

**The *En Commandite* Partnership as  
a Tax Structuring Tool**

Being a technical report submitted by

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## **ABSTRACT**

The aim of this technical report is to provide a detailed and critical review of the suitability of the *en commandite* partnership for tax structuring both generally and specifically. The report takes cognisance of the requirements that a financial institution might consider in its determination of the utility of the *en commandite* partnership as a tax structuring tool in a structured or corporate finance environment.

The report begins with an overview of the primarily legal requirements for the creation of a valid partnership.

It then considers specifically whether the *en commandite* partnership is able to take the place of the 'Lessor Trust Arrangement' and researches specific issues germane to the enquiry.

Specific legislation dealing with *en commandite* partnerships is then researched and includes a commentary on the provisions of s 24H and s 8(5)(a) of the Income Tax Act.

Practical examples of the use of the *en commandite* partnership are then considered which challenges the concept of traditional loan finance and suggests the capital contribution as a tax efficient alternative.

A consideration of the possibility of a challenge under the anti-avoidance provisions of the Income Tax Act concludes the report.

## **DECLARATION**

I hereby declare that this report is entirely my own work.

## **ACKNOWLEDGEMENTS**

I would like to thank Professor Lindsay Mitchell, my supervisor, for his assistance, advice, and patience, in assisting me in the compilation and preparation for submission of this report, to Susan Trollip for her ready preparedness to assist in the review of my submissions and to assist in rendering them suitable for submission in the required form.

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## Chapter 1

### Introduction

In the competitive world of corporate and structured finance, financial institutions are constantly looking for innovative structures for their clients. These structures may be developed as 'off-the-shelf' packages or may be tailored specifically to the needs of a particular client. In either event, the primary objective of these packages is to reduce the after-tax cost of funding for the client. In order to achieve this objective, financial institutions may use a variety of 'tax tools', which are mechanisms used to reduce tax (for example, dividends on preference shares might be used as opposed to interest being repaid on conventional loan funding) or 'tax vehicles', which refers to the body that is used to house the income, allowances etcetera (for example, a private company is taxed at the corporate rate of 30% whereas an individual is taxed on a marginal basis up to 45%). These tax tools and tax vehicles may be used alone or in combination to achieve the objectives sought. (In this paper these concepts shall be referred to generically as tax tools.)

The aim of this paper is to consider the suitability of the *en commandite* partnership as a tax structuring tool. In order to do this it is necessary to have a thorough understanding of the *en commandite* partnership,

- its tax treatment,
- flexibility (no client wants to get 'locked into' a structure that is difficult to unwind),
- its ability to combine with other tax tools, and
- its ability to be used as part of a greater tax plan.

The word partnership comes from the Latin word 'partiarus' which means 'one who shares with another' and this concept of sharing and participation forms the basis of the South African law of partnership. A partnership may be defined as ' a legal relationship arising from a contract between two or more persons, usually not exceeding twenty, each to contribute to a business or undertaking carried on in common, with the object of making and sharing profits'.<sup>1</sup>

### **History of the Partnership**

Partnership as a concept began along with co-operative economic endeavour and was largely based upon family lines. The concept received much attention from the Romans, who distinguished between various kinds of partnerships and whose understanding of the partnership as a consensual contract of the utmost good faith between the parties still prevails today.<sup>2</sup>

Commentators of the Roman Law of partnership in many jurisdictions have accepted the concept of mutual agency and solidary liability for partnership obligations. In many jurisdictions, but not South Africa, the partnership has been accepted as a legal *persona* separate and distinct from the partners of which it is comprised.

The *en commandite* partnership had its beginnings in Italy during the mediaeval period. The commenda was an arrangement in terms whereof a capitalist (commendator) entrusted capital to a trader (commendatarius) for employment in

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<sup>1</sup> Henning and Delpont: *The South African Law of Partnership, An Extract from The Law of South Africa* in para 361.

<sup>2</sup> Henning and Delpont *supra* in para 362.

mercantile enterprises on the understanding that the commendantor, while not in name a party to the enterprise and though entitled to a share of the profits, would not be liable for losses beyond the amount of his contribution. This concept of limiting the liability of non-managing investors spread from Italy into French commercial law where it emerged as the *societe en commandite*, and which then was incorporated into Roman Dutch law under its French name.<sup>3</sup>

In the absence of a modern partnership code the South African law of partnership derives from South African Common Law which is based primarily on the Roman Dutch Law. The most relevant commentary on partnership in Roman Dutch Law was that written by the French jurist Pothier towards the end of the eighteenth century and which has been accepted by the courts as an important authority in this branch of the law.<sup>4</sup> Pothier described the *en commandite* partnership as follows:<sup>5</sup>

‘Partnership *en commandite* is that which a trader enters into with a private person (a person not in trade) for a trade to be carried on in the name of the trader only, and to which the other contracting party contributes only a certain sum of money which he brings into the capital of the partnership under an agreement that he is to have a certain share of the profits if there be any, and to bear, in the contrary event, the same share of the losses, in which, nevertheless, he will only be bound to the extent of the capital that he has brought into the partnership’.

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<sup>3</sup> Henning and Delpoort *supra* in para 362.

<sup>4</sup> Pothier R J: *A Treatise on the Contract of Partnership with the Civil Code and Code of Commerce Relating to that Subject in the Same Order* - translated from the French with notes referring to decisions of the English Courts by O D Tudor London Butterworths 1854 Reprint Durban, Butterworths 1970

<sup>5</sup> Referred to by Bale CJ in *S Butcher and Sons v Baranov Bros* (1905) 26 NLR 589 at 592-593. The passage referred to is Pothier 6 3 106.

In Roman Dutch Law there were various kinds of partnership distinguishable with reference to duration, purpose etcetera but in South African law the main distinction has been between ordinary and extraordinary partnerships.

In ordinary partnerships all the partners are joint co-creditors and joint co-debtors vis-à-vis outsiders whereas in the extraordinary partnership one, or some, of the partners occupy the position of partners only in so far as their co-partners are concerned, but not vis-à-vis outsiders. Extraordinary partners are not liable to third parties for partnership debts as long as they do not act or hold themselves out to outsiders as ordinary partners, in which event they become liable as such.<sup>6</sup>

Three types of extraordinary partnerships existed in South African law prior to the passing of the pre-Union Statute Law Revision Act, 36 of 1976. These were

- the partnership *en commandite*,
- the anonymous (silent) partnership,
- and the limited partnership.

The first two types were known to Roman-Dutch Law and the third kind was introduced by statute in the Cape Province<sup>7</sup> and Natal,<sup>8</sup> but proved unpopular and has since been repealed.<sup>9</sup>

The anonymous or silent partnership is created where parties agree to share the profits of a business to be carried out in the name of one of the partners alone,

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<sup>6</sup> Henning and Delpont *supra* in para 367.

<sup>7</sup> The Special Partnerships Limited Liability Act 24 of 1861 (Cape) as amended by the Special Partnerships' Limited Liability Amendment Act 12 of 1906 (Cape).

<sup>8</sup> The Special Partnerships Limited Liability Act of 1864 (Law 1 of 1865 Natal).

<sup>9</sup> Pre-Union Statute Law Revision Act 36 of 1976.



while the partners whose names are not disclosed remain the anonymous or silent partners, sometimes also referred to as sleeping or dormant partners. The essence of this arrangement is that the existence of the silent partner should be concealed from the outside world. The silent partner, however, does not receive limited liability in that he remains liable to the other partners for the liabilities of the partnership *pro rata* to the profit share arrangement agreed between the parties.

The *en commandite* partnership is similar to the anonymous partnership in that the existence of the undisclosed partner (called a commanditarian partner or partner *en commandite*) must be concealed from the outside world for the commanditarian partner to retain the benefits of the partnership, however, the extent of his liability in the event of loss in the partnership is limited to an agreed capital contribution that he has made to the partnership.

The following characteristics of the commanditarian partner and the anonymous partner are common:

- Both are undisclosed partners, which means that they are not held out to the world as being partners. In terms of the Business Names Act 27 of 1960 s 1 and s 3 state that the names and particulars of a 'special partner', defined as the anonymous partners in an anonymous partnership and as a commanditarian partner in a partnership *en commandite*, need not be disclosed in any trade catalogue, trade circular, business letter, order for goods or statement of account.

- They are not liable for partnership debts to creditors of the partnership, but only to their co-partners. The mere fact that outsiders become aware or are informed of the nature and terms of the partnership does not render them liable to partnership creditors. They only lose their protection against a liability of this nature where they actually have acted as, or held themselves out to be, ordinary partners.
- They may not participate actively in the business of the partnership. It has been held that mere interference does not by itself constitute an active participation in the business that would make them liable to creditors, provided that they do not actively hold themselves out to be partners of the partnership.<sup>10</sup> In Roman Dutch Law a partnership *en commandite* could validly be contracted on the condition that the managing partner take heed of the advice of the other partner in matters effecting the partnership.
- They cannot claim repayment of their contributions or payment of their share of the partnership profits in competition with the creditors of the partnership.

In the event that there is confusion as to the status of the partnership the courts will generally find in favour of the partnership being considered an ordinary partnership.<sup>11</sup>

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<sup>10</sup> Henning and Delpont *supra* in para 367.

<sup>11</sup> In *Barker & Co v Blore* 1908 TS 1156 in 1158-9 Wessels J stated the following: 'The Court will always interpret a deed of partnership in favour of its being an ordinary partnership, rather than in favour of its being an anonymous partnership or a partnership *en commandite*'.

## Chapter 2

### Characteristics of Partnerships in General and *En Commandite* Partnerships Specifically

#### Formation of Partnership

A partnership is formed when the partners conclude a valid partnership agreement. There are no formal requirements that must be met to form a partnership and the agreement can thus be oral or in writing, but it is a requirement that it is an express agreement containing clarity on all the issues affecting the partnership.<sup>12</sup> Thus it has been held that where two parties had entered into negotiations regarding the formation of a partnership and had a partnership deed finalised but not signed, the one party had contributed money to the other and the business was in existence that a partnership had not been formed.<sup>13</sup> It is not clear from the authorities that an *en commandite* partnership is required to be reduced to writing in order to make it valid. In *S. Butcher & Sons v Baranov* Bale CJ stated the following:

'It appears that the French Ordonnance of Commerce of 1673 required that every partnership, whether general or *en commandite*, should be reduced to writing. This requirement is mentioned by Mr Justice Cope in *Cato v Aldridge*, but it had fallen into desuetude and is no longer required by our law, because ordinary partnership may be constituted by verbal agreement, and may be inferred from the acts of the party sought to be bound.'

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<sup>12</sup> *S Butcher & Sons v Baranov Bros supra* at 592.

<sup>13</sup> *S Butcher & Sons v Baranov Bros supra* at 592.

It can thus be concluded that the partnership *en commandite* need not be reduced to writing for it to be valid, but taking into account the inclination of the courts to find in favour of a partnership not being a partnership *en commandite* in the event of their being any confusion as to the issue, it is strongly recommended that the *en commandite* partnership should, for evidentiary purposes, be reduced to writing.

### **Partnership Subject to Condition**

The establishment of a partnership can be made subject to a condition.<sup>14</sup> This is especially important for financial institutions wishing to go into partnership with clients and who do not want to find themselves in partnership with a client before all the security and other requirements are fulfilled.

The parties may also agree on a date upon which the partnership would come into effect, thus aiding the partnership as a tool for tax structuring.

