it may be a case of "The King has no clothes on" to the sharp eyes of the law.' – Felix Frankfurter⁴

The concept of double taxation ironically, is twofold – (1) where one source of income is taxed more than once, in the hands of one or more separate persons within a single jurisdiction ('economic double taxation') and (2) where one source of income is taxed more than once in the hands of the same person, over two or more different jurisdictions ('juridical double taxation'). Lesser attention and focus are generally given to economic double taxation as it usually arises from the provisions of domestic legislation, occurring throughout the world. In South Africa for example, the income earned by an individual through a salary is taxed at the earlier of receipt and accrual (subject to Employee taxes, collected through the 'Pay As You Earn' or 'PAYE' mechanism), and subsequently taxed again when it is utilised by the individual on goods and services consumed (subject to indirect tax, collected through the 'Value Added Tax' or 'VAT' mechanism).⁵ 'Yet no [jurisdiction] is prepared to extend double taxation relief to sales taxes or other consumption taxes.'⁶ This is the phenomenon of economical double taxation.

The question about whether economic double taxation is ethical and fair is not addressed by the observation that it has largely been legislated and it is therefore a global reality. This is, *inter alia*, the reason that the issue of juridical double taxation is not tolerated and is instead continuously and actively remedied. Relief from economic double taxation is in some instances, expressly not permitted.⁷ 'In contrasted with the notion of juridical double taxation, which has, generally, a quite precise meaning, the concept of economic double taxation is less certain. Some states do not accept the validity of this concept and others; more numerous, do not consider it necessary to relieve economic double taxation at the national level (for example dividends distributed by resident companies to resident shareholders).'⁸ Others feel that 'double taxation by national and subnational governments is not necessarily objectionable. Indeed, when the levels of taxation are properly regulated to avoid excessive tax burdens, such double taxation may be an inevitable feature of fiscal federalism.'⁹

The economic double taxation found to occur under the taxation of a company and its shareholders ('company double taxation') is a well - known and well – documented concept. It is based on the perception that double tax arises where company profits are taxed at the corporate level and taxed again when they are distributed as dividends, in the hands of the shareholders. This Research Report however, aims to cast a different perspective on the matter by comparing the

⁴ Easson & Thuronyi, 1998: 1.

⁵ Iqbal, n.d.

⁶ Arnold, B J & McIntyre, M J, 2002: 30.

⁷ Iqbal, n.d.

⁸ Vogel, 1997: 592.

⁹ Arnold, B J & McIntyre, M J, 2002: 30.

economic double taxation in company entity structures, with the ‘avoidance’ of double taxation in partnership entity structures. The use of the term ‘avoidance’ in relation to economic double taxation and partnerships is crucial as it emphasises that merely by forming a partnership instead of a company, the taxpayer will rightfully manage to ‘organise his financial affairs in such a way as to pay the least tax permissible’.¹⁰ This can be illustrated with an example: in the United Kingdom, where the taxpayer organises his enterprise as a partnership, the taxpayer will be subject to tax at a marginal rate of up to 45 percent (year of assessment ending 31 March 2016); whereas should the taxpayer structure his business to operate as a company, the taxpayer will be subject to corporate income tax (20 percent¹¹ for the year of assessment ending 31 March 2016) as well as Dividends Tax up to a rate of 38.1 percent (year of assessment ending 31 March 2016) where dividends are distributed by the company. The effective rate of tax actually incurred by the natural person shareholder will amount to approximately 50.48 percent.¹² The shareholder of a corporation is subject to double taxation, while the partner of a partnership is not, resulting in the additional tax charge incurred of 5.48 percent for the shareholder. In the author’s opinion, this bias in the taxation of the two entity forms (i.e. ‘taxable entity bias’) is invalid. The comparative study undertaken in this Research Report will allow an investigation into the reasons for the differing tax treatment of companies and partnerships in four jurisdictions, and in so doing, expose the creation of an invalid, taxable entity bias in favour of partnerships in three of those jurisdictions. The Research Report determines that no such bias is found to exist in South Africa. The Research Report will demonstrate how the premises typically given by governments and their tax authorities to substantiate the differing tax treatment between partnerships and companies, are largely evasive and inconsistently applied, and therefore do not warrant the continuance of such a bias in taxation over business.

The identification of this bias has opened significant opportunities for tax planning, as well as tax arbitrage. As a result of the tax planning opportunities identified, in the United States, the share of businesses organized as flow-through businesses and the share of business receipts in flow-through entities have risen such that 75 percent of businesses were organized as flow-through enterprises in 2004 (excluding sole proprietorships), up from 60 percent in 1994.¹³ In 2004, S Corporations, a form of ‘quasi-partnership’ discussed within this Research Report, accounted for 64 percent of all corporations with assets less than \$10 million and received 56 percent of gross business revenues of those companies. It also accounted for 37 percent of corporations with assets greater than \$10 million and 12 percent of business receipts in that category.¹⁴ In relation to the LLC, the growth in the number of LLCs established to take advantage of the taxable entity bias is also evident - ‘the rapid development of the LLC is due to two factors, notably the de-linking of limited

¹⁰ Commissioner for South African Revenue Service (CSARS) v *NWK Ltd* [2011] 2 All SA 347 (SCA).

¹¹ As of 1 April 2016, the corporate income tax rate in the United Kingdom will decrease to 19 percent, from percent.

¹² Please refer to section 5.2 of this Research Report for the full calculation.

¹³ Toder, 2008. These figures are stated as recorded by the author of the article referenced to. See also Prakash 2015.

¹⁴ Toder, 2008.

liability from tax classification [for domestic enterprises] and the influence of organised interests that persuaded state lawmakers to enact the statutes.¹⁵

Calls for the tightening up of loopholes in relation to the taxation of partnerships are longstanding. ‘Partnerships and the taxation of their income in international business have been studied at least twice by the International Fiscal Association, directly ... in 1973¹⁶, indirectly ... in 1988¹⁷.¹⁸ Certain basic issues that required international resolution were also highlighted in the General Reports of the International Fiscal Association in 1974¹⁹ ²⁰, and 1988²¹.²² More recently in 1998, the International Monetary Fund recognised that this bias in entity taxation created ‘discrimination’ between different forms of business organisation and enabled taxpayers to indulge in ‘entity shopping’.²³ In 1999, the Organisation for Economic Co-operation and Development (the ‘OECD’) released “The Application of the OECD Model Tax Convention for Partnerships”, which conducted an extensive analysis of the application of treaty provisions to partnerships, including in situations where there is a mismatch between the tax treatment of the partnership. To date, the most extensive tax developments with regard to partnerships have largely been related to the loopholes created by partnerships in the context of juridical double (non -) taxation only.

1.2. THE RESEARCH PROBLEM

1.2.1. Statement of the Problem:

This Research Report will evaluate the existence and validity of economic double taxation occurring under traditional companies (i.e. company double taxation). Through the identification of ‘non – traditional’, ‘modern’ or ‘quasi - partnerships, the research will analyse the validity of the prevention of economic double taxation in this type of entity. This Research Report will then juxtapose the reasons for the prevention of economic double taxation in partnerships, against the arguments for the validity of economic double taxation in companies. To specifically highlight the economic double taxation bias which is the subject of this report, the Research Report will focus on the following foreign jurisdictions -

¹⁵ McCahery, 2004: 12-13. The notion of an influence and pressure on governments by organized interests is illustrated more clearly at 4.1.2 in relation to the South African Personal Liability Company.

¹⁶ Two "Cahiers de droit fiscal international" publications are published once per year. They comprise [International Fiscal Association] IFA Branch Reports together with a General Report on each of the two Subjects selected for the Congress of that year. In 1973, the International Fiscal Association published volume 58b whose subject was ‘Partnerships and Joint Enterprises in International Tax Law’. The General Report therein was authored by Dr Philipp.

¹⁷ In 1988, the International Fiscal Association published volume 73a whose subject was ‘Recognition of foreign enterprises as taxable entities’. The General Report therein was authored by Professor Kees van Raad.

¹⁸ Le Gall, 1995: 660.

¹⁹ In 1974, the International Fiscal Association published volume 59a whose subject was ‘Tax consequences of domestic and foreign interests’ establishing corporations as vehicles for joint ventures’.

²⁰ It is not clear whether Le Gall incorrectly referred to the general report of 1974 instead of the general report of 1973 which he had previously alluded to (see footnote 12 above). In further references to Dr Philipp, he refers to the 1973 General Report (see page 708).

²¹ Professor Kees Van Raad’s General Report dealt with classification conflicts with respect to entities (partnership or corporation). Le Gall, 1995: 707.

²² Le Gall, 1995: 706.

²³ Easson & Thuronyi, 1998: 7.

the United States, the United Kingdom, and Germany; where modern partnerships which are akin to companies have been determined to exist, and yet the modernisation of the partnership in those jurisdictions has surprisingly not led to developments in the taxation of such partnerships. For the sake of completeness, the Research Report will also consider partnerships between Australia and New Zealand, as the South African tax system is largely influenced by the development of taxation in these jurisdictions. The Research Report will explore findings of any inconsistent reasoning and application in each jurisdiction; concluding with a qualitative and quantitative basis whether trading entity bias in favour of trade by form of partnership rather than a company, does in fact exist in each jurisdiction.

1.2.2. The Sub-Problems

The first sub-problem will introduce what is meant by the ‘traditional company’ and ‘traditional partnership’ business forms and will assess their comparability and compatibility. The sub-problem then proceeds to evaluate the occurrence of economic double taxation in companies arising from the taxation of, firstly, the profits of the company and secondly, the further taxation of those profits when received as dividends in the hands of shareholders. This sub-problem will give background on the concept of economic double taxation and the well-documented reasons why this treatment is largely perceived and accepted as fairly ethical and logical in many jurisdictions across the world. The sub-problem will also highlight and discuss the measures taken, if any, to acknowledge and combat such economic double taxation in South Africa. The first sub-problem will be addressed in Chapter 2 and Chapter 3.

The second sub-problem will involve the analysis of taxation of domestic (i.e. formed and operating in South Africa) partnerships in South Africa. The focus will be primarily on the personal liability company which is a form of quasi - partnership incorporated in South Africa, having key characteristics of both a partnership (i.e. unlimited liability) and a company (i.e. a separate legal *persona*). The sub-problem will investigate the grounds of any bias in South Africa, both in a qualitative manner and in a quantitative manner. The second sub-problem will be addressed in Chapter 4.

The third sub-problem will set out the research findings made on the various forms of foreign partnerships with characteristics akin to those of companies, i.e. non - traditional, modern or quasi - partnerships. The aim of this research will be to demonstrate that the traditional partnership entity form has, as a result of much scrutiny and critique, experienced much-needed legal and commercial development, and transformation over time. This will be achieved while emphasising that ‘the partnership [i.e. the traditional partnership] must be distinguished from an association or body of persons which in law constitutes a separate entity with perpetual succession and with no individual liability of the members in respect of its debts [i.e. the traditional company].’²⁴ The foreign entity forms with characteristics of both a partnership and a company researched for purposes of this section of the Research Report are: the Limited Liability Company (‘LLC’) (United States of America), the

²⁴ Meyerowitz, 2008: 16-28 (16.72).

S Corporation ('S Corp') (United States of America), the Limited Liability Partnership ('LLP') (the United Kingdom), and the GmbH & Co. KG partnership (Germany) which is formed where a *Kommanditgesellschaft* ('KG') partnership exists having a limited partner as well as a general partner, and where that general partner is a German incorporated private company, i.e. a '*Gesellschaft mit beschränkter Haftung*' or 'GmbH'. The third sub-problem will conclude on whether a taxable entity bias exists on the gulf between, on one hand, the [traditional] company, the limited liability partnership, and the [personal] unlimited liability company, which are all in essence creatures of company law; and on the other [hand], the [traditional] partnership and the limited partnership, which are creatures of partnership law.²⁵ As was done for purposes of the analysis in South Africa, the sub- problem will investigate the grounds of any bias in each jurisdiction both in a qualitative manner and in a quantitative manner. The third sub-problem will be addressed in Chapter 5.