### **Legal Personality**

A partnership does not have perpetual succession. It ceases to exist when the members of the partnership change. If the partners agree to continue then they in effect form a new partnership. This may have negative consequences for the financial institution seeking to remove itself from partnerships that it has formed with clients, or seeking to change partners, as it may be considered that in so doing there has been a transfer of assets from the one partnership to the newly constituted partnership, and the consequence of there arising transfer duties on

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<sup>14</sup> *Shapiro v Roth* 1911 WLD 43.

property, market securities tax on shares, value added tax and the like needs to be researched. This paper later briefly looks at these possible consequences but is primarily concerned with only the income tax consequences of the partnership.

### **Ownership of Business Assets**

The assets are contributed to the partnership by the partners and they own these assets jointly in undivided shares. Upon the dissolution of the partnership the partnership property is returned to the partners to the extent of their original contribution or as agreed to in terms of the deed of partnership. Individual partners cannot deal with partnership property without the authority of the partnership.

### **Business Owners**

A partnership must consist of at least two partners and not more than twenty partners (except for certain professional partnerships that are allowed to have more than twenty partners).<sup>15</sup> The partners may be natural or legal persons and in ordinary partnerships there would be no distinction between the partners, whereas extraordinary partnerships have different classes of partner, for example, disclosed and non-disclosed partners, commanditarian and disclosed partner etcetera.

### **Management**

The partners manage the partnership and the rights and duties of these partners is set out in a partnership agreement which can either be in writing or oral. In

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<sup>15</sup> In terms of s 30(1) of the Companies Act 1973 no partnership may exceed twenty partners unless incorporated in terms of that Act.

*en commandite* partnerships and anonymous partnerships the undisclosed or commanditarian partners do not take part in the management of the company.

## **Representation**

A partnership acts through its partners and thus any partner in an ordinary partnership has implied authority to act on behalf of the partnership as agent and to bind the partnership provided that he acts within the scope of the business of the partnership.

A partner's act can be authorised or ratified where he has acted beyond the scope of his authority. Generally any partner in an ordinary partnership can represent the partnership. In an *en commandite* partnership only the disclosed partner may represent the partnership.

## **Capital Contributions**

It is a fundamental of the 'sharing' aspect of partnerships that all partners contribute something to the partnership, this may be in the form of money, property or services. In *en commandite* partnerships the capital contribution forms the basis of the extent of the commanditarian partner's liability, and is thus of utmost importance.

## **Distribution of Profits**

The partners can agree on the profit share to be split amongst them in terms of the partnership agreement. In theory partners may not pay themselves a salary,

however, in practise partners may agree to drawings accruing to each of them, which drawings are equivalent to salary, the understanding being that the partners agree that one partner will be entitled to draw an amount from available profits before the balance is distributed in terms of the profit sharing ratio, and that, to the extent that profits are not available to allow that partner to draw these funds, the other partner agrees to contribute that amount to the partnership.

In terms of accounting practice the partners normally become entitled to the net profits at the end of each accounting period, however, for purposes of normal tax they are taxed in their personal capacities as partners and thus the profits of the partnership accrue to them as and when such profits accrue to the partnership itself.

### **Disposal or Transfer of Interests**

A partner may not transfer his interest in a partnership unless all the partners expressly agree to the transfer and upon this happening the partnership is terminated and a new one is constituted in its place.

### **Liability to Creditors**

In ordinary partnerships the partners are all jointly and severally liable to creditors, however, in *en commandite* partnerships the commanditarian partner is not liable to creditors provided that he has not held himself out as a partner to that party. In the

case of *S Butcher & Sons v Baranov Bros* Bale CJ considered the phrase 'holding out' and summarised the law as follows:<sup>16</sup>

'In his observation on the phrase "holding out", Lindley (Partnership 4th Ed. Bk.1, Ch.1, Sec. 2 p. 149) cites Lord Wensleydale in *Dickenson v. Valpy* (10 B. and C., 140) as saying "If it could have been proved that the defendant had held himself out to be a partner, not to the world, for that is a loose expression, but to the plaintiff himself, or under such circumstances of publicity as to satisfy a jury that the plaintiff knew of it and believed him to be a partner, he would be liable to the plaintiff in all transactions in which he engaged, and gave credit to the defendant upon the faith of his being such partner. The defendant would be bound by an indirect representation to the plaintiff arising from his conduct as much as if he had stated to him directly and in express terms that he was a partner, and the plaintiff had acted upon that statement." In *Story on Partnership* (7th Ed. Sec.65) the same principles are well illustrated in a note citing an American case "To charge a defendant with liability as a partner on the ground of representation of himself as a partner, it must be proved either that he has represented himself as a partner to the plaintiff, or has made or allowed to be made such a public representation of himself in that character as to lead the jury to conclude that the plaintiff, knowing of that representation, and believing the defendant to be a partner, gave him credit under that belief.

'No person can be fixed with liability on the ground that he has been held out as a partner, unless two things concur, viz, first, the alleged act of holding out must have been done either by him or by his consent, and secondly, it must have been known to the person seeking to avail himself of it. In the absence of the first of these requisites, whatever may have been done cannot be imputed to the person sought to be made liable; and in the absence of the second, the person seeking to make him liable has not in any way been misled.'

In this case it was held on the above authority that where a disclosed partner sought to receive credit facilities from the plaintiff and disclosed the existence of the commanditarian partner in the hope that this would lead to the partnership being

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<sup>16</sup> (1905) 26 NLR 589 at 601-602.



considered more creditworthy, that as the commanditarius partner had not made the disclosure and had not consented to such disclosure, that it did not lose the protection of the limited liability.

### **Audit**

An audit of the financial statements of a partnership is not required by law.

### **Accounting Requirements**

A partnership is not required to keep specific accounting records in terms of South African law. Under the common law, however, a partner who controls partnership assets must keep and render accounts annually to the partnership.

### **Insolvency**

Upon insolvency the partners' estates will be sequestrated or liquidated unless a solvent partner assumes the liability to pay the creditors. Commanditarius partners in an *en commandite* partnership will not be required to pay anything more than their capital contribution.

### **Taxpayer**

A partnership does not form a separate taxable entity for normal tax purposes and thus the partners are taxed on the profits accruing to them in terms of the partnership agreement in their personal capacities, whether or not there has been a

distribution. Furthermore they are able to claim deductions and allowances in their personal capacities.

### **Year of Assessment**

The year of assessment for normal tax will be the end of February for individuals and where companies are involved, their specific financial year-end.

### **Provisional Tax**

Individuals in partnership are required to register as provisional taxpayers and will consequently be required to pay provisional tax on the profits accruing to them in the partnership.

### **Retained Earnings**

As partnership earnings accrue in the hands of the partner for tax purposes when they in fact accrue to the partnership, there is no taxation on the retention of earnings within the partnership. When they are subsequently paid over to the partner (he has already been taxed on that amount as at the date that it accrued to the partnership generally), they are received by him as a receipt or an accrual of a capital nature.

### **Tax Losses**

Tax losses are deductible by the partners in the determination of their taxable incomes in their profit sharing ratios. Assessed losses may be carried forward and

are not lost when partners who are natural persons cease to trade. Assessed losses of a corporate partner will be lost if it ceases to trade for a year.

### **Deduction for Salaries to Partners**

A salary paid to a partner constitutes an advance against partnership profits and is not tax deductible in the partnership's hands because it is not a separate taxpayer. The partnership is only entitled to a deduction for salaries paid to its employees.

### **Stamp Duty**

A written partnership agreement attracts a stamp duty of R10 which is payable by the affixing and defacing of revenue stamps to the value of R10 on the signed original deed of partnership.<sup>17</sup>

### **Transfer Duty**

Depending on the constitution of the partnership transfer duty will either be levied at rates applying to natural persons or corporate entities when a partnership purchases immovable property. Where an *en commandite* partnership consists of a combination of corporate and natural persons then the transfer duty would be levied in accordance with the identity of the disclosed partner.

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<sup>17</sup> Item 17 of Schedule 1 to Act No. 77 of 1968.

## Chapter 3

# Can the *En Commandite* Partnership take the Place of the Lessor Trust

### Introduction

Financial Institutions developed a product, which is described below, called, amongst other things, the 'Lessor Trust Arrangement'. This product was widely marketed and proved popular with clients, many of whom became participants in the 'Lessor Trust Arrangement'.

Unfortunately a change in legislation has now terminated the efficacy of the 'Lessor Trust Arrangement' and financial institutions are now researching the development of a suitable alternative to the 'Lessor Trust Arrangement' which offers similar benefits.

The main thrust of this paper is to ascertain the viability of the *en commandite* partnership as a tax structuring tool generally. Within this framework it would be beneficial to consider the use of the *en commandite* partnership as a replacement for the 'Lessor Trust Arrangement' as this would ensure that those aspects of the *en commandite* partnership needing to be considered for purposes of tax structuring, have been properly considered.

### **Mechanics of the 'Lessor Trust Arrangement' Sought to be Replaced**

A lessor trust would be formed with a financial institution as the initial vested income beneficiary and the client as the vested capital beneficiary.

The trust would purchase the assets sought to be financed from a supplier (or client where there was a re-financing) with funds borrowed from the financial institution.

The trust would then lease the assets to the client for a period of five years (or whatever period was required to take full advantage of the capital allowances in respect of the asset).

The financial institution might be the founder of the trust and would be the controlling trustee. This would give it the flexibility to agree to changes in beneficiary etcetera.

The financial institution would then make capital contributions to the trust of the after-tax value of any assessed losses that it might enjoy as a beneficiary of the trust.

At the end of the period the income beneficiary would be substituted by the capital beneficiary and the client would then have the option of either

- retaining ownership of the asset in the trust, or
- causing a distribution of assets to the capital beneficiary to take place (and so terminating the trust).

In either event it would seem that the recoupment provisions of s 8(4)(a) would be avoided.

### **Income Tax Consequences of the 'Lessor Trust Arrangement'**

In terms of s 25B of the Income Tax Act (the Act) the trust would act as a conduit and all income, expenditure and allowances would be recognised in the hands of the vested income beneficiary. Section 25 B(2) states the following:

'(1) Any income received by or accrued to or in favour of any person in his capacity as the trustee of a trust referred to in the definition of "person" in section 1, shall, subject to the provisions of section 7, to the extent to which such income has been derived for the immediate or future benefit of any ascertained beneficiary with a vested right to such income, be deemed to be income which has accrued to such beneficiary, and to the extent to which such income is not so derived, be deemed to be income which has accrued to such trust.

'(2) Where a beneficiary has acquired a vested right to any income referred to in sub-section (1) in consequence of the exercise by the trustee of a discretion vested in terms of the relevant deed of trust, agreement or will of a deceased person, such income shall for the purposes of that subsection be deemed to have been derived for the benefit of such beneficiary.

'(3) Any deduction or allowance which may be made under the provisions of this Act in the determination of the taxable income derived by way of any income referred to in subsection (1) shall, to the extent to which such income is under the provisions of that subsection deemed to be income which has accrued to a beneficiary or to the trust, be deemed to be a deduction or allowance which may be made in the determination of the taxable income derived by such beneficiary or trust, as the case may be.'

In terms of the above deeming provision the rentals earned by the trust would be deemed to be income in the hands of the vested income beneficiary.

Likewise the deductions and capital allowances would be deductible in the hands of the income beneficiary.

The financial institution would derive the benefit of any tax loss arising in the trust, subject to the provisions of s 23A of the Act which limits the allowances claimable by a lessor to the taxable income derived from the lessor's 'rental income' as defined in s 23A of the Act.

The client would be able to deduct the rentals payable to the trust for the asset in terms of the general deduction formula set out in s 11(a) and thus would be in the same position that it would have been in for the purposes of the tax treatment of its financing requirements except that the trust, upon receiving the capital allowances would be able to reduce the amount of the rentals charged to the extent of the capital contributions made. This would place the client in an advantageous position in that he would be receiving a reduced financing rate and would receive the asset at the end of the period as a distribution to the capital beneficiary.

This 'Lessor Trust Arrangement' had favourable consequences for the client who could sell an asset already owned by him to a trust over which he retained a measure of control (by way of the trust deed and the appointment of the client as a trustee) and which he was assured he would receive by way of capital distribution upon dissolution of the trust.

In the interim the financial institution would claim the capital allowances that the client would otherwise have received. Provided that the financial institution had

taxable income against which it could claim the capital allowances, it would make an adjustment in either the interest rate charged to the Trust, or where a lease was contemplated, by a reduction of the rental charged for the asset financed. In some cases a 'Capital Contribution Agreement' was entered into which generally referred to a 'computer model' which would calculate the exact after tax benefit received by the financial institution and would require the financial institution to make payment of a large portion of this amount as a 'tax base contribution' to the trust, the balance remaining with the financial institution as its 'tax base contribution fee'. The use of any of these mechanisms would ensure a lower effective rate of financing to the trust which would be passed through to the client in the rate charged by the trust to the client.

The 'Lessor Trust Arrangement' was especially effective with clients that were in assessed loss positions but were not willing to hire the goods directly from the financial institution, for whatever reason. It also had popularity with clients that were in assessed loss positions and preferred to receive a reduction in their funding costs by way of a reduced financing rate than to claim the capital allowances themselves which merely resulted in them receiving an increased assessed loss. Obviously a reduced funding cost would give the client an immediate cash flow benefit which would be more valuable than an increased tax assessed loss.

Furthermore, the payments to the trust in terms of the rental/lease would be fully deductible in the hands of the client.

There was also a benefit in that upon distribution of the asset to the capital beneficiary there would be no recoupment in terms of s 8(4). From the beginning of



the transaction the asset was held on behalf of the capital beneficiary and thus the distribution would merely pass formal ownership to the legitimate owner.

Unfortunately for the taxpayer who had requirements that would have made the Lessor Trust Arrangement an ideal vehicle for financial planning, the Legislature amended the Income Tax Act in terms of the Taxation Laws Amendment Act 30 of 1998 to provide for a 'ring-fencing' of the allowances. It amends section 25B of the Act by the addition of the following subsections:

'(4) Notwithstanding the provisions of subsection (3), any deduction or allowance contemplated in that subsection which is deemed to be made in the determination of the taxable income of a beneficiary of a trust during any year of assessment shall be limited to the income which is deemed to be income which has accrued to such beneficiary in terms of subsection (1) during such year of assessment.

'(5) The amount by which the sum of the deductions and allowances contemplated in subsection (4) exceeds the income contemplated in that subsection, shall be deemed to be a deduction or allowance which may be made in the determination of the taxable income of the trust during such year of assessment: Provided that the sum of such deductions and allowances shall be limited to the taxable income of such trust during such year of assessment as calculated before allowing any deduction or allowance under this subsection.

'(6) The amount by which the sum of the deductions and allowances contemplated in subsection (4) exceeds the sum of the income contemplated in subsection (4) of such beneficiary and the taxable income of such trust contemplated in subsection (5) shall for the purposes of subsection (3) be deemed to be a deduction or allowance which may be made in the determination of the taxable income derived by such beneficiary by way of income referred to in subsection (1) during the immediately succeeding year of assessment.'

The new subsections are deemed to have come into operation on 11 March 1998 and apply in respect of

- any new trust created on or after 11 March 1998; and
- any existing trust, with effect from years of assessment commencing on or after 1 January 1999.

The effect of the above amendments is to 'ring-fence' the allowances available to a vested income beneficiary by limiting any allowance or deduction to the extent of the income received by that beneficiary from the trust.

This effectively sounded the death knell for the 'Lessor Trust Arrangement' as it relies upon the allowances being set-off against other income accruing to the financial institution concerned.

The position is that financial institutions had until the end of 1998 to continue the 'Lessor Trust Arrangement', whereafter they would have to find some other arrangement that would be able to satisfy the needs of those clients whose requirements were previously met by the 'Lessor Trust Arrangement'.

*En commandite* partnerships may provide the solution, but in order to do this they would have to provide a vehicle whereby a separate *persona* (not necessarily legal) could form a link between the financial institution and the client, which *persona* could enter into agreements with both the financial institution and the client, and which would provide a mechanism for separating the income from the capital. This would then allow the financial institution to receive the benefit of the allowances without having these allowances limited to the income received from the said *persona*. It would also allow the client to fully deduct all payments made to the *persona* for the use of the asset and at the end of the period would allow the client

to receive ownership of the assets financed without incurring a recoupment or any other tax disadvantage.

The *en commandite* partnership provides many of the requirements of the replacement vehicle sought. In order to determine how effective it might be some of the more pertinent aspects need to be considered.

### **Can the Partnership Enter into Contracts with its own Partners**

In order to answer this question it is important to consider the two theories regarding the legal nature of partnerships.

- The first theory is that the partnership is a legal entity distinct and separate from its members – this has been called the ‘entity’ or ‘mercantile’ theory, and
- the second theory is that the partnership is merely a collection of individuals – known as the ‘aggregate’ theory.

### **The Entity Theory**

The ‘entity’ theory considers that the partnership is a separate body to the partners of which it is composed, much like the concept of a company. It has been adopted in many civil law jurisdictions, notably France, Belgium, Spain, Scotland, Louisiana and many Latin American countries. In Scotland, for example, however, although the separate entity of the partnership is explicit it is still treated differently to the juristic *persona* of an incorporated association.<sup>18</sup>

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<sup>18</sup> See Henning and Delpont *supra* in footnote 9 to para 386.

### The Aggregate Theory

English law does not recognise the partnership as an entity separate and distinct from the members comprising it, and it is this 'aggregate' theory that is generally followed in common law jurisdictions (of which South Africa is one). The theory is

- that the partnership is treated merely as an aggregate or collection of individuals composing it,
- that the partners own the assets forming the partnership assets,
- that the rights and obligations of the partnership are their own rights and obligations,
- and that any change of partners destroys the identity of the partnership.

A partner can be the debtor or creditor of the other partners but not of the partnership itself according to a strict interpretation of the 'aggregate' theory, and he also cannot be employed by the partnership nor can he contract with the partnership.

Notwithstanding the strict statement of each of the above theories there are many instances where the distinction in practice between the two theories has been blurred and aspects of the one theory are incorporated in the other.

In South African law the aggregate theory is not strictly pursued, thus it has been held in *Silbert & Co v Evans & Co*<sup>19</sup>

- that a distinction be made between the partnership creditors and the creditors of the individual partners,
- that partnership creditors should have preference over partnership assets, and

- that creditors of an individual partner could not lay claim to that share of the partnership assets accruing to the debtor to the prejudice of partnership creditors.

Furthermore Voet in his treatise on the law of partnership considered that a partner could be convicted of theft of partnership property, thus implying that the property is owned by some 'entity' separate from the partners themselves.<sup>20</sup>

The Insolvency Act<sup>21</sup> changes the common law approach to partnerships in that it retains the partnership estate as a separate estate from the estates of the individual partners and precludes partnership creditors from preferring their claims against the individual estates. Thus partnership creditors have to look initially to the partnership assets only and the trustee of the partnership can then only look to the residue of the partners non-partnership assets once these have been used to settle creditors of his private estate. Separate accounts have to be drawn in respect of each of these estates. It has thus been held that upon insolvency the partnership asset must be treated 'as a separate entity as soon and as long as its liabilities exceed the value of its assets'.<sup>22</sup>

In Civil Practice and Procedure the partnership is also treated as a separate entity, albeit not a separate legal entity.

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<sup>19</sup> 1912 TPD 173

<sup>20</sup> Voet, J; *Commentarius ad Pandectas* – Den Haag De Hondt 1698-1704 in 17 2 28.

<sup>21</sup> Act 24 of 1936.

<sup>22</sup> *Michalow N.O. v Premier Milling Co. Ltd* 1960 2 SA 59 at 63; *Strydom v Protea Eiendomsagente* 1979 2 SA 206 (T) at 209.

For example,

- a partnership creditor is obliged to sue all the partners together for payment of a partnership debt,<sup>23</sup>
- judgment must be taken against the partnership and not the individuals themselves,
- the partnership assets must be attached first and only upon them being exhausted may the assets of the individual partners be attached,<sup>24</sup>
- and a partnership may sue and be sued in its own name.<sup>25</sup>

In South Africa there has thus not been a strict compliance with the aggregate theory and one sees that the above exceptions or quasi-exceptions have led Hahlo and Kahn to describe the partnership as being<sup>26</sup>

‘without substance, a kind of juristic ghost which comes nearest to materialising in the statutory provision for the separation of partnership estates’.

Although it is generally accepted that a person cannot contract with himself and that upon a strict application of the ‘aggregate’ theory it would not be possible for a partner to contract with the partnership, because of the peculiar nature of the South African partnership the following was held in *Executors of Paterson v Webster, Steel & Co*<sup>27</sup> that:

‘The real question ...[is] whether the firm should be looked upon as a body distinct from the members comprising it, or whether, ignoring the firm, the law should not

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<sup>23</sup> See Henning and Delpont *supra* at footnote 38 in para 389.

<sup>24</sup> Supreme Court Act 59 of 1959 s 26(2); Supreme Court Rules r 14(5) (h); Magistrates Courts Rules r 40 (3).

<sup>25</sup> SC Rules r 14; MC Rules r 54.

<sup>26</sup> Hahlo and Kahn, *Union of SA: Development of its Laws and Constitution* at 702.

<sup>27</sup> (1881) 1 SC 350 355-356.

look merely to the partners comprising the firm. There can be no doubt that, as a general principle, the Court can only recognise the members of which the firm consists. ... [I] do not wish to be understood as laying down that a contract may not be made with a firm as a firm if this be clearly the intention of the parties.'

There is further evidence to support this submission – in the case of *Strydom v Protea Eiendomsagente* Nestadt J, in considering whether two partnerships having common members could sue each other based on a contract purportedly entered into between them, stated that<sup>28</sup>

'The solution of this problem in our law depends largely on whether our Courts would regard a partnership as having a *persona legis* for this purpose, and it is submitted that according to our law it has. ... It is clear that for certain purposes a partnership is considered to possess a *persona legis*, eg in cases of compensation in insolvency etc.'

In *Standard Bank of SA Ltd v Lombard* it was held that a partner could bind himself as surety *in solidum* for debts of the partnership to creditors. Botha J stated that<sup>29</sup>

'this ... was plainly the object sought to be achieved by means of the documents in question ... I can see no reason why the documents should not be valid and operative as such, even if it is to be assumed that they do not qualify as suretyships *stricto sensu*, a matter on which I need not express any firm opinion.'