The fourth sub-problem will focus on Australia and New Zealand, two jurisdictions that South Africa consistently models many of its domestic tax policies after. This will allow for some perspective of the South African quasi - partnership against its closest tax mentors. The fourth sub-problem will be addressed in Chapter 6.

The fifth sub-problem will explore the main, most frequently identified causes for the general inconsistent tax treatment of partnerships, with a distinction between Civil Law and Common Law jurisdictions, and their corresponding application of the Entity Theory and Aggregate Theory to partnerships. The sub-problem will conclude by briefly proposing a way forward for the resolution of the taxable entity bias of economic double taxation between partnerships and companies. The fourth sub-problem will be addressed in Chapter 7.

1.3. RESEARCH METHODOLOGY

The research methodology adopted is mainly of a qualitative, comparative and interpretive nature, based on a detailed interpretation and analysis of information sourced from, *inter alia*: (1) books, (2) case law, (3) electronic resources (including articles, e-books, journals, periodicals and reports), and (4) Statutes. Sources used contain content from both domestic and foreign jurisdictions. Minor quantitative assessments are used to numerically validate the outcome determined by qualitative methods.

1.4. SIGNIFICANCE OF THE RESEARCH

This research is significant as it addresses the following:

(1) The modernisation of the concept of a partnership within certain local and foreign jurisdictions, often spear-headed by local organised business interest groups; (2) the taxation of domestic and foreign partnerships in South Africa; and (3) the creation of a taxable entity bias where two entities (generally referred to as the 'company' and the 'partnership') with (in modern times) inherently the

²⁵ Gower & Davies, 2008: 7.

same founding characteristics are taxed differently on the basis of (in the author's opinion) out-dated, invalid, and inconsistent reasoning.

1.5. SCOPE AND LIMITATIONS

This Research Report highlights the following exclusions and limitations from its scope:

(1) The bias investigated in this Research Report relates to the extent of taxation borne by a company or a partnership, merely as a result of its chosen entity form, rather than by virtue of its operating activities. The taxable entity bias is assessed on both a qualitative and quantitative basis. The qualitative basis does not extend to consider any bias from a purely commercial or Company Law perspective, only a bias in relation to tax is considered; (2) All references to a 'company (companies), or corporation (corporations) within this Research Report refer to a private company or private corporation²⁶, with restricted free transfer of share capital, having separate legal personality and limited liability with respect to debts of the company or corporation. This Research Report is not applicable in the context of public companies; (3) The system of taxation for companies referred to throughout this Research report is limited to the 'Classical' system which 'is based on the premise that a company and its shareholders respectively ought to be taxed (the company on its income and the shareholders on their dividends, i.e. company double taxation).'²⁷ The 'Integrated' (full or partial) or 'Imputation' system, whereby the tax paid by the company is taken into consideration in the attribution of undistributed profits or the actual dividend distributions made to shareholders, is excluded from the scope and therefore is not considered for purposes of this Research Report; (4) All references to 'quasi - partnership(s)' within this Research Report refer to an entity vehicle (identified as a company (incorporated) or otherwise (unincorporated entity vehicles)) with characteristics similar to those of a partnership. The term therefore does not refer to instances where the 'corporate veil' of separate legal personality is 'pierced' by the Courts taking into cognisance that despite the incorporation status of the partners, the underlying intention and conduct of the business by its 'partners' was on the basis of personal relationship and mutual confidence;²⁸ and (5) the phenomenon of double non-taxation which is often times achieved through the use of hybrid mismatch arrangements²⁹, which arrangements include, *inter alia*, the use of domestic and foreign partnership structures.

²⁶ The author wishes to emphasise that the Limited Liability Company, an entity vehicle associated with the United States under section 5.1 of this Research Report should not be confused with a Limited Liability Corporation which is a unincorporated entity vehicle which is not covered in the scope of this Research Report.

²⁷ Williams, 2006: 533.

²⁸ Cassim et al, 2011: 47.

²⁹ According to the OECD (2013, quoted by the Davis Tax Committee, 2015: 1).

2. CHAPTER 2: BACKGROUND ON DOUBLE TAXATION, COMPANIES AND PARTNERSHIPS.

The background on double taxation is that there are two forms of double taxation currently acknowledged to being in existence – economic double taxation and juridical double taxation. Economic double taxation is considered as acceptable as there are supposedly two different taxable persons or entities subject to the tax – e.g. one taxable person in the capacity of a company paying corporate tax at a rate of 28 percent (South Africa for the year of assessment ending 28 February 2017), and another, separate taxable person in the capacity of a natural person shareholder paying Dividends Tax of 15 percent (South Africa for the year of assessment ending 28 February 2017). Instances of economic double taxation are most often found in domestic legislation. Further examples of economic double taxation occur ‘when income is taxed to a partnership entity and to the partners in their individual capacity, or when income is taxed to within a trust vehicle and subject to tax again in the hands of the beneficiaries of the trust.’³⁰

Juridical double taxation refers to circumstances where a taxpayer is subject to tax on the same income in more than one jurisdiction. Instances of juridical double taxation are therefore most often found in matters of cross - border taxation.

The focus of this Research Report will be economic double taxation and how it is deemed acceptable for it to be incurred by companies in many jurisdictions, but yet considered unacceptable to be incurred under the partnership entity structure. This is a phenomenon not unique to South Africa, but currently acknowledged and occurring in many jurisdictions across the world, some of which are featured in this Research Report.

A company and a partnership, *prima facie*, do not appear as comparable. One is an incorporated business vehicle with a separation at most, or a distinction at the very least, between management and the owners (shareholders) of the company; while the other, is merely a formal or informal ‘association’ designated as a body of persons.³¹ The following table³² below (as adapted) illustrates the characteristics of a traditional partnership and a traditional company in South Africa, while contrasting the two entity forms:

Characteristic	Traditional Partnership	Traditional Company
Separate legal identity	No. Private individuals or entities.	Yes.
Ownership of property	The partners.	The company itself.
Can creditors attach private goods?	Yes, but partnership assets must be exhausted first.	No.
Liability for debts	The partners personally [jointly and severally].	The company itself, not the shareholders.

³⁰ Arnold, B J & McIntyre, M J, 2002: 29.

³¹ According to Jean Shaffner (2000, quoted by Oguttu, 2007: 54 - 55).

³² Kopel, 2012: 406 – 407.

Extent of liability	Unlimited, except for a commanditarius partnership.	Limited to the value of the share capital.
Capacity to contract	Usually any one of the partners [excluding extraordinary partners].	Directors and authorised company agents; not the shareholders.
Minimum number of participants	Two.	One (profit company); three or more (non - profit company).
Maximum number of participants	No limit.	No limit.
Liability for tax	Partners in their individual capacities.	The company.
On death of a participant	Partnership ceases, but may be reinstated [no perpetual succession].	No change; company can exist indefinitely.
Transferability of interest	Transferability of partnership interest is not possible. Partnership dissolves.	Transferability of securities ³³ is restricted (Private company), and unrestricted (Public company).
Operating style	Partners are the owners and management, except in the instance of extraordinary partners.	Separation between ownership (shareholders) and management.
Taxation	Flow-through to individual partners [Aggregate Theory] or taxation of the partnership itself as a separate 'person' [Entity Theory].	Taxation of the company itself as a separate 'person'.

Upon closer inspection by the author, commonalities, which are frequently overlooked, traverse between the two entity forms defined above. For instance, the definitions within the Act of a 'company' and of a 'foreign partnership' both include an 'association'. The term association itself is however not defined within the Act. Therefore, an association could be classified as either a company or a [foreign] partnership. Similarly, many basic as well as complex commonalities between companies and partnerships are constantly overlooked or disregarded with respect to the subsequent tax classification and treatment of such entities. It

³³ 'The term "securities" has a much wider meaning than "shares", and includes any shares, debentures or other instruments' See Kopel, 2012: 79.

is however noted upfront that the United States of America has recognised many such commonalities and therefore applies them less stringently in distinguishing between the two entity forms. This is more clearly illustrated in the development of partnership taxation in the United States.

Initially recognising, *inter alia*, the need to categorically state the factors which differentiate a partnership from a company, the Supreme Court of America initially formulated a six (effectively reduced to four) factor approach to classify companies apart from partnerships (and vice-versa), which was later legislated by the American Department of the National Treasury.³⁴ The six key factors were considered to be: (1) associates, (2) objective to carry on business and divide the profits, (3) continuity of life, (4) centralized management, (5) free transferability of ownership interests, and (6) limited liability. As the presence of factors (1) and (2) are common to both a company and a partnership, for purposes of differentiating between both entities, only the remaining four are considered the 'four-factor test'.³⁵ Despite the stringent nature of the four-factor test, as the partnership vehicle evolved, the U.S government found these rules to be too formalistic.³⁶ However, the simpler, elective approach³⁷ which was adopted in 1997 in the form of check-the-box regulations still relied primarily on the question of limited liability, especially in relation to foreign entities.³⁸

³⁴ The test was legislated into the Treasury Regulation § 301.7701-2(a).

³⁵ Seevers, 2002: 206-207.

³⁶ Department of the Treasury, 1996. See also Seevers, 2002: 207.

³⁷ Department of the Treasury, 1996. See also Seevers, 2002: 207.

³⁸ Department of the Treasury, 1996.

3. CHAPTER 3: THE OCCURRENCE OF ECONOMIC DOUBLE TAXATION WITHIN COMPANIES

The occurrence of economic double taxation within companies is best described by way of example. Companies are subject to corporate income tax on their taxable income, of which the rate is 28 percent in South Africa. The post-tax reserves, when distributed as dividends are subject to a South African Dividends (withholding) Tax of 15 percent on the shareholders. Therefore, the shareholders receive income, after it has been subjected to tax, twice. The impact of economic double taxation is further exasperated in a situation where the shareholder and the company as represented by management, are the same individuals, i.e. in a private company where although in legal theory there is a separation of ownership and management (i.e. the 'Agency Theory'), in practice, management are also the owners of the equity in the business (i.e. the two persons are the same).

In the case of a public company, it may indeed be argued that the company and the shareholder are largely separate persons, as the principle of a mandatory separation of management and ownership exists. At most, management is permitted to hold shares in the company, but most appropriately, such shares should be issued in the minority compared to those issued to the public. The Agency Theory concept however, largely does not exist within private companies, which are by their very nature founded and controlled by the owners.

The reasons in defence of economic double taxation for companies include, *inter alia*: (1) that the company and the shareholders are separate legal persons and are therefore each taxpayers in their own right, (2) 'without taxes on dividends, wealthy individuals could enjoy a good living off the dividends they received from owning large amounts of common stock',³⁹ and in the case of many wealthy individuals, they could afford to live entirely off those tax-free dividends thereby escaping all other forms of direct tax on income; (3) that 'dividend payments are voluntary actions by companies and, as such, they are not required to have their income "double taxed" unless they choose to make dividend payments to shareholders';⁴⁰ (4) that other forms of economic double taxation also exist, as illustrated in the Introduction (see 1.1) of the payment of indirect taxes (VAT) on goods and services acquired, settled from incomes accrued or received and already subjected to direct taxes (corporate income tax). Therefore as economic double taxation is already occurring (i.e. it is not a new phenomenon), affects everyone (through the levying of direct and indirect taxes), it is perceived by many to be acceptable and fair; and (5) that the definition of economic double taxation is exceedingly broad and difficult to specify with the precision needed for tax laws⁴¹. The most significant of these reasons considered in favour of the system of taxation over companies, is the reason of the company's separate legal persona, i.e. reason (1) stated above.