In *Shingadia Bros v Shingadia* the following was stated in this regard:<sup>30</sup>

'The issue in this appeal does not relate to the validity of a lease by a partnership to a partner. That was assumed to be valid in the High Court, and there is considerable authority for that view. In England in *Doe d. Colnaghi v. Bluck* ... there was direction that there could be a lease by a partner to a partnership and another

<sup>28</sup> 1979 (2) SA 206 (T) at 210 G-H.

<sup>29</sup> *Standard Bank of SA Ltd v Lombard* 1977 2 SA 808 (W) at 813H.

<sup>30</sup> 1958(1) SA 582 (FSC) at 582 G-H and approved in *De Abreau v Silva* 1964 (2) SA 416 (T).

similar case is set out in a note 173 .... See also *Pocock v Carter* ... In *Whitaker v Whitaker & Rowe* ... Pittman J said:

“The contract sued on, a lease by one partner to a partnership firm, appears to embody a somewhat anomalous relationship, but its validity according to our law is admitted ... In England it is clear ... that such a contract is regarded as valid, and the admission just mentioned induces us in the absence of authority to the contrary to accept the law as being to the same effect in South Africa.” ’

The above authorities confirm then that if the partners have the intention to enter into a contract with the partnership then the courts will recognise the contract. The conclusion is thus that a partner can contract with the partnership.

### **Property in Partnership**

As was discussed above, South African legislation grants partnerships recognition of the separate nature of the partnership estate, especially as regards the Insolvency Act. Unfortunately the courts have not yet had the opportunity to clarify many of the other aspects of partnership property that arise, and until the courts can apply their judicial mind to these other aspects, a determination of the approach that would be considered correct by the courts must be based upon existing judicial precedent.

The establishment of a partnership fund is not one of the *essentialia* for the constituting of a partnership and thus partnership assets do not need to be jointly owned by the partners. It is therefore quite possible for a particular asset to be treated by the partners *inter se* as a partnership asset although from a property law point of view it is held in the name of only one of the partners (this is particularly so in the *en commandite* partnership).



Property vests in the partnership as a fulfilment of the intention of the partners – thus if the partners intend property to vest in the partnership then it shall be considered to be a partnership asset. This is all the greater reason to reduce the partnership agreement to writing, especially in *en commandite* partnerships. Furthermore, it is beneficial to the commanditarian partner in that there is no need to register a transfer of the asset into the name of the client at the end of the financing period, as the asset is already registered in his name.

### **Shares in Partnership**

A partner's share in a partnership is two-fold.

- He first has a share to his proportionate interest in the partnership property remaining after realisation and settlement of partnership creditors, and
- secondly he has a right to his proportionate share of the profits of the partnership that are earned from time to time.

The first right can be equated to equity capital in a company, or the rights to capital in a trust.

The second can be equated to the income proceeds emanating from the equity capital or the rights to the income from the trust.

A partner cannot look upon any partnership assets as his own until the assets have been realised and the extent of his share has been determined and this would

normally only take place upon the termination of a partnership. Partners generally agree on interim sharing of profits at year-end though.

### **Can a Partner's Share be Ceded**

For the purposes of financial structuring, it is important that at all times the partner has an interest that can be valued and if necessary realised. It is important in assessing the creditworthiness of a partner that his interest in the partnership can be ceded to the financial institution or realised.

It is accepted law that the right to receive the profit sharing ratio upon dissolution, as with most other rights, is capable of being ceded to another party. This asset forms part of the partner's private estate and can be attached and sold in execution to satisfy the claims of a partner's private creditors.<sup>31</sup>

It is important to be aware that although a partner is entitled to cede or alienate his interest in the business, a cession or alienation is not sufficient to make the cessionary or purchaser a partner in the partnership. This principle is embodied in the legal maxim *socii mei socius, meus socius non est*, which may be translated as

'the partner of my partner is not my partner'.

Thus a party may only become a partner with the consent of all the remaining partners.

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<sup>31</sup> *Sacks v CIR* 1946 AD 31 at 43.

The tax structuring opportunity that this provides is that if one were to secure the irrevocable consent by the partners to the joining of a proposed partner to the partnership in advance of the deal being concluded then it is conceivable that one could enter into a forward sale of the entitlement. This could be expanded so as to allow the partners to irrevocably agree to the admission of one of a class or order of people as partner (for example, a financial institution). This would give the partnership the option of agreeing up-front that in a set number of years, or upon the happening of an event, the remaining partners would agree to the substitution of one partner for another, provided that the proposed new partner met the criteria agreed upon. As the criteria would be agreed in advance and would be irrevocable there would be nothing to prevent the first-mentioned partner from entering into a forward sale of his interest in the partnership. In like manner there would be nothing to stop the partner discounting his entitlement to benefits arising in terms of the agreement at a later date. This may provide an opportunity for 'bare dominium' arrangements to be put into place using partnerships as the vehicle.

Bare dominium structures rely on the rights of use and the rights of ownership being split for a period in order that the person with the rights of use can enter into a rental over the property, in the knowledge that the rights of use and ownership will later be re-united – this is generally achieved by forward selling the rights of ownership to the lessee's holding company or to another related company. The benefit to the client is that he is able to deduct in full the rentals paid whilst transferring the bare dominium to a company in which he has an interest at a fraction of the cost of a normal transfer, the justification being that the property is subject to the lease and as the lease proceeds do not accrue to the bare dominium

holder, but rather to the lessor, the market price for the bare dominium is consequently relatively low.

As the right to receive the proceeds on termination of the partnership can be ceded, this can be incorporated into financial planning. In terms of the 'Lessor Trust Arrangement', the parties would agree, upon entering into the arrangement, that there would be a participation switch between the income beneficiary and some other party (normally the capital beneficiary) at some time in the future, but normally once all the tax allowances had been claimed by the income beneficiary.

There is thus the possibility that in a partnership the partners could agree to sell their interest to another party and so re-create those rights, obligations and advantages that were created in the Lessor Trust Arrangement.

### **Sharing of Profits and Losses**

A distinction can be drawn between the concepts of capital rights (the rights upon dissolution) and income rights (the rights to the profits generated from the partnership from time to time) and whereas the potential for discounting or ceding capital rights has been explored, the potential for the structuring of the income rights needs to now be considered.

In the absence of agreement the partners would normally share the profits in accordance with the contributions that they have made to the partnership, however, the partners are at liberty to agree to whatever profit-sharing ratios they wish.

Indeed the Act envisages that there may exist a different ratio in respect of losses and profits respectively. Section 24H(5)(a) states in reference to partnership profits and losses that:

'Where any income has in common been received by or accrued to the members of any partnership, a portion (determined in accordance with any agreement between such members as to the ratio in which the profits or losses of the partnership are to be shared).'

This provision implies that a different ratio may be agreed between the partners as to the splitting of profits and losses respectively. *Meyerowitz* agrees that the legislation allows for the different ratios but states that this raises a further problem, namely the determination of what ratio should be utilised to restrict the allowances. He states the problem as the following:<sup>32</sup>

'The reference to the profit or loss ratio raises a difficulty where the ratio of profit sharing differs from the loss sharing ratio. Where this is the case, it may be that neither the accruals nor the deductions can be determined until in terms of the partnership agreement the profit or loss is determined. Where the ratios differ, it also becomes questionable as to the ratio in which tax allowances which do not affect profit or loss are to be apportioned. It would seem more appropriate to use the loss ratio rather than the profit ratio on the ground that an allowance is connected with expenditure (capital or revenue).'

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<sup>32</sup> Meyerowitz, D: *Meyerowitz on Income Tax 1997 ♦ 1998*, Cape Town, The Taxpayer CC in §§16.74.

### **Can One Partner Agree to Bear All the Losses and the Other Partner Agree to Receive All the Profits**

If one partner were to bear all the losses and the other all the losses this would not meet the requirement that the partnership should have as its object the sharing of profits, however, this particular type of arrangement did exist in Roman Dutch Law and was called the '*societas leoninas*'.<sup>33</sup> It was not considered a valid partnership.

There is debate as to whether the insertion of this type of clause, referred to as a *leonine* clause, would have the effect of making the entire partnership invalid, or whether that particular clause is merely void, thus leaving the partners to share profits in terms of common law principles.<sup>34</sup> Henning and Delpont state that there is authority for both these viewpoints but that the South African courts have not yet had an opportunity to express their view in this regard.

There is a further view in certain legal jurisdictions that a clause of this nature, and consequently the partnership agreement itself, is valid as a donation agreement.<sup>35</sup>

### **Can One Party Agree to Bear all the Loss**

In the case of *Blumberg and Sulski v Brown and Freitas* Wessels JP had the following to say in regard to whether one partner could agree to bear all the loss in a partnership:<sup>36</sup>

'It is quite true that parties may agree that one partner is entitled to share the profits, but not to be liable for any portion of the losses. If, however, it appears that the one

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<sup>33</sup> See Henning and Delpont *supra* in note 30 to para 370.

<sup>34</sup> *Ibid.*

<sup>35</sup> *Ibid.*

<sup>36</sup> 1922 TPD 130 at 137.

partner is to have no share at all in any loss, whatever the transaction may be, it is not a partnership.'

In *Dickinson and Brown v Fisher's Executors* Maasdorp JA stated the following:<sup>37</sup>

'One of the first points raised by counsel for the plaintiffs was that no valid partnership existed, because neither Fisher nor Brown were liable under the agreement to bear a share in the losses of the business. But the great weight of authority in our law is to the effect that participation in losses is not essential to the constitution of a valid partnership. I need only refer to the following passage in *Voet* (17,2,8):

" But a community in profit and loss is of the very essence of a partnership, so much so that there is no legal partnership where such community cannot exist."

'And further on he adds:

"And in fact the partners might legally agree that one should receive a share of the profit and yet not be liable for any loss."

'In the last case the agreement would seem, at first sight, to induce a community in the profits only and not in the loss, a thing contrary to the principles of partnership; but this is not really so, for in the case in question the profits are understood to include only what remains after every liability has been met; and he, therefore, who according to the apparent meaning of the words, at first sight would seem to be freed from the burden of bearing a share in the loss, yet because of this set-off of liability against profit, is in point of fact, a sharer in the loss also.'

There seems to be some confusion in South African law as to what the correct situation is, bearing in mind that the *Dickinson and Brown* case was an Appellate Division case and was heard in 1916, and that *Blumberg and Sulski* was heard in

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<sup>37</sup> 1916 AD 374 at 394.

1920 in the Transvaal Provincial Division (which was bound by decisions in the Appellate Division).

The best way to summarise the situation in South African law is to say that the sharing of losses is a requisite of a valid partnership agreement, but that the reference to losses should be taken as a reference to a sharing of gross losses, and not net losses of the partnership. The sharing of the profits and losses therefore implies that a partner must at all events share in the losses 'so far, at least, as they constitute a charge upon, and diminution or deduction from the profits'.<sup>38</sup>

It has furthermore been held that as long as it is clear that each partner receives a share of the profits, it does not matter that the formula that is used for the determination of the respective shares is complex or unusual. In *Dickinson and Brown v Fisher's Executors*<sup>39</sup> a partner's share in the profits was fixed on the basis of a certain percentage on his capital contribution to the partnership and this was considered to be sharing in the profits and not repayment of a loan.

The above reference gives authority for the view that the profit sharing ratio can be complex provided, however, that all partners receive a profit. If this is indeed the case then nothing should preclude the partners from agreeing to change the partnership profit sharing ratio from time to time – indeed it is accepted that the partners may decide on a split at the end of each year regarding the profits of that year, and this decision would no doubt take place having regard to various factors

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<sup>38</sup> Henning and Delpont *supra* in para 371.

<sup>39</sup> *Ibid.*



pertaining at that time. If this principle is accepted then its application can be extended to agreement on different profit sharing ratios prior to and upon entering into the partnership.

### **Profit Motive**

It is one of *Pothier's* requirements for a valid partnership that the partnership makes profits and divides them amongst the partners.<sup>40</sup> A partnership is therefore not established where the aim is merely the acquisition and not the ultimate sharing of profits. The making of profits must be the immediate and main aim of the partnership and cannot be an incidental possibility of the venture.<sup>41</sup> Although the main aim of the partnership must be the making of profits, it is not a requirement that it actually make a profit, just as long as the partnership was capable of making a profit and this was the intention. A speculative venture can therefore be a partnership.<sup>42</sup>

The question that really needs to be addressed is whether this profit motive need be a profit motive in the partnership itself, or is it sufficient that the partner derives a benefit elsewhere that he would otherwise not have got had he not entered into the partnership.

South African courts have never directly decided the question whether gain as opposed to profits can be the aim of the partnership and, if so, what type of gain would qualify. Common law authorities quoted by Henning and Delpont generally

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<sup>40</sup> Referred to by Bale CJ in *S Butcher & Sons v Baranov Bros* (1905) 26 NLR 589 in 592.

<sup>41</sup> *Van der Keessel – Dictata ad Justiniani: Institutionum* (Beinart, Hijmans and Van Warmelo) – Amsterdam Balkema 1967 2v in 3 26 1.

<sup>42</sup> *Laughton v Griffin* (1893) 14 NLR 84.

require *lucrum* or *quaestus*<sup>43</sup> to be the aim of the partnership.<sup>44</sup> The concepts are wide enough to include both profits and other gains and it can thus be accepted that the profit motive referred to by *Pothier* in his description of the partnership is capable of being interpreted in the wider sense.<sup>45</sup>

In *Isaacs v Isaacs*<sup>46</sup> it was held that the object of a partnership being 'to provide for the livelihood and comfort of the parties, and that of their children, including the proper education and upbringing of the latter' was equivalent to the making of a profit and was thus sufficient for partnership purposes.

In England, the Partnership Act of 1890 does not contain a definition of the concept of profit although English law does require that profit be the motive for a properly constituted partnership. As the English law requirements are similar to South African law it is beneficial to consider how the English courts of law have approached the profit requirement. Although not decisive in South African law, these decisions do have persuasive value. It is important in the determination of the ability to use partnerships as tax structuring tools to ascertain what South African courts would consider to be a proper profit motive.

In the case of *Newstead (Inspector of Taxes) v Frost*<sup>47</sup> there is authority for the proposition that a partnership entered into for a fiscal motive, namely, tax avoidance, can be a partnership. The facts of the case were briefly that the British

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<sup>43</sup> The word 'lucrum' means 'gain or profit' and the word 'quaestus' means 'a gaining, acquiring; gain, profit, advantage' as defined in the *Chambers Murray Latin – English Dictionary*.

<sup>44</sup> See Henning and Delpont *supra* at footnote 34 in para 370.

<sup>45</sup> See discussion in Chapter 1: Introduction.

<sup>46</sup> 1949 1 SA 952 (C) 956.

<sup>47</sup> 1979 2 All ER 129 (CA); 1980 1 All ER 363 (HL)

actor David Frost had set up a partnership with an off-shore company based in the Bahamas and the partnership had then conducted the business of entertaining with an agreement that any profits would be split in the ratio 95/5 in favour of the taxpayer and the off-shore company respectively. Most of the activities forming part of the partnership business were conducted outside of Britain and no part of the taxpayer's share of the profits were remitted to Britain. The Crown sought to challenge the validity of the partnership on two main bases,

- the first being that the company could not enter into partnership with the taxpayer as it could not do the same activity (namely entertaining) as the taxpayer, and
- secondly, that the sole motive for entering into the partnership was to derive a fiscal advantage, namely, avoidance of tax, which was not a profit motive as was required in terms of their Partnership Act.

Buckley LJ held the following: <sup>48</sup>

'It is in my judgment clear from s 1 of the 1890 Act that the statutory definition of 'partnership' requires that the parties shall carry on business (a) in common and (b) with a view of profit. It has been submitted that the adverbial phrases "in common with" and "with a view of profit" both qualify the words "carry on business", and this would seem to me to be correct. Nevertheless, counsel for the Crown submits that the common intention here was not to make a profit but to avoid tax.

'For my part, it seems clear that the activities on which the company and the taxpayer were embarking were intended to be profitable. The company and the taxpayer were to divide the profits of these activities in specific proportions. The fact that by setting up the partnership the parties hoped to achieve a measure of tax avoidance by the taxpayer does not import that the partnership business was not to

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<sup>48</sup> At 137-138.

be conducted with a view of profit. It was to be conducted with a view of profit, which it was hoped would avoid tax.

'... This scheme is admittedly a scheme devised to avoid tax; but that in itself, in my judgment, does not in any way vitiate the scheme, provided they were genuine transactions which were entered into.'

Roskill LJ agreed with the judgment of Buckley LJ and quoted the following passage from the case of *Lupton (Inspector of Taxes) v FA & AB Ltd*, which extract had been expressly approved in the House of Lords:<sup>49</sup>

'If on analysis it is found that the greater part of the transaction consists of elements for which there is some trading purpose or explanation (whether ordinary or extraordinary), then the presence of what I may call "fiscal element", inserted solely or mainly for the purpose of producing a fiscal benefit, may not suffice to deprive the transaction of its trading status. The question is whether, viewed as a whole, the transaction is one which can fairly be regarded as a trading transaction. If it is then it will not be denatured merely because it was entered into with motives of reaping a fiscal advantage. Neither fiscal elements nor fiscal motives will prevent what in substance is a trading transaction from ranking as such. On the other hand, if the greater part of the transaction is explicable only on fiscal grounds, the mere presence of elements of trading will not suffice to translate the transaction into the realms of trading. In particular, if what is erected is predominantly an artificial structure, remote from trading and fashioned so as to secure a tax advantage, the mere presence in that structure of certain elements which by themselves could fairly be described as trading will not cast the cloak of trade over the whole structure.'

According to Dutch law a pecuniary profit motive is not strictly required and the gaining of another material advantage would suffice, the example given in Henning and Delpont being a joint exercise for the purpose of saving costs. In *Ally v Dinath*<sup>50</sup> it was held that in determining whether a universal partnership between a common

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<sup>49</sup> [1971] 3 All ER 948.

<sup>50</sup> 1984 2 SA 451 (T).

law man and wife had been brought into existence, the objective of 'the accumulation of an appreciating joint estate' was considered a sufficient profit motive for the establishment of the partnership. Eloff J stated the following:<sup>51</sup>

'What is required is not a pure pecuniary profit motive; the achievement of another material gain, such as a joint exercise for the purpose of saving costs, will suffice. *De Groot* 3.12.1 requires no more than that the aim should be "gemene baat te trekken". And in *Isaac's* case *supra* at 956 an object "to provide for the livelihood and comfort of the parties, and their children, including the proper education and upbringing of the latter" was held to be equivalent to making a profit and thus sufficient for partnership purposes. In the present case the objective of the accumulation of an appreciating joint estate is alleged, and, at least for pleading purposes, that is in my estimation sufficient.'

The authorities do not seem to draw a distinction between commercial partnerships and other partnerships and it would seem that there is no difference in the requirements between a partnership formed for commercial reasons and one formed as a universal partnership. Accordingly, the cases referred to above that deal with universal partnerships are relevant with respect to partnerships formed for commercial purposes.

To summarise the law as it stands is to state that there is a general move towards a widening of the scope of the profit motive, but that this has not yet been clearly expounded. If it were to be argued that the gaining of a fiscal advantage, or a benefit otherwise not attainable other than through the partnership, is the profit motive of the partnership, then it would seem that the profit requirement would have been met. This trend has been seen in England and the Netherlands and should

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<sup>51</sup> At 455B-C.

provide enough authority for the view that a gain other than an actual profit should suffice to meet the profit motive requirement.

In any event, in order to make certain that there is no doubt as to the profit criterion it is advised that a partnership be entered into where there is a pecuniary profit motive.

If the wider interpretation of 'profit motive' is accepted then any partnership that a financial institution were to enter into with a client would by its very nature meet the profit motive criterion. The simple fact is that parties contracting at arm's length to each other would not enter into a partnership in the first place unless they stood to gain something from it. Generally this gain would be that a client would derive a fiscal advantage as a result of a reduced funding rate and the financial institution would lend money to or via the partnership that it otherwise would not have lent.

## Chapter 4

### Specific Legislation Dealing with *En Commandite* Partnerships

#### Introduction

A partnership is not defined in the Income Tax Act and for normal tax purposes it is not regarded as a taxpaying entity. There are, however, certain sections of the Act that deal with partnerships.

Section 66(15) requires that a partnership make a joint return. Each partner is separately and individually liable but the Commissioner usually accepts a copy of the partnership's financial statements from any one of the partners.<sup>52</sup>

Section 77(7) states that the partners are liable for income tax in their individual capacities. The Commissioner, therefore, apportions the taxable income of the partnership amongst the partners in their profit sharing ratio, and each partner is then taxed on his share of the profits. The partnership itself is not liable for the payment of the tax.

Section 24H is aimed at regulating the tax treatment of limited partners and clarifying the question of accruals to individual partners in general.

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<sup>52</sup> Huxham, K and Haupt, P: *Notes on South African Income Tax*, 1998, Seventeenth Edition, H and H Publications in para 9.5.

Section 24H(5) was inserted in order to override a legal principle that arose in the case of *Sacks v CIR*<sup>53</sup> where it was held that a partner's share of the profits only accrued to him when the profits were brought to account. Although this was normally at the end of the partnership's financial year, the principle was abused and led certain partnerships to delay finalisation of their accounts until, in some cases, termination of that partnership.

The facts of the *Sacks* case were that the partners had agreed a partnership profit sharing ratio, which, prior to the financial year-end of the partnership they amended so as to agree a fixed amount with the one partner, Sacks, which then later turned out to be less than the amount to which he would otherwise have become entitled. The Commissioner contended that the amount calculated in terms of the profit ratio had already accrued to Sacks and that he should be taxed on the greater amount. The Appellate Division held that only the lesser amount had accrued to Sacks.

The *ratio* of this case had the effect of entrenching the principle that partners only became entitled to the profits and liable for the debts of the partnership upon finalisation of the accounts.

It was thus considered necessary to amend the legislation so as to ensure that amounts accrued to the partners at the same time as they accrued to the partnership.

Section 24H(5) legislates that income accruing to the partnership is deemed to accrue to the partners in their profit sharing ratios on the same date, and that

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<sup>53</sup> 1946(AD) 13 SATC 343.



expenses and allowances relating to these amounts are deemed to be that of the individual partners.

Section 24H states the following:

'(1) For the purposes of this section, "limited partner" means any member of a partnership *en commandite*, an anonymous partnership or any similar partnership, if such member's liability towards a creditor of the partnership is limited to the amount which he has contributed or undertaken to contribute to the partnership or is in any other way limited.

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

'(3) Notwithstanding anything to the contrary in this Act contained, the amount of any allowance or deduction which may be granted to any taxpayer under any provision of this Act other than section 11*bis* in respect of or in connection with any trade or business carried on by him in a partnership in relation to which he is a limited partner shall not in the aggregate exceed the sum of—

- (a) the amount, whether it consists of the taxpayer's contribution to the partnership or of any other amount, for which the taxpayer is or may be held liable to any creditor of the partnership; and
- (b) any income received by or accrued to the taxpayer from such trade or business.