In South Africa, the economic double taxation of income as dividends in the hands of shareholders is remedied in various cases. Examples where economic double taxation in the hands of shareholders is eliminated, are as follows: (1) in relation to domestic companies - an exemption exists in terms of s 64F(1)(a) of the Act, for dividends distributed by one resident company to another; (2) in relation to other institutions - exemptions on Dividends Tax are also available for other 'special' institutions such as Public Benefit Organisations (these are tax exempt institutions in South Africa) and micro businesses; and (3) in relation to

³⁹ Investopedia, n.d.

⁴⁰ *Ibid.*

⁴¹ Arnold, B J & McIntyre, M J, 2002: 30.

natural persons - for example, where the dividend arose from a tax free investment, it would be exempt from Dividends Tax.

It is further noted that the elimination of certain instances of economic double taxation is provided for in treaties, which follow the OECD Model Tax Convention (“MTC”). South Africa has observer status but is not a member of the OECD; it serves as an Associate on seven OECD Bodies and Projects, as a participant in thirteen and adheres to eleven OECD instruments.⁴² As a result, treaties between South Africa and other jurisdictions follow the MTC. ‘... the obligation on the other contracting state to make a corresponding adjustment to the profits of the other party under Article 9(2) (or, in the context of a PE, Article 7(3) of the OECD Model Convention only) can be viewed as a form of relief from economic double taxation. Further, Article 25(3) provides that the competent authorities of the contracting states may consult for elimination of double taxation not covered by the tax treaty. There is no obligation to reach agreement in this regard and in practice this provision is rarely used and is not used as a general mechanism to provide relief from economic double taxation of corporate income’.⁴³ It is noted that the elimination of economic double taxation in the instance of companies and their shareholders is not addressed within any double tax agreement to which South Africa is a party.

⁴² OECD, n.d: 3.

⁴³ Harris, 2013: 9.

4. CHAPTER 4: ANALYSIS OF TAXATION OF DOMESTIC AND FOREIGN PARTNERSHIPS IN SOUTH AFRICA

‘Recognition of a partnership, even if partial, temporary or imperfect, is worth identifying in order to measure the degree to which this legal institution is transparent.’ – Le Gall, J - P⁴⁴.

4.1. In South Africa, a partnership is a construct of Common Law. No ‘Partnerships Act’ or other similar act currently exists which sets out the legal requirements of a valid partnership, in law. The Special Partnerships Limited Liability Act of the Cape Province (Act 24 of 1861) and Natal (Law 1 of 1864) which made provision for ‘special partnerships’ have both since been repealed⁴⁵. As a result, there is no definition of a domestic partnership in the Act. Despite domestic partnerships not being defined in the Act, section 24H of the Act is applied to partnerships. This section applies to general and extraordinary⁴⁶ partnerships (i.e. *en commandite* or anonymous partnership and other ‘similar partnership[s] or foreign partnership[s] (if such member’s liability towards a creditor of the partnership is limited to the amount which the member has contributed or undertaken to contribute to the partnership or is in any other way limited)’⁴⁷). The taxation of partnerships under section 24H also applies to the taxation of joint ventures to the extent that the *essentialia* of a partnership are met. In general, the principle tax treatment of a partnership is the flow-through of its profits by way of pre-agreed ratios, to be taxed separately in the hands of the partners themselves. Domestic Partnerships

4.1.1. Traditional Partnerships

The Common Law in South Africa establishes 4 principles for the existence and recognition of a partnership arrangement (i.e. the *essentialia* of partnership contract) – (1) each of the partners brings something into the partnership, or binds himself to bring something into it, whether it be money, his labour or skill; (2) the business should be carried on for the joint benefit of the partners – i.e. the business must be carried on in common; (3) the object of the partnership should be to make profits; and (4) the contract between the parties establishing the partnership should be a legitimate contract but there are no formal requirements for the formation of a partnership⁴⁸. Partnership profits (i.e. gross income less all expenses) must be distributable to the partners in the agreed proportions; the losses of the partnership however, need not be shared⁴⁹. It is important to note that an agreement providing for a sharing of profits (and losses if applicable) does not necessarily create a partnership⁵⁰. Where one of the partners no longer makes a contribution towards the partnership, while there may be some evidence of a dissolution, it is not a conclusive factor

⁴⁴ Le Gall, 1995: 665.

⁴⁵ Visser et al, 2003: 252.

⁴⁶ Visser et al, 2003: 251.

⁴⁷ The Act.

⁴⁸ Adcock, Ansermino & Noeth, 1995: 465.

⁴⁹ Ibid.

⁵⁰ Meyerowitz, 2008: 16-26.

determining whether the partnership is in fact dissolved, in law.⁵¹ Domestic, traditional partnerships are not incorporated business vehicles.

South Africa no longer has a specific, enabling Act with regard to partnerships, but two forms of Common Law extraordinary partnership still exist in practice until today⁵² – ‘anonymous’ and ‘*en commandite*’ partnerships. In both instances, ‘one or more of the partners (sleeping partners) are not liable to third parties for the debts of the partnership, provided there is no holding out publicly of their status as partners.’⁵³

‘The partnership *en commandite* is carried on in the name of one or some of the partners whilst the other partner (or partners) remains undisclosed – the undisclosed partner is called the *commanditarian* partner’⁵⁴. The *commanditarian* partner contributes a specific, fixed, sum of money to the partnership⁵⁵.

In an anonymous partnership the partners also agree the business will be carried out in the name of one or some of the partners, but not all. The anonymous partner is also required to make a capital contribution to the partnership.

The difference between the two extraordinary partnerships lies in the extent of liability of the extraordinary partners. In an *en commandite* partnership the *en commandite* partner is only liable up to the [fixed] amount he or she contributed to the partnership fund⁵⁶, whereas an anonymous partner is liable to the disclosed partners for his full share of the partnership debts incurred by them⁵⁷. In other words, the anonymous (limited) partner is jointly and severally liable for the debts of the partnership, and in contrast, the *en commandite* (limited) partner has limited liability. In both types of extraordinary partnership, the undisclosed partner is liable only to co-partners and not to third party creditors of the partnership⁵⁸. Therefore, the limitation of a deduction to the amount that the taxpayer may be held liable to ‘any creditor of the partnership’, in terms of section 24H(3)(a) is a misnomer as the extraordinary partners are never liable to third parties in the first place⁵⁹.

Section 24H of the Act accommodates the existence of the extraordinary partnership (despite not having defined a traditional partnership), with the inclusion of the definition of a ‘limited partner’. The definition provided is as follows: “‘limited partner’ means any member of a partnership *en commandite*, an anonymous partnership, any similar partnership or a foreign partnership, if such member’s liability towards a creditor of the partnership is limited to the amount which the member has contributed or undertaken to contribute to the partnership or is in any other way limited.”⁶⁰ Therefore, in terms of the taxation of general and extraordinary or limited partners, the flow-through basis of taxation is accessible to both types of partners.

⁵¹ Meyerowitz, 2008: 16-27. See also ITC 634 (1974) 15 SATC 114.

⁵² Adcock, Ansermino & Noeth, 1995: 467.

⁵³ Visser et al, 2003: 251.

⁵⁴ Adcock, Ansermino & Noeth, 1995: 467.

⁵⁵ Visser et al, 2003: 252.

⁵⁶ Olivier & Honiball, 2011: 167.

⁵⁷ Meyerowitz, 2008: 16-30.

⁵⁸ Meyerowitz, 2008: 16-30.

⁵⁹ Adcock, Ansermino & Noeth, 1995: 468.

⁶⁰ Section 24H(1) of the Act.

The liability of the partners has no bearing on the entity's ability to be classified as a partnership. This critical principle will be further discussed below in relation to the South African quasi - partnership, the 'Inc.'. Bearing no consequence on the commercial classification of the partnership, the liability of the partnership similarly bears no consequences on the system of taxation (flow-through) available to the partners, with only a few reservations in the area of losses.

4.1.2. Quasi - partnership

The introduction of the Companies Act 71 of 2008 ('New Companies Act'), which came into effect on 1 May 2011, saw the transformation of the former section 53(b) company under the Companies Act 61 of 1973 ('Old Companies Act') into the current personal liability company ('Inc.'). The change was provided for mainly through section 15(2)(b) and section 19(3) of the New Companies Act. In terms of schedule 5 of the New Companies Act which deals with transitional arrangements between the Old Companies Act and the New Companies Act:

'the Articles of which imposed personal liability on its directors or past directors, as contemplated in section 53(b) of the previous Act, is deemed to have amended its Memorandum of Incorporation as of the general effective date to expressly state that it is a personal liability company, and to have changed its name in so far as required to comply with section 11(3).'⁶¹

A more accurate term to describe a personal liability company could perhaps be an incorporated partnership.⁶² This is because in South Africa, where the regulatory bodies of certain professions previously did not permit professionals to operate through an incorporated entity vehicle⁶³, professionals who wanted to conduct business in tandem were forced to resort to the use of a 'professional' partnership entity vehicle⁶⁴. Although being a partnership and not a company, section 4 of the Companies Act 46 of 1926 (the 'Initial Companies Act') targeted, *inter alia*, professional partnerships, which were considered to have been formed to carry on 'business'^{65, 66}.

Section 4 in the Initial Companies Act (i.e. the 'Prohibition of Large Partnerships' provision) restricted the number of partners in a partnership to a maximum of twenty. In 1970, a Memorandum prepared for the Commission of Enquiry into the Companies Act (the 'Van Wyk de Vries Commission') recommended that this restriction should be removed, referring to its purpose of 'prevent [ing] the mischief arising from large trading undertakings

⁶¹ Companies Act, No. 71 of 2008. Schedule 5, 2011: par 4(1)(b).

⁶² David et al, 2011: 326.

⁶³ 'Neither the accountancy profession nor the legal profession will permit firms of practitioners to incorporate as companies' (Van Wyk de Vries Commission, 1970: 40, at 22.03).

⁶⁴ 'In consequence, in those professions where partnerships are permissible, the normal, and indeed, the only method of two or more persons carrying on such profession in association, is by means of a partnership' (Van Wyk de Vries Commission, 1970: 545, at 11 (3.03)).

⁶⁵ Section 4 of the Companies Act 46 of 1926 identifies as carrying on a business, any 'company, association, syndicate, or partnership' formed in the Union with the purpose of carrying on any business that has for its object the acquisition of gain.