'(4) Any allowance or deduction which has been disallowed under the provisions of subsection (3) shall be carried forward and be deemed to be an allowance or deduction to which the taxpayer is entitled in the succeeding year of assessment.

'(5)(a) Where any income has in common been received by or accrued to the members of any partnership, a portion (determined in accordance with any agreement between such members as to the ratio in which the profits or losses of the partnership are to be shared) of such income shall, notwithstanding anything to the contrary contained in any law or the relevant agreement of partnership, be deemed to have been received by or to have accrued to each such member individually on the date upon which such income was received by or accrued to them in common.

'(b) Where a portion of any income is under the provisions of paragraph (a) deemed to have been received by or to have accrued to a taxpayer, a portion (determined as aforesaid) of any deduction or allowance which may be granted under the provisions of this Act in the determination of the taxable income derived from such income shall be granted in the determination of the taxpayer's taxable income so derived.'

The main purpose of s 24H is to restrict the allowance or deduction which a limited partner may claim to the amount for which he is or may be held liable to creditors, plus any income received by him from the partnership. Any allowance or deduction that cannot be claimed because of the restriction may be carried forward to the following year. There are a number of inconsistencies regarding the above legislation that are discussed in an article entitled '1988 Amendments to the Taxation of Partnerships'.<sup>54</sup>

The first is that s 24H(1) defines a limited partner as meaning a member of a partnership *en commandite*, an anonymous partnership, if that member's liability towards a creditor of the partnership is limited to the amount he has contributed or undertaken to contribute to the partnership. This definition is not in keeping with the common law definitions of these two partnerships as in common law an anonymous partner in an anonymous partnership does not have limited liability, but rather is liable to the extent of the profit sharing ratio that he has entered into with the other partner. If his liability were limited then it would be an *en commandite* partnership, thus it is contended that, in fact, this legislation only deals with *en commandite* partnerships and not anonymous partnerships.

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<sup>54</sup> Editorial '1988 Amendments to the Taxation of Partnerships' (1988) October *The Taxpayer* 183.

The second inconsistency is that the definition in s 24H(1) states 'if such member's liability towards a creditor is limited' whereas in the common law a commanditarius partner's liability is solely to the disclosed partners and not to the creditor directly. This statement runs counter to the very purpose of the *en commandite* partnership which is to hide the existence of the commanditarius partner from the creditor thus ensuring that at no time could the undisclosed partner ever become liable to the creditor directly.

The possibility is thus raised that a taxpayer might seek to exclude the provisions of the section from applying to him on the basis that his liability as commanditarius partner is solely to the disclosed partners thus arguing that he does not fall under the definition and that consequently the provisions of s 24H should not apply to him. This is a risky argument as the intention of the legislation is quite clear. The article states that it might have been preferable for the definition in the section to read: 'if such member's liability *in respect of* a creditor or creditors is limited'. This it is agreed would express the intention more clearly. With the trend in interpretation of taxing statutes towards interpreting the meaning of the legislation as opposed to the strict letter of the law it is doubted that a defence of this nature would have much chance of success.

### **How should section 24H(3) be construed**

It needs to be considered whether the deductions and allowances should be determined on an annual or cumulative basis.

The 'annual basis' would be to determine the income and deductions for each year in isolation from the previous year save for the fact that s 24H(5) allows for any disallowed amount to be carried forward to the next year as a deduction to which that taxpayer is then entitled in that following year.

The 'cumulative basis' is to determine income and deductions allowed by comparing the aggregate allowances and deductions over all the relevant years of assessment, including the current year, taking into account the taxpayer's contributory liability and the income derived by him from the trade or business over the relevant years.

*Meyerowitz*<sup>55</sup> is of the opinion that as there is no reference in the section to the current year of assessment, either in regard to the aggregate allowances and deductions, or in regard to the income received by or accrued to the taxpayer, that this is indicative of the intention being to interpret the section using the cumulative basis.

Section 24H(3) refers to the allowances and deductions being limited to the aggregate of the capital contribution and the amount of the income received, however, the word 'income' is used which is defined in the Act as 'the amount remaining of the gross income of any person for any year or period of assessment after deducting therefrom any amounts exempt from normal tax under Part I of Chapter II'. *Meyerowitz* argues the following:<sup>56</sup>

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<sup>55</sup> *Meyerowitz on Income Tax, supra* in §§16.81.

<sup>56</sup> *Meyerowitz on Income Tax, supra* at §§16.82.

'It is in our view possible to argue with a good deal of merit, having regard to the intention to permit the taxpayer to deduct allowances and deductions to the extent of his liability for the debts of the partnership, that in the context of s 24H(3) "income" should be given a wider meaning to include all gross revenue of the partnership from all sources and not its definition meaning, that is gross income less so much thereof as is exempt from tax.'

This would be the approach that the partnerships should take in order to ensure that the availability of the allowances and deductions in the hands of the commanditarius partner are maximised.

The importance of this provision is that if the intention is to be the commanditarius partner and to claim tax allowances and deductions, then it is important that the partner's contribution plus income earned from the partnership exceeds the allowances sought to be claimed.

### **Revenue Practice**

In terms of s 66(13) *ter* the Commissioner has a discretion to allow for income received up until a different date to be included in the year of assessment of the taxpayer. Thus it is the practice of the Commissioner to allow, in bona fide cases, where the partnership year-end is different to that of one of the partners, to accept returns of income to that date. Where companies or close corporations are involved then they may have different financial year-ends and, in the event of that happening, the Commissioner will accept partnership accounts drawn to one date for the purposes of all the partners.<sup>57</sup>

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<sup>57</sup> Meyerowitz *supra* in §§16.75.

Section 24H(2) is a deeming provision which applies to all partners in a partnership which is carrying on a trade and deems them all to be carrying on a trade.

Section 23(g) of the Act requires that deductions may only be claimed against income to the extent that the deductions have been expended or laid out for the purpose of trade. The deeming provision thus removes the necessity for a partner to prove that it has met the trade requirement. This has benefited the commanditarius taxpayer in that prior to this legislation being enacted, he was required to prove that he was carrying on the trade of the partnership before he would be allowed to claim any deductions.

## Chapter 5

### Recoupments

An advantage that a partnership offers to the financial institution that is looking to replace the 'Lessor Trust Arrangement' is that an asset being financed in a partnership need not be transferred out of the partnership at the end of the financing period and, consequently, a recoupment liability can be avoided.

The problem that may arise is where the financial institution wishes to terminate its involvement with the partnership entirely once the financing of the transaction is complete. This termination may be effected in one of two ways:

- The partnership might sell the asset to a third party (or even the client) and then split the proceeds; or
- it may sell its interest in the partnership to a third party who then takes over the position of the financial institution in the partnership, which partnership, for all intents and purposes, continues to lease the asset as if there had been no change in partners.

If the first option is followed then there will be a termination of the partnership and if a transfer to a third party purchaser is concluded then there should be a recoupment in the hands of the partnership, as there is now a sale of the asset and a consequent transfer.

If, however, this sale were done at the tax value of the asset then there would be no recoupment.

If the second option is followed then the question needs to be addressed as to whether a recoupment will arise, or whether a deemed recoupment will arise.

Sections 8(4)(a) and (k) deal with recoupments and deemed recoupments and state the following:

'There shall be included in the taxpayer's income all amounts allowed to be deducted or set off under the provisions of sections 11 to 20, inclusive, section 24D, section 24F, section 24G and section 27 (2) (b) and (d) of this Act, except section 11 (k), (p) and (q), section 11quin, section 12 (2) or section 12 (2) as applied by section 12 (3), section 12A (3), section 13 (5), or section 13 (5) as applied by section 13 (8), or section 13bis (7), or section 15 (a), or section 15A, or under the corresponding provisions of any previous Income Tax Act, whether in the current or any previous year of assessment which have been recovered or recouped during the current year of assessment.'

'For the purposes of paragraph (a), where during any year of assessment any person has donated or distributed by way of a dividend, any asset in respect of which a deduction or an allowance has been granted to such person in terms of any of the provisions referred to in that paragraph, such person shall be deemed to have recovered or recouped an amount equal to the market value of such asset as at the date of such donation or distribution.'

*Silke*<sup>58</sup> expresses the view that a recoupment may occur upon the transfer of a partner's interest, as there is a disposal of the partnership assets, to the extent of the interest that changes hands. However, *Silke* does say that if the amount that is due for the disposal of the asset is not due and payable but represents a capital

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<sup>58</sup> Divaris, C and Kahn, E: *Silke on South African Income Tax*, Eleventh Memorial Edition, Juta in §§11.5.



contribution, there may be no recoupment.

In *Desai and others v Desai and another*<sup>59</sup> and *Smith v Weston*<sup>60</sup> it was held that no sale of partnership assets occurs where an existing partnership dissolves and a new partnership is formed. These cases effectively reversed the decision in *Whiteaways Estate and others v CIR*<sup>61</sup> which had held that where a partnership held immovable property, the partners should become liable for transfer duty each time that the ratio of the interest held in the partnership by the partners changed or that a new partner was admitted or an existing partner left the partnership.

This *ratio* was not followed and in the *Desai* case Meskin AJ referred to the *Smith v Weston* case and stated that the decision in that case that the transfer of a partnership constituted a transfer of a *ius in personam* and not a *ius in rem* and so consequently could not be considered a transfer of immovable property, was correctly decided.<sup>62</sup> He went on further to state, in regard to a previous decision in *Berry v Mann*<sup>63</sup> that:<sup>64</sup>

'[w]ith respect, I consider that there must be considerable doubt as to whether this case was correctly decided. Insofar as it decides that a partner's interest in a partnership, that is the bundle of rights of action which the existence of such interest predicates, represents immovable property or an interest in immovable property, within the meaning of legislation such as s 1 of Natal Law 12 of 1884, merely because one of the partnership's assets is an immovable property, then I regret I am unable to agree with it.'

<sup>59</sup> 1993 (3) SA 874 (N) at 880 A - 881C.

<sup>60</sup> 1961 (1) SA 275 (W) at 277F.

<sup>61</sup> 1938 TPD 482.

<sup>62</sup> 1993 (3) SA 874 (N) at 880 H.

<sup>63</sup> 1937 NPD 53.

<sup>64</sup> 1993 (3) SA 874 (N) at 881 A.

In the light of the above it seems that *Silke's* view may not be correct and that in fact, even if the commanditarius partner were to sell his interest he would not become liable for the recoupment.

In any event, even if *Silke's* view were correct then the recoupment would only be in respect of that portion of the allowances as was allowed to the commanditarius partner (that is 99% or 1%).

Obviously, if the financial institution is concerned about the risk of incurring a recoupment it can limit its risk by agreeing in the partnership agreement that there be a split between the rights to income from the assets and the rights to the capital of the asset. If the financial institution only receives a 1% interest in the asset itself upon dissolution (that is the capital) this would ensure that any recoupment would be limited to the 1% value of the asset. The risk can thus be limited.