⁶⁶ Van Wyk de Vries Commission, 1970: 545, at 11 (3.05).

being carried on by large fluctuating bodies⁶⁷ as being obsolete.⁶⁸ The recommendation of the Memorandum was as follows: ‘the prohibition in section 4 against partnerships of more than twenty persons should be abolished in respect of professional firms which cannot by law or professional practice or custom be incorporated as a company.’⁶⁹ An amendment was effected ‘upon the recommendation of the Jenkins Committee’⁷⁰. The Van Wyk de Vries Commission agreed with this recommendation in their Main Report, however certain reservations were made by Advocate Arthur Suzman Q.C. (‘Suzman’). In Appendix C of the Main Report by the Van Wyk de Vries Commission, Suzman expressed how the removal of such a restriction on professional partnerships failed to address the most relevant issue faced by professional partnerships: ‘While not strongly opposed to the above recommendation, I consider that it does not really meet the situation. The proposed amendment ... still leaves unchanged the position that members of professional and semi-professional bodies cannot obtain the undoubted benefits of incorporation. Members of such bodies will still remain subject to all the disadvantages of partnerships.’⁷¹ Despite, arguably the true hindrance to the incorporation of professional partnerships at that time being the rules set out by the regulators of such professions themselves, Suzman and the Van Wyk de Vries Commission proceeded to recommend that ‘provision should be made to enable members of professional and semi-professional bodies to obtain the benefits of incorporation, but without the benefit of limited liability.’⁷² Suzman further recommended an ‘Incorporated Partnerships Act’ stating that virtually none of the provisions of the [Initial] Companies Act would apply to such a partnership.⁷³ In the opinion of the author, one may consider this further recommendation to appear to suggest that the ‘professional partnership’ was never intended to lose its partnership nature, by virtue of its incorporation. This is expressed in the condition suggested by Suzman that the ‘the relationship between members inter se and between members and third parties would be governed by the law of partnership.’⁷⁴ Strangely, although Suzman opposed the idea of the ‘ordinary private company, under the Companies Act, [being] coupled with unlimited liability of directors’, as he considered it unsuitable⁷⁵; he was not opposed to the partnership enjoying the same tax advantages as ordinary trading corporations.⁷⁶

Suzman’s recommendations were not supported by the Van Wyk de Vries Commission who had previously given an indication of [their] intention to recommend the abolition of unlimited companies⁷⁷. Nevertheless, in finality they agreed to recommend a similar recommendation as that made by the Broome Commission on an enquiry on the

⁶⁷ According to *Smith v. Anderson* (1880, quoted by Friedman, 1970: 25).

⁶⁸ Friedman, 1970: 25.

⁶⁹ Friedman, 1970: 26.

⁷⁰ The Jenkins Committee Report is dated 30th May 1962 and therefore precedes the 1970 Memorandum submitted to the Van Wyk de Vries Commission.

⁷¹ Van Wyk de Vries Commission, 1970: 545, at 12 (3.07).

⁷² Van Wyk de Vries Commission, 1970: 545, at 12 (3.08).

⁷³ Van Wyk de Vries Commission, 1970: 545, at 12 (3.09).

⁷⁴ Van Wyk de Vries Commission, 1970: 545, at 15.

⁷⁵ Van Wyk de Vries Commission, 1970: 545, at 17 (3.12).

⁷⁶ Van Wyk de Vries Commission, 1970: 545, at 18 (3.12).

⁷⁷ Van Wyk de Vries Commission, 1970: 497 (49.14).

Stock Exchanges Control Act 7 of 1947 to provide for a ‘special form of private company’⁷⁸. This resulted in an amendment to section 6A of the Initial Companies Act, which later became the section 53(b) provision of the Old Companies Act and most recently, is section 15(2)(b) read with the section 19(3) provisions of the New Companies Act. A comparative diagram of the changes is depicted below:

Initial Companies Act as amended (Companies Act 46 of 1926)	Old Companies Act (Companies Act 61 of 1973)	New Companies Act (Companies Act 71 of 2008)
<p>Section 6A:</p> <p>“The directors and former directors of a private company limited to shares shall be liable jointly and severally, together with the company, for such debts and liabilities of the company as are or were contracted during their period of office, if the Memorandum contained a provision to this effect.”</p>	<p>Section 53(b):</p> <p>“The memorandum of a company may, in addition to the requirements of section 52 - ...</p> <p>(b) In the case of a private company, provide that the directors and past directors shall be liable jointly and severally, together with the company, for such debts and liabilities of the company as are or were contracted during their periods of office, in which case the said directors and past directors shall be so liable.</p>	<p>Section 15(2)(b):</p> <p>“The Memorandum of Incorporation of any <u>company</u> may— ...</p> <p>(b) Contain any restrictive conditions applicable to the company, and any requirement for the amendment of any such condition in addition to the requirements set out in <u>section 16</u>”; and</p> <p>Section 19(3):</p> <p>“If a company is a personal liability company the directors and past directors are jointly and severally liable, together with the company, for any debts and liabilities of the company as are or were contracted during their respective periods of office.”</p>

‘A personal liability company would usually be formed by those persons who would normally form a partnership ...’⁷⁹. Persons who would normally form a partnership, and instead could choose to form a personal liability company are ‘associations of professional

⁷⁸ Van Wyk de Vries Commission, 1970: 498 (49.14).

⁷⁹ Cassim et al, 2011: 78.

persons, such as attorneys, stockbrokers, public accountants, auditors and quantity surveyors, who wish to have the convenience and advantages of separate legal personality, especially perpetual succession, while still complying with their professional rules, which require personal liability.⁸⁰ Therefore ‘a personal liability company is usually formed as an alternative to a partnership to reap some benefits of incorporation (such as perpetual succession).’⁸¹

The personal liability company is a form of company in which the directors are personally liable to a certain extent, for its debts. Although an Inc. meets the requirements of a private company including perpetual succession, unlike a private company, it operates on the principle of ‘personal liability’. This term means that the current directors, as well as previous directors of the company, will be responsible - jointly and severally liable, together with the company for the debts of the company that are or were contracted into during their respective periods of office⁸². This makes the personal liability company akin to an unincorporated South African partnership with perpetual succession, in which the partners have unlimited liability.

It is however important to note that the extent of liability of a director in a personal liability company, differs from the unlimited liability of a partner in a partnership; it is in fact the same limited liability of a company, i.e. ‘limited liability *in contract* - ...to creditors who have contractual claims on the corporation ... not extend [ing] to limited liability *in tort* – that is, to persons who are unable to adjust the terms on which they extend credit to the corporation, such as third parties who have been injured as a consequence of the corporation’s negligent behaviour.’⁸³ The distinction is best explained as follows: ‘The decision in *Fundtrust (Pty) Ltd (In Liquidation) v Van Deventer*, ... laid down that the extent of the directors’ liability is limited to the company’s contractual debts and liabilities that were contracted during their periods of office, and that the directors’ joint and several liability does not include any liability for delictual claims or unjustified enrichment claims against the company, because these liabilities are not “contracted”. Nor does it extend to liability for tax and other statutory charges ..., as none of these liabilities are of a contractual nature. The court found that the intention of the legislature was to relate the directors’ liability to nothing other than the company’s ordinary financial or commercial commitments.’⁸⁴

In *Sonnenberg McLoughlin Inc v Spiro* it was further upheld that the intention of the legislature was not to impose a liability equivalent to the common law liability of partners, but rather to impose an entirely new statutory liability, giving the creditors an entirely new remedy to hold the directors jointly and severally liable prior to the liquidation of a company. ‘There is accordingly a twofold effect: first, creditors are entitled to hold the directors jointly and severally liable for the company’s contractual liabilities contracted during their periods of

⁸⁰ Ibid.

⁸¹ David et al, 2011: 340.

⁸² David et al, 2011: 326.

⁸³ Kraakman et al, 2004: 11.

⁸⁴ Cassim et al, 2011: 79-80.

office; and second, if a director pays any such debt of the company he or she would have a right of recourse against his or her fellow directors for their proportionate shares of the debt⁸⁵.

Albeit that the liability of the directors of a personal liability company, which is essentially a private company, are not privy to limited liability for debts of the company; the incorporation of the company awards it with a separate legal *persona*. The company then becomes a “nexus for contacts”, in the sense that a firm serves, fundamentally, as the common counterparty in numerous contracts with suppliers, employees, and customers, coordinating the actions of these multiple persons through exercise of its contractual rights.⁸⁶ This single characteristic of separate legal personality then distinguishes the personal liability company with joint and several liability of its directors, from an unincorporated, partnership with joint and several liability of its partners. As a result of this single characteristic of legal persona, a number of consequences flow logically⁸⁷, further distinguishing the personal liability company from a partnership. Such consequences include, *inter alia*: (1) the business of the company will be its own business and not the business of its members, (2) property which is owned by the company cannot be treated as if it were owned by the members, (3) no payments payable to the company may be paid into a private bank account of any individual director, and (4) notwithstanding changes in membership, whether by death or otherwise, the company itself will continue to survive.⁸⁸ The above list excludes ‘limited liability’ as a consequence which flows from a separate legal persona as the ‘rule of “limited liability” has not, historically, always been associated with the corporate form.’⁸⁹ This is found to be true once again in the example of the personal liability company.

The personal liability company therefore, although exhibiting the characteristic of unlimited liability, which is akin to a partnership, is easily determined to not be a partnership in the major sense. Consequently, its profits are therefore appropriately subject to corporate income tax in South Africa, and distributions in the form of dividends also bear tax incurred by the directors of the company.

In conclusion, we have established that in South Africa the characteristic of separate legal personality acquired through a ‘general enabling Act’⁹⁰, which is the Companies Act, is the founding distinction for which entity vehicles should be recognised and taxed as companies and which should be recognised and taxed as partnerships, despite a company incidentally having some characteristics of a partnership⁹¹ (such as unlimited liability) or

⁸⁵ Cassim et al, 2012: 87.

⁸⁶ Kraakman et al, 2004: 6.

⁸⁷ Beuthin & Luiz, 2000: 10.

⁸⁸ Beuthin & Luiz, 2000: 10-11.

⁸⁹ Kraakman et al, 2004: 9.

⁹⁰ Cilliers & Benade, 1982: 6.

⁹¹ ‘Generally, in [jurisdictions] with a common law tradition, partnerships do not have legal personality, ... In civil law [jurisdictions], partnerships normally have legal personality, ... but [partnerships] do not have legal personality in South Africa.’ Easson & Thuronyi, 1998: 6.

characteristics of another type of entity vehicle all - together. This conclusion will be crucial for purposes of comparison between other jurisdictions. As mentioned previously in the conclusion paragraph of Chapter 2 – Background on double taxation, companies and partnerships, the United States of America relies primarily on the legal characteristic of limited liability as a determining factor between foreign companies and foreign partnerships.

The personal liability company is therefore a company in terms of South African commercial law, and is taxed as such in terms of tax law. Although the personal liability company appears to be a quasi - partnership, no clear taxable entity bias between companies and partnerships is identified in South Africa, due to the alignment of commercial and tax laws.

4.2. Quantitative Assessment – South Africa:

We now assess any taxable entity bias on the basis of a quantitative assessment. In South Africa for the 2017 year of assessment ending 28 February 2017, the corporate income tax rate is 28 percent for all companies; Dividends Tax is payable at a rate of 15 percent (resident company - to - company dividends are however exempt); and individuals are taxed at marginal rates of between 18 percent and 41 percent.

Calculation Components	Classical System of taxation applied to Companies including the Inc.	Partnership flow - through taxation ⁹²
Net Profit Before Tax	100	100
Corporate Income Tax (28%) or maximum marginal rate of taxation for natural persons (41%)	(28) [100*28%]	(41) [100*41%]
Net Profit After Tax	72	59
Dividends Tax (15%)	(10.8) [72*15%]	N/A
Effective Tax Rate	38.8% [(28+10.8)/100]	41% [41/100]

⁹² An assumption is made that the partner is a natural individual.

Therefore, even on a quantitative basis, no taxable entity bias is identified in South Africa between the taxation of partnerships and companies, as although companies and their shareholders are subject to economic double taxation, they enjoy a lower effective rate of tax than the highest earning partners within partnerships.