#### **A Liability under s 8(5)(a)**

Section 8(5)(a) reads as follows:

'Any amount which has been paid, whether in the form of rent or otherwise, by any person for the right of use or occupation of any movable or immovable property and has been allowed as a deduction in the determination of such person's taxable income, and which or the equivalent of which is upon the subsequent acquisition of such property by that or any other person applied in reduction or towards settlement of the purchase price of such property, shall be included in the income of the person by whom the property is acquired as aforesaid for the year of assessment in which such person exercises the option or concludes the agreement, as the case may be, in consequence of which the property is acquired by him: Provided that the provisions of this subsection shall not apply in any case where, in consequence of the acquisition of such property, the person who has acquired the property or any

other person has derived a taxable benefit the cash equivalent of which has been included in his gross income in terms of the provisions of paragraph (i) of the definition of "gross income" in section 1.'

This section provides that where an amount has been paid in the form of rent by any person for the right of use or occupation of movable property, and that amount has been allowed as a deduction in the determination of that person's taxable income, and which is upon the subsequent acquisition of that property by that or any other person applied in reduction or towards settlement of the purchase price of that property, that amount shall be included in the income of the person by whom the property is acquired.

The question to be considered is whether the acquisition of the commanditarius's interest in the partnership can be equated with the acquisition of a percentage of the relevant partnership assets and whether the rental paid by the lessee has been applied in reduction or towards settlement of the purchase price of the said property. The important concept in this provision is that the payment of the rental must be applied in reduction or towards settlement of the purchase price of the property.

In the proposal being considered there is no link between the payment of the rental and the purchase price of the interest held by the commanditarius partner and thus there should not be a recouplement in the hands of the disclosed partner.

## Chapter 6

### Business Rationale For Using the *En Commandite* Partnership

The *en commandite* partnership is an ideal vehicle for a financial institution to provide financing to the client. As the commanditarian partner is not disclosed it means that the financial institution is not able to be marketed by the disclosed partner (the client) as its partner in business – this ensures that a financial institution's reputation is not able to be harmed by the actions of the disclosed partner. The anonymity provided by the *en commandite* partnership also ensures that the financial institution's business is not harmed if it were seen to be providing finance to a competitor of a potential client. Furthermore the financial institution's liability is limited to that amount that it contributes to the partnership, and thus unlike normal partnerships, the financial institution is able to limit its risk.

The financial institution might also require that, as a condition of it entering into the partnership, that it receive a right of first refusal in respect of all future funding requirements of the client and thus it might establish a monopoly on future funding to that client.

Furthermore, where it remains in partnership once the funding period has elapsed, it continues to receive a profit share (albeit perhaps only 1%) which it otherwise would not have received at all.

From the viewpoint of the disclosed partner it is an ideal relationship as it lifts the relationship of lender and borrower to that of business partner which has numerous benefits, which might include, amongst others,

- better rates,
- advice on business dealings, and
- the use of bank facilities (for example, credit checking etcetera).

It is to be stressed that there is an essentially different relationship between business partners and borrowers and lenders. For example, business meetings to discuss strategy etcetera will lead to greater understanding between the parties and will develop a relationship that is more beneficial than that merely of borrower and lender.

If a client finds itself in financial difficulty it would be able more readily to find a sympathetic ear of a partner than someone with whom it only shares a borrower and lender relationship.

Furthermore, it can be expected that the client would normally insist on agreement regarding

- future funding,
- rates,
- discounts on funding etcetera,

at the time of going into the partnership, and not thereafter as and when funding was required. This gives the client a better negotiating position. Not only is the client able to negotiate good facilities from the commanditarian partner, if it becomes unhappy with the rates, service etcetera it is still able to source funding

elsewhere without having to disclose the existence of the commanditarius partner. This is positive for the client who is now able to rely on one financial institution to provide his funding requirements at pre-agreed rates etcetera according to an established modus operandi, but who has not extinguished the possibility of receiving funding elsewhere, as the commanditarius partner remains undisclosed.

### **Basic Structure to be Formed**

The partners agree that the financial institution will provide the financing for the acquisition of the assets and that in return it shall be entitled to a 99% portion of the profits arising out of the partnership. It can be agreed that the financial institution will only receive this portion for the first four years (as it can be accepted that the financial institution is in the business to make money from financing and that once it receives the return that it wishes to receive it is prepared to reduce its profit sharing portion).

Thereafter the financial institution reduces its portion to 1%.

This would be normal business practice for a financial institution because it would effectively have no further loan exposure to the partnership (it having received its 'capital' with a return commensurate with that which it would have received had it loaned the money to the partnership in a conventional manner) and its risk exposure would be limited to the total contribution that it had already made to the partnership.

On the other hand, there does remain a profit motive as it will continue to receive 1% of the profits of the partnership for as long as the partnership continues to exist.

Furthermore, the client receives the benefit of not having to pay any recouplements in respect of the asset as there is no transfer of the asset out of the hands of the partnership – the partnership retains ownership of the asset.

### **Loan vs Contribution**

The following was stated in *LAWSA*:<sup>65</sup>

'It is clear that a partnership cannot be formed unless a party's contribution to the enterprise is subject to the risks of the venture. Thus, where a party advances capital to a business upon the basis that the full amount plus interest must be returned to him at a later stage, whatever the fortunes of the business, the arrangement is one of loan and not partnership.'

In order for the partnership to be used as a tax structuring tool the financial institution must have risk in the venture.

In the proposed replacement structure to the 'Lessor Trust Arrangement', the financial institution must be careful not to structure the arrangement as one of loan. As long as there is an element of risk to the venture then the arrangement will be considered one of partnership.

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<sup>65</sup> Henning and Delpont, *The Law of South Africa*, Volume 19, 1984, Butterworths.

A capital contribution is only repayable to the commanditarius partner once all creditors have been settled – accordingly there is a risk to the commanditarius partner.

The financial institution is faced with three avenues for structuring this deal,

- it can either inject funds into the partnership by way of capital contribution, or
- by loan, or
- by a combination of the two.

A capital contribution ensures that the arrangement is not considered one of loan, and there must thus be at least a monetary contribution in order to ensure that this requirement is met. The important choice that faces the financial institution is to decide as to what ratio it wishes to make a contribution and a loan. A consideration of the provisions of s 24H might aid in the determination of a suitable ratio.

Section 24H(3)(a) limits the deductions and allowances available to the commanditarius partner to the amount that the partner is liable to pay towards the liabilities plus any income he has received from the partnership. If it is assumed that the funding requirement of a partnership is R100 then the following normal tax calculations would be done for,

- in the first instance, that partnership that decides to use mainly loan funding, and
- in the second instance, that partnership that decides to fund the requirement entirely by way of contribution.



**Example I**

Partnership relying upon loan funding. On-going capital contributions based on capital allowance savings and interest expenses are not taken into account for purposes of this calculation.

**Assumptions**

Commanditarian partner's contribution: R0,99.

Disclosed partner's contribution: R0,01.

Balance of loan funding: R99.

Income for each year: R10.

Asset purchase price: R100.

Wear-and-tear capital allowance on asset: R 25 a year (four year write off in terms of s 11(e) as read with Practice Note: No. 19)

**Year 1**

|   |              |               |               |
|---|--------------|---------------|---------------|
| Capital allowance   |              | R25,00        |               |
| Limited to:   |              |               |               |
| 99% of income   | R9,90        |               |               |
| Plus extent of contribution                                   | <u>R0,99</u> | <u>R10,89</u> |               |
| <b>Tax deduction disallowed and carried forward to year 2</b> |              |               | <b>R14,11</b> |

**Year 2**

|   |               |              |               |
|---|---------------|--------------|---------------|
| Capital allowance (see above)                                 | R25,00        |              |               |
| Add amount carried forward from year 1:                       | <u>R14,11</u> | R39,11       |               |
| Limited to  |               |              |               |
| 99% of income for years 1 and 2:                              | R19,80        |              |               |
| Plus extent of contribution                                   | <u>R0,99</u>  |              |               |
|   | R20,79        |              |               |
| Less deduction allowed in year 1                              | <u>R10,89</u> | <u>R9,90</u> |               |
| <b>Tax deduction disallowed and carried forward to year 3</b> |               |              | <b>R29,21</b> |

**Year 3**

|   |               |        |
|---|---------------|--------|
| Capital allowance (see above)           | R25,00        |        |
| Add amount carried forward from year 2: | <u>R29,21</u> | R54,21 |

|   |               |              |
|---|---------------|--------------|
| Limited to                              |               |              |
| 99% of income for years 1,2 and 3       | R29,70        |              |
| Plus extent of contribution:            | <u>R0,99</u>  |              |
|   | R30,69        |              |
| Less deduction allowed in years 1 and 2 | <u>R20,79</u> | <u>R9,90</u> |

**Tax deduction disallowed and carried forward to year 4: R44,31**

**Year 4**

|  |               |        |
|--|---------------|--------|
| Capital allowance (see above)          | R25,00        |        |
| Add amount carried forward from year 3 | <u>R44,31</u> | R69,31 |

|  |               |              |
|--|---------------|--------------|
| Limited to                                 |               |              |
| 99% of income for years 1,2, 3 and 4       | R39,60        |              |
| Plus extent of contribution:               | <u>R0,99</u>  |              |
|  | R40,59        |              |
| Less deductions allowed in years 1,2 and 3 | <u>R30,69</u> | <u>R9,90</u> |

**Tax deduction disallowed and carried forward to year 5: R59,41**

**Example 2**

Partnership obtains funding from contributions by partners. On-going capital contributions based on capital allowance savings and interest expenses are not taken into account for purposes of this calculation.

**Assumptions**

Commanditarian partner's contribution: R99.

Disclosed partner's contribution: R1.

Income for each year: R10.

Asset purchase price: R100.

Wear-and-tear capital allowance on asset: R 25 a year (four year write off in terms of s 11(e) as read with Practice Note: No. 19)

**Year 1**

|                             |            |             |
|-----------------------------|------------|-------------|
| Capital allowance           |            | R25         |
| Limited to                  |            |             |
| 99% of income:              | R9         |             |
| Plus extent of contribution | <u>R99</u> | <u>R108</u> |

**Tax deduction disallowed and carried forward to year 2** R ----

**Year 2**

|  |            |            |
|--|------------|------------|
| Capital allowance                      | R25        |            |
| Add amount carried forward from year 1 | --         | R25        |
| Limited to                             |            |            |
| 99% of income for years 1 and 2        | R18        |            |
| Plus extent of contribution            | <u>R99</u> |            |
|  | R117       |            |
| Less deduction allowed in year 1       | <u>R25</u> | <u>R92</u> |

**Tax deduction disallowed and carried forward to year 3** R ----

**Year 3**

|  |            |            |
|--|------------|------------|
| Capital allowance                        | R25        |            |
| Add amount carried forward from year 2:  | ---        | R25        |
| Limited to                               |            |            |
| 99% of income for years 1,2 and 3        | R27        |            |
| Plus extent of contribution:             | <u>R99</u> |            |
|  | R126       |            |
| Less deduction allowed in years 1 and 2: | <u>R50</u> | <u>R76</u> |

**Tax deduction disallowed and carried forward to year 4** R -----

**Year 4**

|  |               |            |
|--|---------------|------------|
| Capital allowance                          | R25           |            |
| Add amount carried forward from year 3:    | ---           | R25        |
| Limited to:                                |               |            |
| 99% of income for years 1,2, 3 and 4       | R36           |            |
| Plus extent of contribution                | <u>R99</u>    |            |
|  | R135          |            |
| Less deductions allowed in years 1,2 and 3 | <u>R75,00</u> | <u>R60</u> |

**Tax deduction disallowed and carried forward to year 5** R-----

## **Comparison of Results**

As is evident from the above calculations, a partnership funded by way of loan funding has deductions limited in the hands of the commanditarius partner, whereas the capital-contribution funding route allows the deductions to be fully used in the hands of the commanditarius partners.