4.3. Foreign Partnerships

The definition of a foreign partnership in the Act has recently been revised, and the revision is effective from 1 October 2011. The revised definition aims to prevent, through domestic legislation, the occurrence of juridical double taxation, which arises where one jurisdiction recognises a partnership as a flow-through entity, and the other jurisdiction recognises the partnership as a taxable person or taxable entity. The South African classification of the foreign partnership as a flow-through or as a taxable person or entity will therefore depend on its classification in its state of residence. This measure aimed mainly at the prevention of juridical double taxation, has placed South Africa in line with recommendations by the OECD⁹³. It is most important to note that the classification by the foreign jurisdiction, is a classification determined by the system of company law. It is not a classification of the entity in terms of the jurisdiction's tax legislation⁹⁴. 'For example, a US entity that is regarded as a partnership under the law of the state in which it was formed may elect to be taxed as a C or S Corporation for US tax code purposes. To determine whether the entity is regarded as a company, ... the general South African domestic law principle is that US law has to be applied. Based on the wording of para (b) of the definition of a company in the South African Income Tax Act, it is submitted that the relevant US law is US corporate law, and not US tax law'⁹⁵. It is however noted that any further classification provisions within a DTA between South Africa and the relevant jurisdiction would override the company law classification given.⁹⁶ Therefore, in the example of the US partnership given above, the 'domestic law interpretation rule is mostly overridden by the application of the US tax treaty which specifically provides that for purposes of the application of the tax treaty, the US **tax** [own emphasis] treatment of the entity must determine the tax treatment in South Africa'⁹⁷. In addition to the United States, certain other jurisdictions, such as 'Canada, Finland, Switzerland, the United Kingdom ... and Germany, make sure that the treaties to which they are a party include provisions designed to remove any ambiguity',⁹⁸ regarding the taxation of partnerships from those foreign jurisdictions.

Therefore, to the extent that a foreign partnership is recognised as a flow-through entity in its resident jurisdiction, it will be recognised as a flow-through entity in South Africa and not subject to the economic double taxation occurring in companies, and the potential occurrence of any juridical double taxation is also essentially eliminated. Conversely, to the extent that the foreign partnership is treated as a taxable person or taxable entity in its resident jurisdiction, the partnership itself will be subject to tax in South Africa – corporate income tax at a rate of 28 percent on business profits

⁹³ Olivier & Honiball, 2011: 186.

⁹⁴ Oguttu, 2007: 71. See also Olivier & Honiball, 2011: 172.

⁹⁵ Olivier & Honiball, 2011: 565.

⁹⁶ Ibid.

⁹⁷ Ibid.

⁹⁸ Le Gall, 1995: 666.

where the partnership's activities have created a permanent establishment in South Africa, and tax at the applicable rate (reduced by the application of a DTA) for other income deemed to be sourced from South Africa in terms of s 9 of the Act where no permanent establishment is determined to exist in South Africa. Distributions made by a taxable foreign partnership to South African tax residents will not be considered an attribution of partnership profits and rather will be subject to taxation as foreign dividends in the hands of the South African tax residents, prior to the application of any exemptions available under section 10B of the Act.

5. CHAPTER 5: TAXATION OF QUASI – PARTNERSHIPS IN CERTAIN JURISDICTIONS

5.1. The focus of this chapter is to provide evidence giving 'credence to the argument that partnership law may be unravelling to the lowest possible level'.⁹⁹ United States of America ('USA')

In the United States, a partnership includes virtually any non-corporate organisation carrying on business in a joint manner by two or more persons. 'Whether the organization is formed under the partnership statutes of one of the states is not determinative. As a result, an entity may be classified as a partnership under tax law but not be classified as a partnership under the relevant state law, and vice-versa'¹⁰⁰. The United States of America ('USA') has two forms of quasi – partnership selected for purposes of this Research Report - the Limited Liability Company ('LLC') and the S Corporation ('S Corp'). Both incorporated entities have the operation of the Agency Theory, limited liability for debts of the business, as well as perpetual succession of the business.¹⁰¹

LLC owners, called "members," can choose a partnership - style management and therefore run company operations themselves, or they can choose to elect officials to handle day-to-day business matters, similar to the way in which a company is run.¹⁰² Like a company, an LLC can also have a single member.¹⁰³

An S Corp can have no more than 100 shareholders, and only U.S. citizens and/or resident aliens who are generally individual shareholders, may participate in an S Corp. S Corporations cannot be owned by C Corporations, other S Corporations, LLCs, partnerships or many trusts¹⁰⁴. These restrictions on the ability of persons to participate in an S Corp, limit its resemblance to a company.

Both the LLC and S Corp, although having the characteristics of companies are taxed like partnerships in a process of pass-through taxation. Company profits are shared equally among partners, and partners report the profits as income on their individual tax returns which is then subject to personal income tax.¹⁰⁵ By passing the profits through to the partners, the companies avoid paying corporate income tax on their profits.¹⁰⁶ An S Corp must however pay reasonable remuneration to its employees and management and therefore cannot avoid employment taxes by attributing all its profits as distributions.¹⁰⁷ Also, the members of an LLC are subject to self-

⁹⁹ McCahery, 2004: 6.

¹⁰⁰ Brown & Rabinovitz, 1995: 565.

¹⁰¹ U.S Small Business Administration, n.d.

¹⁰² Howell, 2015.

¹⁰³ Prakash 2015.

¹⁰⁴ BizFilings, 2015d.

¹⁰⁵ BizFilings, 2015d.

¹⁰⁶ Howell, 2015. See also BizFilings, 2015d.

¹⁰⁷ Nitti, 2014: 3. See also U.S Small Business Administration, n.d.

employment taxes on their share of profits – this is arguably¹⁰⁸ an instance of economic double taxation where the LLC elects to be taxed as a partnership.¹⁰⁹

LLCs also have the flexibility to choose to be taxed as a corporation, in which case company profits in excess of the members' salaries are taxed at the corporate level.¹¹⁰ This election is favourable where LLC members do not require a substantial distribution of profits, as the first \$75,000 of taxable income can be made subject to corporate income tax through election of C Corporation status, which tax is at a rate lower than the personal income tax rate paid by natural persons earning \$75,000.¹¹¹ This election was introduced through the check-the-box regulations introduced in 1996 and which became effective from 1 January 1997.¹¹²

The check-the-box regulations applied to an LLC, “contemplate and in some cases, depend on, the existence of a single test to determine the validity of a business entity and the identity of the entity’s members ... If there is a valid business entity with two or more members, the taxpayer (that is, the entity and its members) may elect whether the entity is classified as a corporation (making the members shareholders) or as a partnership (making them partners)”¹¹³. ‘Under those rules, the classification of many entities has become entirely elective for taxpayers. Instead of manipulating four factors to achieve the desired characterisation, taxpayers could simply opt to have an entity treated as a corporation or partnership by checking a box on a prescribed form’¹¹⁴. It is however important to note that ‘a check-the-box election cannot be made with respect to certain entities that are clearly corporations ... The election can be made with respect to LLCs, partnerships, joint ventures, branches, and other business entities.’¹¹⁵

The single test applied in the form of the check-the-box regulations is one however which has seemingly not been relied upon in the courts. In the case of *Southgate Master Fund LLC v. United States*, “the taxpayer did not make the argument that for years after the effective date of the check-the-box regulations, there is a single test governing the validity of all business entities and so the government’s argument – that there are separate tests for corporate and partnership validity – is no longer true...”.¹¹⁶ Until the introduction of the check-the-box regulations, three relevant tests existed in this area of entity classification: (1) For corporations, the test applied was in terms of the principles set out in the *Moline Properties, Inc. v. Commissioner (1943)* case. The only requirement to prove a corporation had been established was ‘so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity’¹¹⁷; (2) For partnerships, in the 1949 decision in *Commissioner v. Culbertson*, the Supreme Court announced the following test, quoted from *Commissioner v. Tower*, 327 U.S. 280 (1946), to be used when determining whether the relationship between putative

¹⁰⁸ A deduction for self-employment taxes paid by the employer, is available in computing the profits attributable to the member of the LLC. See CalcXML, n.d.

¹⁰⁹ Prakash 2015.

¹¹⁰ Howell, 2015.

¹¹¹ Laurence, 2015.

¹¹² According to Lawrence Lokken (2005, quoted by Oguttu, 2007: 67). See also Department of the Treasury (1996, quoted by Seevers, 2002: 197).

¹¹³ Yale, 2011.

¹¹⁴ Arnold, B J & McIntyre, M J, 2002: 146.

¹¹⁵ Arnold, B J & McIntyre, M J, 2002: 146.

¹¹⁶ Yale, 2011.

¹¹⁷ Justia Case Law, n.d: 319 at 439.

partners constitutes a partnership for federal income tax purposes: 'The question whether [a] partnership is real for income tax purposes depends upon "whether the partners really and truly intended to join together for the purpose of carrying on business and sharing of profits or losses or both. And their intention in this respect is a question of fact, to be determined from testimony disclosed by their agreement, considered as a whole, and by their conduct and execution of its provisions";¹¹⁸ (3) For entities which had the characteristics of both a corporation and a partnership, the six factor test was used. This test was adapted from the *Morrissey v. Commissioner*, 296 U.S. 344 (1935) case, and was later incorporated into the Kintner regulations¹¹⁹ introduced in 1960.¹²⁰ The six key factors were considered to be: (1) associates, (2) objective to carry on business and divide the profits, (3) continuity of life, (4) centralized management, (5) free transferability of ownership interests, and (6) limited liability¹²¹. As the presence of factors (1) and (2) are common to both corporations and partnerships, for purposes of differentiating between both entities, only the remaining four are considered relevant therefore making the test effectively a 'four-factor' test. An entity was classified as either a partnership or a corporation for tax purposes depending on whether it possessed more than two of the four characteristics thought to be quintessentially corporate¹²².

'Tax planners could typically manipulate these factors to achieve the desired entity status for an entity, although the intended status did not always withstand a challenge by the US tax authorities'¹²³. US tax authorities however also haggled with the regulations themselves, as 'the Kintner regulations had been adequate during the first several decades after their adoption. But, as explained in the 1996 proposal for their amendment, the Kintner regulations were complicated to apply, especially in light of the fact that many states ha[d] revised their statutes to provide that partnerships and other unincorporated organizations may possess characteristics that traditionally have been associated with corporations, thereby narrowing considerably the traditional distinctions between corporations and partnerships under local law.'¹²⁴

In the opinion of the author, the check-the-box election availed to an LLC to be taxed as a partnership (S Corp taxation) or as a corporation (C Corp taxation) is a clear illustration that that this form of entity vehicle cannot be concluded to be more 'partnership' than 'company' or vice versa. By virtue of the check-the-box election, the two entity forms are seemingly aligned – "If member means something different for partnerships than it does for corporations, it confounds the regulations"¹²⁵. The election therefore recognises the quasi nature of the entity vehicle and allows a more equitable approach to taxation. In the author's opinion, this is the ideal standard that should be availed to all quasi - partnerships across the world. One may consider the U.S to have admitted that in modern times, there is essentially no substantial difference between the partnership and the company.

¹¹⁸ Yale, 2011.

¹¹⁹ Lederman, 2002: 5.

¹²⁰ Suzanne J. Pierre v. Commissioner, 2009.

¹²¹ Seevers, 2002: 206 – 207.

¹²² Brown & Rabinovitz, 1995: 566.

¹²³ Arnold, B J & McIntyre, M J, 2002: 146.

¹²⁴ Suzanne J. Pierre v. Commissioner, 2009.

¹²⁵ Yale, 2011.

The LLC is therefore a company in terms of commercial law, but can elect to be classified as either a company or a partnership in terms of tax law. The LLC is concluded to be a quasi - partnership, as it is not a traditional partnership neither is it a traditional company. The lack of consistent alignment in commercial and tax laws produces this modern partnership. ‘Tax law has made selecting a tax entity relatively simple with an elective regime that generally does not rely upon the state-law classification or general non-tax attributes of an arrangement’¹²⁶.

5.1.1. Quantitative Assessment – United States:

We now assess any taxable entity bias in the United States on the basis of a quantitative assessment. In calculating the effective rates of taxation in the United States paid by partners electing flow-through taxation and partners electing corporate taxation it is important to highlight that in the U.S, companies are not only subject to income tax at federal level, but also at a local state level. The LLC or C Corporation is therefore in actual fact subject to triple taxation! The example below therefore assumes the state tax is incurred in only a single state, and as a result there is no apportionment of the tax rate or the resultant tax.

Calculation Components	Classical System of taxation applied to C Corporations and elected by LLCs	Partnership flow-through taxation as elected by a LLC ¹²⁷
Net Profit Before Tax	100	100
Corporate Income Tax (35% ¹²⁸) or maximum marginal rate of taxation for natural persons (39.6%)	(35) [100*35%]	(39.6) [100*39.6%]
Local Income Tax ¹²⁹ (12%)	(12) [100*12%]	
Self-employment taxes ¹³⁰ (16.2%) [15.3% + 0.9%]		(16.2) [100*16.2%]

¹²⁶ Borden, 2015: 159.

¹²⁷ An assumption is made that the partner is a member of an LLC, and is a natural individual who is filing a return on his or her own behalf only (i.e. not filing a joint return together with a spouse).

¹²⁸ 35 percent is not the highest rate of corporate tax payable, but rather the rate paid at the highest income bracket, which is the bracket used in all calculations for the sake of consistency.

¹²⁹ This a tax levied on the company by each state. The tax laws of the large majority of states determine the applicable rate (between 1 percent – 12 percent), and then apportion such income tax due to their state in relation to 3 factors, each carrying equal weight: (1) the share of the corporation’s total (tangible) property held within that state (where property is not owned in a particular state, the rental expenditure incurred therein is considered); (2) payroll (i.e. the payroll expenditure incurred on behalf of company employees employed within the relevant state), and (3) sales located in each state. See PwC, 2016 and Mazerov, 2005.

Net Profit After Tax	53	44.2
Dividends Tax (20%)	(10.6)	N/A
Employers contribution deducted		8.1 [16.2/2]
Effective Tax Rate	57.6% [(35+12+10.6)/100]	47.7% [39.6+16.2-8.1/100]

On a quantitative basis, the taxable entity bias between corporate taxation and partnership taxation is clear. The level of taxes incurred by the corporation and its shareholder far exceed the effective tax rate incurred by a partner of a partnership.

5.2. United Kingdom ('UK')

The quasi – partnership form investigated by this Research Report from the UK, will be the Limited Liability Partnership ('LLP'). LLPs are common¹³¹ throughout the world and generally maintain the same characteristics throughout each jurisdiction. They are almost always limited to certain professions. The UK LLP however has sought to notably differentiate itself from what is generally understood to be an LLP in the following respects: (1) it is considered to not be a modified form of partnership, but rather a modified form of company;¹³² and (2) it is not limited to any specific professional fields.¹³³ Accordingly, the Limited Partnerships Act 2000 and the Limited Liability Partnerships Regulations 2000, which together contain the complete framework of commercial law legislation applicable to LLPs, do not incorporate any provisions of the Partnership Act 1890.¹³⁴

The LLP is an incorporated, legal entity with limited liability for its members, which may be natural persons or corporations.¹³⁵ There must be at least two persons to form an LLP and no maximum.¹³⁶ No member shall be entitled to remuneration for acting in the business or management of the LLP.¹³⁷ No person may be introduced as a member or voluntarily assign an interest in an LLP without the consent of all existing members.¹³⁸

The Act does not impose a structure for the management of an LLP. There are no statutory provisions for general meetings, directors, company secretary, share allotments, etc. As with a

¹³⁰ The Self-employment tax rate of 15.3 percent comprises of social security tax of 12.4 percent and Medicare of 2.9 percent. The tax rate on Medicare is further increased by 0.9 percent where the taxpayer earns annual income exceeding \$200,000 – see IRS, 2016. The employers contribution is however deductible by the employee. See CalcXML, n.d.

¹³¹ The LLP has been determined to exist in at least 11 other jurisdictions besides the United Kingdom, namely: Canada, China, Germany, Greece, India, Japan, Kazakhstan, Poland, Romania, Singapore and the United States. See Limited Liability Partnership, n.d.

¹³² Morse, 2004: 323. See also Oguttu, 2007: 64.

¹³³ Ibid: 322.

¹³⁴ Ibid: 323. See also Oguttu, 2007: 64.

¹³⁵ Company Formations Today. n.d.

¹³⁶ Her Majesty Revenue and Customs ('HMRC'), 2015.

¹³⁷ Company Formations Today. n.d.

¹³⁸ Ibid.

Common Law partnership, these are matters for the LLP member agreement. There is however, no legal requirement to register (or even to have) a written LLP agreement.¹³⁹

The LLP's existence as a corporate entity means that the effect of the general law is different in comparison with a partnership.¹⁴⁰ For the purposes of tax law however, the general law is irrelevant – 'once a business vehicle is characterised as a partnership, the law governing or constituting the partnership has little further impact upon the UK tax analysis.'¹⁴¹ Therefore, not surprisingly, in terms of s[ection] 10 of the Limited Liability Partnerships Act 2000, for tax purposes, the LLP is treated as a partnership¹⁴² - i.e. each partner is liable to income tax for his or her share of the profits. Accordingly, corporate members are subject to corporate tax.¹⁴³ This uncanny ability for an LLP to be classified as a corporation for all purposes other than tax is achieved through the notion of 'statutory fiction'¹⁴⁴. The term 'statutory fiction' is also referred to as 'fiction' or 'legal fiction'. Legal fiction is defined as: "An assumption that something is true even though it may be untrue, made esp[ecially] in judicial reasoning to alter how a legal rule or institution is diverted from its original purpose to accomplish indirectly some other object."¹⁴⁵ Therefore, this is an intentional, misconstruing of the tax laws applicable to corporations, in favour of this particular form of partnership, the LLP.

The question rises as to why such lengths were implored to ensure this particular flow-through tax treatment which, until 2000 was designated to partnerships and sole traders, was now bestowed upon this newly created, incorporated trading vehicle to be known as the LLP. At face value, the push for such an initiative is said to have been led by the major accountancy and legal firms founded in the United Kingdom that were operating as partnerships at that time, which threatened to re-establish themselves in Jersey, after LLP legislation had recently been introduced there.¹⁴⁶ The insights of the Fourth Report of the Trade and Industry Committee of the House of Commons however, reveal a process, which began in the 19th century and already recognised the desire for limited liability within the law of partnership.¹⁴⁷ With that goal in mind the LLP was formed, ensuring that 'the commercial choice between using an LLP or a general partnership is a tax neutral one'¹⁴⁸, as both forms of entity vehicle had flow-through treatment for their members and partners respectively. Through the creation of the LLP, the concerns of partners subject to unlimited liability were significantly addressed, mainly: '(a) a general increase in the incidence of litigation for professional negligence and in the size of the claims; (b) the growth in the size of the partnerships; since in a very large partnership, not all the partners will be personally known to one another; (c) the increase in specialisation among partners and the coming together of different professions within a partnership; (d) the risk to a partners personal assets when a claim exceeds the sum of the assets

¹³⁹ Company Formations Today. n.d.

¹⁴⁰ Oguttu, 2007: 64.

¹⁴¹ Clayson, 1995: 540.

¹⁴² Limited Liability Partnerships Act 2000

¹⁴³ Oguttu, 2007: 65.

¹⁴⁴ McGowman, Michael, Thomson, Andrew, Hardwick, Emma, 2013: 4.

¹⁴⁵ Garner, 2014: 1031.

¹⁴⁶ Trade and Industry Committee of the House of Commons, 1999: 1, 3 and 6.

¹⁴⁷ Ibid: 2

¹⁴⁸ House of Lords, 1999: 3.

and insurance cover of the partnership.¹⁴⁹ With the concerns over unlimited liability of professionals and their regulatory bodies addressed, specific tax legislation was introduced to ensure that they remain treated as partnerships for tax purposes, rather than as companies.¹⁵⁰

Recently however, the taxation of members of LLPs has come into question, based on the realisation that such members do not have the rights, duties and obligations of partners in a traditional partnership and yet receive the same flow-through tax treatment, achieving the elimination of double tax. The members of the LLP therefore do not have to act as partners do in order to receive the tax benefit of being partners; they merely need to be registered as members of the LLP. The benefit of flow-through taxation has been granted to the LLP member without differentiating instances where the role of the member is similar to that of a partner, or more similar to that of an employee.¹⁵¹ The updated tax laws will only find application where all three of the following conditions are all met: (1) the member performs services for the LLP in return for fixed remuneration or remuneration that is variable other than by the overall profits or losses of the LLP ('disguised salary'); (2) the member does not have significant influence over the affairs of the LLP; (3) the LLP member's capital contribution to the LLP is less than 25 percent of the disguised salary expected to be payable for the entire tax year.¹⁵² Meeting all 3 of the above conditions will have the effect that both the affected LLP and its members will have to pay national insurance as though the affected members were employed by the LLP.¹⁵³

Therefore, although the initial taxation of an LLP was intentionally designed to make the decision between partnership forms tax - neutral, today the tax treatment of the LLP differs from that of other Limited and General partnerships in the UK.

5.2.1. Quantitative Assessment – United Kingdom:

As was done for South Africa and the United States, we now assess any taxable entity bias in the United Kingdom on the basis of a quantitative assessment.

Calculation Components	Classical System of taxation applied to Companies	Partnership flow through taxation in LLP ¹⁵⁴
Net Profit Before Tax	100	100
Corporate Income Tax (20%) or maximum marginal rate of	(20)	(45)

¹⁴⁹ Ibid: 2.

¹⁵⁰ HMRC, 2014: 3.

¹⁵¹ HMRC, 2014: 3.

¹⁵² Watts & Evans, 2014.

¹⁵³ Law Society, 2014.

¹⁵⁴ An assumption is made that the partner is a natural individual.

taxation for natural persons (45%)	[100*20%]	[100*45%]
Net Profit After Tax	80	55
Dividends Tax (38.1%)	(30.48) [80*38.1%]	N/A
Effective Tax Rate	50.48% [(20+30.48)/100]	45% [45/100]

Although the difference in effective rates is not as high as the difference computed for the United States, a quantitative taxable entity bias is also determined to be present in the United Kingdom.

5.3. Germany

‘Similar to the U.S., partnerships under German civil law have a dual nature that is reflected in the tax treatment of partners and partnerships under German tax law... German partnership taxation is a mixture of aggregate and entity concepts similar to that in the U.S.... - Seevers¹⁵⁵

The evaluation of the GmbH & Co. KG starts with the important principle that ‘under German company law, there are no general restrictions on mixing corporate forms... mixed corporate forms may emerge from mixing basic types, by means of one company’s participation in another. The most common example is the limited liability company & limited liability partnership (GmbH & Co. KG): it is a limited partnership (*Kommanditgesellschaft* or ‘KG’) in which a limited liability company (GmbH) participates as the sole personally liable partner.¹⁵⁶ A *Kommanditgesellschaft* is a limited partnership whose purpose is the operation of a commercial enterprise under a firm name¹⁵⁷. Although not formally and specifically legislated as a separate form of entity vehicle, the GmbH & Co. KG has essentially been recognised by the courts as a business association in its own right.¹⁵⁸ As a result of the permissible ‘mixing’ of entity types, several variations of the GmbH & Co. KG have been found to exist: (1) where the partners are separate– i.e. the limited partners differ from the general partner, which is a GmbH; (2) GmbH is the general partner and the limited partners are investors¹⁵⁹; (3) the sole shareholder of the GmbH and general partner of the GmbH & Co. KG, is also the limited partner of the KG; (4) the sole shareholder of the GmbH is the limited partnership itself (*Einheits - GmbH &*

¹⁵⁵ Seevers, 2002: 166 – 168.

¹⁵⁶ Assmann et al, 2005: 144.

¹⁵⁷ Andenas & Woolridge, 2009: 154.

¹⁵⁸ Ibid.

¹⁵⁹ These are typically large GmbH & Co. KGs, which may even decide to issue their shares to members of the public (Andenas & Woolridge, 2009: 163).

Co. KG); and (5) a three-tier GmbH & Co. KG where the general partner in the GmbH & Co. KG is itself a GmbH & Co. KG.¹⁶⁰

In terms of German company law, a new term is introduced in this Research Report, the concept of ‘partial legal personality’ or partial legal *persona*. This concept is used to describe where joint ownership exists – i.e. two or more persons holding property not in distinct shares but jointly¹⁶¹.

‘The GmbH & Co. KG combines certain advantages of partnerships with the liability limitations of corporations’¹⁶². The general partner in a GmbH & Co. KG is personally liable for all the debts and obligations of the firm.¹⁶³ If the general partner is a GmbH, however, its liability is limited to its assets.¹⁶⁴ The GmbH functions as the general partner of the KG, which leads to a factually limited outside liability of the entire quasi - partnership unit.¹⁶⁵ The main difference between a GmbH & Co. KG and a standard KG is that by introducing a GmbH, which by its status as a legal person only has limited liability per se, as general partner to the KG, the general partner in the GmbH & Co. KG also receives limited liability status as a consequence of the partnership.¹⁶⁶

The limited partner is only liable up to the amount contributed in share capital to the partnership, as stated in the commercial register.¹⁶⁷ Typically, the shareholders of the general partner (GmbH) are identical to the limited partners of the KG.¹⁶⁸ As a result, this form of limited partnership is frequently used by small to medium- size family businesses¹⁶⁹ (the GmbH & Co. KG is in fact the most used form of limited liability partnership in Germany).¹⁷⁰ In this way, a scheme is devised in terms of which either as limited partners to a limited partnership or as shareholders to a limited company, all partners and members have limited liability, and the company is transformed into a partnership that is transparent for tax purposes.¹⁷¹ The limited partner(s) can be either natural persons or legal persons.¹⁷²

The limited partners are principally excluded from the management of the partnership, i.e. they are essentially silent investors as they do not have the authority to represent the partnership, and may not oppose any transactions entered into by the ordinary partners unless such transaction is determined to be beyond the scope or object of the ordinary business of the partnership. The

¹⁶⁰ Andenas & Woolridge, 2009: 161.

¹⁶¹ Assmann et al, 2005:144.

¹⁶² KPMG, 2008: 36.

¹⁶³ Solmecke, n.d2.

¹⁶⁴ Ibid: 2.

¹⁶⁵ Neubert, n.d.

¹⁶⁶ Rutow et al, 2007: 11.

¹⁶⁷ “Every German company, partnership and association must be officially registered in the Handelsregister (Commercial Register) ... there is also the Partnership Register (reserved for professional partnerships like law firms, tax and accountancy firms, medical practitioners, etc.)” (Schmeilzl, 2014). Also see Schwidetzky, 1995: 1334.

¹⁶⁸ Germany Trade & Invest, n.d.(a).

¹⁶⁹ Andenas & Woolridge, 2009: 160.

¹⁷⁰ Assmann et al, 2005:174.

¹⁷¹ Tlale, 2014: 15.

¹⁷² Solmecke, n.d.

above applies with exception only where such activity is not expressly permitted in terms of the partnership agreement.¹⁷³

The taxation of this limited partnership with a limited liability company as a general partner in Germany is similar to the taxation of all other forms of partnerships in Germany, i.e. a system of flow-through or conduit taxation is used. The profits of the GmbH & Co. KG will therefore be taxed individually for each partner. Every partner in the company will be required to report and pay the taxes on their share profits through their personal or corporate income tax returns in Germany. The income of any limited liability company partner could be additionally subject to the German trade tax.¹⁷⁴ According to section 15(1)(No.2) of the German Income Tax Act, a partner could find him/herself subject to trade tax if the activity of the partnership is determined to be a trade within the meaning of German tax law. This does not apply to the majority of pure asset managing partnerships. However, the activity of a classical GmbH & Co. KG is usually determined as a trade, because no natural person has unlimited personal liability for the obligations of the KG, resulting in it being subject to trade tax.¹⁷⁵ A partner would also be subject to trade tax where the individual qualifies as an entrepreneur.¹⁷⁶

5.3.1. Quantitative Assessment – Germany:

We now assess any taxable entity bias in Germany on the basis of a quantitative assessment. In calculating the effective rates of taxation in Germany paid by partners compared to corporates and their shareholders, it is important to highlight that in Germany (as is done in the U.S), all operating entities are subject to an additional tax, known as trade tax. In calculating the trade tax due, the taxable income of the entity is multiplied with the tax base rate (3.5 percent), which is the same throughout Germany. The tax base amount determined is then multiplied with the corresponding municipal multiplier; which results in the sum total of trade tax that is due. The multiplier is set at a municipal level. On average, it is between 350 - 400 percent but may not total less than 200 percent, with no defined upper limit for the municipal multiplier¹⁷⁷. As a result it can average from a minimum of 7 percent to the present high of approximately 17.15 percent (multiplier of 490 percent). Although seemingly applicable to all entities, partners of a partnership are able to offset the trade tax incurred against personal income taxes paid. The offset is however limited to the total of 3.8 times of the trade tax base amount. Essentially this results in the partnership not only avoiding economic double taxation, but also triple taxation, which cannot be avoided by the company.

¹⁷³ Andenas & Woolridge, 2009: 155.

¹⁷⁴ Lawyers Germany.Com, 2015: 2.

¹⁷⁵ Hogan Lovells, 2014: 16.

¹⁷⁶ Seevers, 2002: 169.

¹⁷⁷ Germany Trade and Invest, n.d.(b).

Calculation Components	Classical System of taxation applied to Companies	Partnership flow - through taxation in GmbH & Co. KG ¹⁷⁸
Net Profit Before Tax	100	100
Corporate Income Tax (15+5.5%) or maximum marginal rate of taxation for natural persons (45%)	(20.5) [100*20.5%]	(45) [100*45%]
Trade Tax (17.15%)	(17.15) [100*17.15%]	(17.15) [100*17.15%]
Net Profit After Tax	62.35	55
Dividends Tax (25.5+5.5%)	(19.33) [62.35*31%]	N/A
Offset	N/A	13.3 [3.5*380%]
Effective Tax Rate	56.98% [(20.5+17.15+19.33)/100]	48.85% [(45+17.15-13.3)/100]

Once again, on a quantitative basis, a taxable entity bias between corporate taxation and partnership taxation is clear. The level of taxes incurred by the company and its shareholder in Germany exceeds the effective tax rate incurred by a partner of a partnership.

¹⁷⁸ An assumption is made that the partner is a natural individual.

6. CHAPTER 6: FURTHER RESEARCH

Having demonstrated the development of traditional partnerships into quasi - partnerships in the jurisdictions selected for specific purposes of this Research Report, a more general comparative study of partnerships and their corresponding tax treatment is explored. This section of the Research Report is intended to provide insight on the taxation of partnerships by a jurisdiction from which South Africa has in the past and currently still models many of its domestic tax policies. The relevant jurisdiction is the Australia's – i.e. Australia and New Zealand.

6.1. Australia

Australia has two types of partnership – general and limited, both governed by the Partnerships Act 1958¹⁷⁹. A further derivative of the limited partnership is the corporate limited partnership¹⁸⁰.

In Australia, most Australian Limited Partnerships are corporate, limited partnerships in terms of Division 5A of the Income Tax Assessment Act 1936 (the 'ITAA'), essentially making such partnerships companies for tax purposes¹⁸¹. Section 94K of the ITAA states that a corporate limited partnership is excluded from the definition of a partnership for purposes of income tax law and section 94J of the ITAA states that a corporate limited partnership is included in the definition of a company for purposes of income tax law (with exception to a few definitions). Furthermore, section 94L of the ITAA defines a dividend to include a distribution by a corporate limited partnership.

For a partnership to be a corporate limited partnership, it needs to meet the requirements of the relevant state law.¹⁸² It is in terms of state law that the extent of limited liability of the partners in terms of third parties is determined. 'The corporate limited partnership provisions were enacted by Parliament on the basis that no such extended meaning was being given to limitation of the liability of a "partner" (as to include a 'partner' benefiting from an indemnity or from a liability being subject to limited recourse) ... showing such extended meaning being expressly put to the Parliament and rejected by and for the government'¹⁸³.

Therefore, similar to the South African personal liability company, the corporate limited partnership is an entity form having legal persona,¹⁸⁴ perpetual succession despite changes in composition¹⁸⁵ as is characteristic of companies and yet the extent of limitation of liability granted to it does not equate to that of a corporation, i.e. - 'while corporate limited partnerships are generally treated as companies for the purposes of the income tax law, this does not convert them into

¹⁷⁹ State Government of Victoria, 2016.

¹⁸⁰ 'An association of persons cannot be a corporate limited partnership unless it is a limited partnership under paragraph (a) of the definition of 'limited partnership' in subsection 995-1(1) of the Income Tax Assessment Act 1997 (ITAA 1997)'. See Australian Taxation Office, 2008: 1.

¹⁸¹ Elliffe & Yin, 2012: 3.

¹⁸² Australian Taxation Office for the Commonwealth of Australia, 2010.

¹⁸³ Senate Finance and Public Administration Committee of Taxation Laws Amendment Bill (No. 6) 1992 (1992, quoted by Australian Taxation Office, 1998: 4).

¹⁸⁴ Similar to the South African personal liability company which is established under the Companies Act, the Corporate Limited Partnership is incorporated 'under a law in force in that place'. See The Parliament of the Commonwealth of Australia House of Representatives, 1992: 39.

¹⁸⁵ The Parliament of the Commonwealth of Australia House of Representatives, 1992: 39.

companies for other purposes, including criminal law, monetary claims, and so on.¹⁸⁶ Nevertheless, despite the expectation of similarities between the South African personal liability company and the Australian corporate limited partnership being met, we do highlight that the enabling act, which incorporates personal liability companies, is the Companies Act whereas the enabling act of the corporate limited partnership is the Partnerships Act. Therefore, in the opinion of the author, the alignment of tax and commercial law principles in South Africa appear to be more sophisticated than the alignment of those principles in Australia. Both forms of quasi - partnership are taxed as corporations.

6.2. New Zealand

In New Zealand, limited partnerships are taxed as flow-through entities in terms of section HG2 of the Income Tax Act 2007. The profits flow through the partnership to the limited partners who are taxed each as is appropriate to them¹⁸⁷. They are incorporated¹⁸⁸ in terms of the Limited Liability Partnerships Act 2008 and therefore have separate legal *persona*¹⁸⁹ from their partners. The partnership consists of a minimum of one general partner and one limited partner¹⁹⁰. The general partners are liable for all the debts and liabilities of the partnership, while the limited partners are liable only to the extent of their capital contribution to the partnership¹⁹¹. It is usual for only the limited partners to make capital contributions and to be entitled to receive distributions pro rata to their capital contribution¹⁹². At face value such partnership appears comparable to a South African *en commandite* partnership, where the general partner makes a contribution of their time and skills as capital contributed toward the partnership. It is also noted that unlike the German GmbH & Co. KG, with the South African *en commandite* partnership and the New Zealand limited partnership the liability status of the general partner does not affect the liability status of the partnership as a whole; the general partners remain joint and severally liable for debts of the partnership.

6.3. Conclusion

Although similarities have been identified in the quasi - partnerships of South Africa, Australia and New Zealand as was initially anticipated; it is important to note that the Australia's do not have a classical system of corporate taxation but rather an Imputation system. Therefore, the burden of corporate tax incurred by shareholders is relieved in their personal income tax returns. The Imputation system is not found in many jurisdictions, due to the overwhelming support and implementation of the classical system, which facilitates economic double taxation. The Imputation system has in modern times only been identified to still exist in Australia, New Zealand and Malta¹⁹³. The Imputation system of taxation is therefore not covered for purposes of this Research Report.

¹⁸⁶ Ibid.

¹⁸⁷ Trust New Zealand, 2011.

¹⁸⁸ Ibid.

¹⁸⁹ Ibid.

¹⁹⁰ Ibid.

¹⁹¹ Companies Office. n.d.

¹⁹² Trust New Zealand, 2011.

¹⁹³ Wikipedia, n.d.(b).

7. CHAPTER 7: CAUSES MAINLY IDENTIFIED FOR THE DIFFERING TAX TREATMENT OF PARTNERSHIPS ACROSS THE WORLD IN GENERAL

Having assessed the differing tax treatment of partnerships in certain jurisdictions across the world, we now try to understand what the cause of the differences is, and what measures, if any, aimed at a measure of harmonisation, have been sought and taken. According to Oguttu¹⁹⁴, with reference to a sentiment expressed in 1995 by the International Fiscal Association¹⁹⁵, 'there are almost no laws, rulings, or authoritative statements on most of the issues concerning the taxation of partnerships'. It was the scholar's opinion that over a decade later since the 90's, this was the case. This is an opinion, which in 2016, the author of this Research Report also agrees with.

Generally, the cause of the differences in tax treatment is two - fold: (1) There is a clear difference between the approaches followed by Common Law and Civil Law jurisdictions, in that the "Aggregate"¹⁹⁶ or Fractional Theory and the "Entity"¹⁹⁷ or Agency Theory respectively, are applied by each ('Difference 1'); and (2) causing further disparities within the two groups of Common or Civil Law jurisdictions, is the domestic differences between the civil and commercial (including tax) laws within each and every Common or Civil Law jurisdiction ('Difference 2'). As a result of the disparity caused by Difference 2, an entity can be regarded as a taxable entity under tax law, but not be recognised as a person under commercial law of that same jurisdiction, and vice-versa.¹⁹⁸ Ironically, until recently it was typical for one state to rely on the [commercial] laws of the other contracting state to ascertain the nature of the partnership, but then proceed to interpret those laws in a manner different from the courts and authorities of the other state¹⁹⁹.

Common Law jurisdictions and the Aggregate/Fractional Theory: Under the Aggregate approach, the partnership does not exist independently of the partners, therefore income is not determined at the partnership level,²⁰⁰ but in the hands of the separate partners who are also the end recipients and therefore the income is only taxed once.

Civil Law jurisdictions and the Entity/Agency Theory: The Entity approach views the entity as separate from its partners. The income accrued or received is therefore taxed separately in the hands of the partnership itself,²⁰¹ and thereafter in the hands of the owners

¹⁹⁴ Oguttu, 2007: 54.

¹⁹⁵ 'By contrast, certain national Reporters feel that there is no clearly defined international tax treatment for partnerships, and their reports reveal their personal opinions in this respect....' Le Gall, 1995: 661.

¹⁹⁶ Easson & Thuronyi, 1998: 10.

¹⁹⁷ Easson & Thuronyi, 1998: 10.

¹⁹⁸ Easson & Thuronyi, 1998: 2.

¹⁹⁹ Sharma & Sharma, n.d: 2.

²⁰⁰ Easson & Thuronyi, 1998: 5.

²⁰¹ Easson & Thuronyi, 1998: 9.

as well who are the end recipients. The income stream is therefore subject to economic double taxation.

The distinction between the Civil Law Entity Theory and the Common Law Aggregate Theory can further be made as follows: ‘The distinction between the two theories, broadly stated, is that the Civil Law entity (or mercantile) theory view[s] a partnership as “a body distinct from the members composing it, and having rights and obligations distinct from those of its members” . . . [U]nder the Common Law theory, a partnership is nothing more than an aggregate of its partners. If a partner leaves or dies or a new partner enters the business, the first partnership necessarily dissolves and a new partnership is formed (often by implication) because the business is now being carried on by a different aggregate of people.’²⁰²

The use of each theory is defended by its advocates. Admittedly, each theory and tax system has its strengths: ‘The Aggregate [Theory and its tax] provisions of partnership taxation accommodate the unique nature of the capital structure of traditional partnerships, which can include complex profit-and-loss sharing arrangements. The entity [Theory and its tax] provisions provide the framework needed to tax partnership income, prevent the abusive use of the partnership tax rules, and facilitate tax administration.’²⁰³ Absolutely no clear standards exist to determine when the Aggregate Theory or Entity Theory should be applied, and no definite pattern of consistent application has emerged. This has created a significant obstacle to law making, where ‘no standard exists to guide law makers considering new partnership laws’²⁰⁴. As a result, partnership taxation similarly suffers from this severe lack of clarity.²⁰⁵ Therefore perhaps, the approach taken by the U.S that ‘the considerations that lead to the predominance of the entity or aggregate concept in one context may be only subtly different from those that give rise to the use of the opposing concept in another [context]’²⁰⁶, is the most accurate approach of all.

The starting point toward a resolution, as in all matters related to cross-border or international taxation, must be determined to lie within the domestic legislation of each jurisdiction. In relation to difference 1, a threshold determination needs to be set as to which entities should be subject to tax on legal persons (Entity Theory) and which entities should be subject to flow-through treatment (Aggregate Theory).²⁰⁷ Where a jurisdiction takes the view that economic double taxation is fair and equitable as is applied to companies in that jurisdiction, it should also find the Entity Theory appropriate to the taxation of partnerships in such jurisdiction. Where a jurisdiction takes the view that economic double taxation must be actively reduced to alleviate the tax burden on citizens and corporations while discouraging

²⁰² According to Hynes (1998, quoted by Seevers, 2002: 150).

²⁰³ Borden, 2015: 149.

²⁰⁴ Borden, 2009b: 720.

²⁰⁵ Ibid.

²⁰⁶ According to McKee, Nelson & Whitmire (1997, quoted by Borden, 2009b: 721).

²⁰⁷ Easson & Thuronyi, 1998: 7.

government spending, the Aggregate Theory should be applied to the taxation of partnerships and similarly the economic double taxation occurring within companies should be eliminated.

In relation to Difference 2, it is submitted that where the jurisdiction's tax and commercial laws are harmonised, the determination of what constitutes a partnership and what constitutes a corporation will naturally become consistently and uniformly applied. As explained previously in relation to South Africa and the personal liability company, the determination of a taxable legal person is based on distinct legal personality. In agreeing the concepts of what defines and distinguishes companies and partnerships under both tax and commercial laws, the taxable entity for tax and commercial purposes will be better defined, if not identical. Unless "(1) the rules regarding what it means to be a member of a partnership and a corporation are equated, and (2) the rules regarding what is required for all business entities – partnerships and corporations – to be respected for federal income tax purposes are equated", problems in entity form classification will persist²⁰⁸.

In conclusion on the issue identified as Difference 2, it is worth noting the issue is not widespread. 'Subject to [certain] reservation[s], tax treatment of partnerships is always tied to the legal definition of partnerships, even if its scope of application is sometimes broader, sometimes narrower. Very few states have adopted a separate definition of *partnership* for tax purposes^{209, 210}. The United States of America is a unique exception in that although the legal and tax definitions of partnerships may be aligned, the resultant tax treatment facilitated through the check-the-box regulations, is almost entirely not bound to such definitions. Hence the United States is considered to apply a system of partnership taxation incorporating both Aggregate and Entity theories.

It is believed that where the commercial and tax definitions and treatment of partnerships and companies can be aligned, and this alignment systematically enforced throughout each Common Law and Civil Law jurisdiction, only then will the taxable entity bias between the two entity forms be adequately addressed. Once the taxable entity bias of economic double taxation between companies and partnerships in each jurisdiction is removed, through the elimination of differences and anomalies in commercial and tax law; only then can any attempt to address residual matters emanating from Civil Law and Common Law tradition or custom rule start to be addressed.

²⁰⁸ Yale, 2011.

²⁰⁹ 'For instance, Australia and Finland recognize tax *partnerships* in addition to legally defined *partnerships*.'

Le Gall, 1995: 659.

²¹⁰ Le Gall, 1995: 659.

8. CHAPTER 8: CONCLUSION

8.1. Summary of Findings

The development of partnership forms across the world has occurred to the extent such that partnerships in many instances are no longer necessarily viewed as increasing personal risk and liability, being continuously dissolvable at the mercy of unforeseeable circumstances, only accessible by closely related persons with a view to operating a small to medium size business. As a result, partnerships have become more akin to companies.

For, for reasons supplied as arising from the particular Common or Civil Law background of a jurisdiction however, as well as legislative differences between commercial and tax law found within each jurisdiction, the taxation of partnerships as companies has not necessarily materialised. The main premises asserted by this Research Report are best summarised as follows: ‘When the U.S Congress enacted the current income tax Law in 1913, it treated corporations as entities separate from their owners, but disregarded partnerships, treating them as aggregates of their owners. The treatment reflected the then - current understanding of the non-tax distinction between corporations and partnerships. That understanding was based in part upon the historic view ... from that theory evolved the Entity Theory and a list of entity attributes. Although commentators were struggling with whether partnerships were legal persons separate from their owners at the turn of the twentieth century, the more dominant view appeared to be that they were not separate entities. The theories and views of corporations, partnerships, and now LLCs have changed over time and continue to change as business and legal practices evolve and lawyers find innovative uses of entities. Such changes and innovations affect the tax treatment of such entities, but current tax regimes still reflect some aspects of the early non-tax theories of the various entities. Corporate tax remains an entity regime ... The current partnership tax regime is a mere shadow of the almost pure aggregate structure ... Although the *non-tax* [own emphasis] view of partnerships has almost universally shifted to the Entity Theory over the last 100 years, partnership tax retains significant aggregate components. The history of partnership tax reveals Congress’s attempt to strike the appropriate balance between aggregate and entity provisions. The development of partnership tax is one of apparent trial and error.’²¹¹

As a result, presently a taxable entity bias between companies and partnerships exists, asserting that companies are subject to double tax where partnerships in the same economy, are not.

This observation requires each jurisdiction to relook its policy on economic double taxation, and take the appropriate, corresponding perception that such economic double taxation is equitable and fair and therefore should not be allowed to create a taxable entity bias, encouraging ‘entity shopping’ and essentially tax avoidance within the jurisdiction.

²¹¹ Borden, 2015: 148 – 149.

8.2. Areas Requiring Further Research

During the course of the research undertaken for purposes of this Research Report, the following areas for further research were uncovered: (1) the realisation that modern partnerships are akin to companies begs the further question whether partnerships should be treated as companies in all respects. For example, should all the rules that govern transactions between corporations and shareholders apply to partnerships as if partners were shareholders?²¹² As well as special roll-over relief provided to companies in certain restructuring transactions (i.e. the 'Corporate Rules' in South Africa) (2) the taxation of Trusts around the world is subject to partial flow-through (also often referred to as the 'Conduit Principle'). This is a phenomenon intentionally designed with the purpose of eliminating economic and/or juridical double taxation. If such a principle to ensure the income received by a Trust is only taxed once can be universally upheld despite the jurisdiction or its civil, common, commercial and tax background, history, and development; then surely the principle of a no tolerance approach to double economic taxation can also be upheld in favour of companies.

Therefore, of the 3 main types of business vehicles – companies, partnerships and trusts, the taxation of companies is the only form of direct taxation which is biased, excessive, economically unethical and exploitative towards taxpayers.

²¹² Easson & Thuronyi, 1998: 7.

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