In example 1 it is evident that the commanditarius partner was unable to make full use of the deductions which he would otherwise have been able to make if he had funded the partnership by contribution.

In example 2 the effect of the funding by contribution was to allow the commanditarius partner a full deduction of all the allowances available.

It is quite simple to structure a partnership agreement so that the commanditarius partner receives 99% of the income from the asset that is leased (for example) and then to provide tax assumptions, or even a computer model, which calculates the amount that is payable on the lease, thus effectively regulating the return that the commanditarius partner is entitled to receive.

A legal draftsman should be able to provide that the financial institution incur the same tax consequences as it would had it received conventional loan funding.

The only issue that might tempt a financial institution to avoid structuring an agreement along these lines is if it were to be concerned that it might not be in the same position as if it had granted a conventional loan and taken security for that loan from the disclosed partner. It would seem, however, that this is a fear that can

be circumvented. Being a 99% partner the financial institution would become entitled to 99% of any claim against a defaulting debtor. In addition if it were fearful of taking the risk on the disclosed partner then it could call for suretyships to be provided for the performance of the disclosed partner to it. It could in turn require security to be provided by the persons standing surety as it would normally require for conventional loan funding.

Some financial institutions have looked at the possibility of using the *en commandite* partnership as a tax-structuring alternative to the 'Lessor Trust Arrangement'. Much of the research that has been undertaken has been undertaken with a view to incorporating conventional lending into the partnership. This research has exposed the consequences highlighted in example 1 above, where the ring-fencing provisions of s 24H (3) (a) and (b) limit the deductions allowed to the commanditarian partner so that the benefit to the client is reduced to an extent that does not warrant the effort and expense required to achieve the benefit.

The conclusion that has generally been reached by these institutions is that the only way to receive the full benefits of the flow of capital allowances and deductions is to enter into a normal partnership which is not subject to s 24H(3) (a) and (b) and thus escape the ring-fencing constraints of these provisions. The problem that then presents itself relates to neither tax nor financial modelling, but is a problem of risk.

Financial institutions do not wish to enter into unlimited partnerships as they may then be exposed to an unlimited risk.

In order to be competitive financial institutions need to find alternatives to conventional loan funding. One alternative is to provide financing by way of a contribution to a partnership.

### **Alternatives at Finance Term End**

As financial institutions wish to provide finance for a certain period only, during which time they expect to realise a return and amortise the capital advanced, or in the case of a contribution by the commanditarius partner, the capital contribution, they must decide on what to do at the end of this financing period.

- Does the financial institution remain a partner even though the financing period has fully elapsed, or
- does it extricate itself entirely from the partnership?

The issue, as commanditarius partner, is really to determine what the risk is to the financial institution should it remain as a partner. Bearing in mind that a commanditarius partner's risk is limited to the extent of the capital contribution, the financial institution need only really reduce its contribution to an amount that it is prepared to write-off. Thus at the end of the four year financing term the financial institution could agree to a change in profit-sharing ratio's so that the disclosed partner now receives 99% of the income and the financial institution 1%.

To achieve this the disclosed partner could purchase the outstanding 98% interest from the commanditarius partner. This would then entitle the disclosed partner to receive 99% of the income and so too also bear 99% of the risk, whilst the financial institution would only receive 1% of the income but correspondingly be liable to only

a 1% risk factor. As the cost of the 1% risk would have been built into the return required by the financial institution, the actual cost to the financial institution would be nil. It would still continue to receive 1% of the income generated by the assets financed in the partnership. This provides the financial institution with a profit motive for entering into the partnership as opposed to providing conventional loan funding (which would not entitle the financial institution to any more returns once the funding period had elapsed).

## Chapter 7

### Section 103 Attack on the Structure

Section 103(1) provides as follows:

' (1) Whenever the Commissioner is satisfied that any transaction, operation or scheme (whether entered into or carried out before or after the commencement of this Act, and including a transaction, operation or scheme involving the alienation of property)—

(a) has been entered into or carried out which has the effect of avoiding or postponing liability for the payment of any tax, duty or levy imposed by this Act or any previous Income Tax Act, or of reducing the amount thereof; and

(b) having regard to the circumstances under which the transaction, operation or scheme was entered into or carried out—

(i) was entered into or carried out—

(aa) in the case of a transaction, operation or scheme in the context of business, in a manner which would not normally be employed for bona fide business purposes, other than the obtaining of a tax benefit; and

(bb) in the case of any other transaction, operation or scheme, being a transaction, operation or scheme not falling within the provisions of item (aa), by means or in a manner which would not normally be employed in the entering into or carrying out of a transaction, operation or scheme of the nature of the transaction, operation or scheme in question; or

(ii) has created rights or obligations which would not normally be created between persons dealing at arm's length under a transaction, operation or scheme of the nature of the transaction, operation or scheme in question; and

(c) was entered into or carried out solely or mainly for the purposes of obtaining a tax benefit,

the Commissioner shall determine the liability for any tax, duty or levy imposed by this Act, and the amount thereof, as if the transaction, operation or scheme had not been entered into or carried out, or in such manner as in the circumstances of the case he deems appropriate for the prevention or diminution of such avoidance, postponement or reduction.'



Section 103 curtails the *Duke of Westminster*<sup>66</sup> principle, which is that there should be no obligation to pay any tax that can validly be avoided by the structuring of one's tax affairs.

The provisions of s 103 have been summarised in most, if not all, s 103 cases, in particular *SIR v Geustyn Forsyth & Joubert*<sup>67</sup> and *CIR v Louw*<sup>68</sup> where it was confirmed that all the four requirements set out below must be present for the Commissioner to invoke the section.

If the Commissioner is satisfied that the four requirements set out are present then he may determine the liability for income tax as if the particular transaction, operation or scheme had not been entered into or had been entered into in such a manner that he has deemed fit for the prevention or diminution of the avoidance, postponement or reduction of the liability for tax.

In order to invoke the section the Commissioner must form the view that

- a transaction, operation or scheme has been entered into or carried out;
- which has had the effect of avoiding or postponing liability for tax on income or reducing the amount thereof;

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<sup>66</sup> 'Every man is entitled to order his affairs so as that the tax attaching under the appropriate Acts is less than it otherwise would be' – per Lord Tomkin in *IRC v Duke of Westminster* [1936] AC 1 at 19.

<sup>67</sup> 1971 (3) SA 567 (AD) at 571E-572A.

<sup>68</sup> 1983 (3) SA 551 (AD) at 569A-H.

- having regard to the circumstances under which the transaction, operation or scheme was entered into or carried out either it was entered into or carried out by means or in a manner which would not normally be employed in relation to a venture of the nature of the transaction, operation or scheme in question or it has created rights or obligations which would not normally be created between persons dealing at arm's length under such a transaction, operation or scheme; and
- the avoidance, postponement or reduction of the amount of the liability for tax was in the opinion of the Commissioner the sole or one of the main purposes of the transaction, operation or scheme. (This is to be presumed, in terms of s 103(4) where the other three elements of the section are satisfied but may be rebutted by the taxpayer on a balance of probabilities.)

The use of an *en commandite* partnership in the manner proposed in this report must be considered to constitute a transaction, operation or scheme. It will also have the effect of reducing the amount of the client's liability for tax on income.

That leaves two critical questions.

- Is the arrangement one that would normally be employed in similar circumstances?
- If not, was the reduction of the client's liability for income tax the sole or one of the main purposes of the transaction, operation or scheme?

The 'abnormality test' consists of two parts,

- the first relating to the business purpose in respect of which the particular transaction, operation or scheme has been entered into, and
- the second being the test in regard to the creation of abnormal rights or obligations between the parties.

If the abnormality test is met, that is it is considered abnormal then the next test to apply is the 'purpose test', which is to determine whether the sole or one of the main purposes for entering into the particular transaction, operation or scheme is the obtaining of a tax benefit.

It is submitted that the s 103 test should be approached in the following manner:

- First, the operation of a 'normal transaction' should be postulated, that is, one that takes no account of the tax benefit that could otherwise be obtained if the transaction were to be structured differently.
- Then the actual set of facts should be compared with those as postulated in order to ascertain what differences might arise between the two structures.
- Then it should be determined whether there is any explanation other than the obtaining of a tax benefit that could be advanced in respect of the difference.
- If no such explanation exists then the transaction does not pass the bona fide purpose test.
- The reasons that are advanced, however, need to be plausible and reasonable if a challenge under s 103 is to be withstood.

In the proposed structure, the benefits that are obtained are the following:

- the *en commandite* partner is able to claim the tax capital allowances and deduct these from its gross income; and
- by keeping the partnership in existence beyond the duration of the required financing term (indeed possibly for the entire useful life of the asset) the possibility of a recoupment is avoided, or reduced to a fraction of a percentage of that which would have become payable had it transferred the asset out-of-hand at the end of a normal lease that it had entered into individually with the lessee.

Reasons that may need to be evident for a challenge in terms of s 103 to be successfully withstood could include the following:

In respect of financial institutions the fact that

- the setting up of a partnership would secure more or better lines of business to the financial institution;
- the client could administer the partnership and so save the financial institution those costs that it would otherwise have borne;
- the client has specific knowledge and skill vis-à-vis assets of the nature sought to be financed;
- for a limited risk the financial institution would be entitled to continue to receive a profit share for the remainder of the useful life of the asset which it would otherwise not have received.

And in respect of the client the fact that

- the financial institution is going into partnership with it could secure benefits relating to financial and business advice;

- they would be securing a source of financing for future assets which would form the stock and future stock of the partnership;
- the partnership agreement could incorporate rights and privileges for the client which he would otherwise not be in a bargaining position to negotiate were he negotiating agreements in isolation;
- the client would share in some of the margin on the leases that he would otherwise have not been able to claim.

In addition to the above, the fact that the financial institution 'kicks back' the majority of any tax deduction or allowance to the lessee by way of a reduction in the lease payable should in isolation prove an absence of a motive to purely take advantage of the tax allowances and deductions.

Furthermore, and importantly, it must be remembered that most assets used in the production of the income and in the course of a trade or business automatically become entitled to the capital allowances.

Depending upon the financing structure elected, either the financial institution or the client becomes entitled to claim these allowances.

Thus, for example, an asset forming the subject matter of a lease has the capital allowances deduced by the financial institution whereas a client financing an asset by way of instalment sale becomes himself entitled to the tax allowances. There is no prejudice against the client for choosing one or the other of the financing options available to him, and so consequently there can be no attack on the structure as

proposed because it allows the lessor (that is the partnership) to claim the capital instead of the client.

### **Comparison to Secondary Leases**

The only real basis of an attack by the Commissioner is if he considers that the sole or main purpose of the structure is to avoid the recoupment at the end of what would otherwise have been a conventional lease.

If the situation is considered from the viewpoint of each partner it is obvious that the main purpose for which the client is entering into the partnership is to obtain the beneficial rate that the financial institution is able to offer him, and the main reason that the financial institution is entering into the partnership is to secure more lending (albeit in the form of a contribution). Thus each party has a good and valid (that is, a bona fide) business reason for entering into the partnership.

Furthermore, it is accepted banking practice when dealing with conventional leases that upon the expiry of a conventional lease a client is faced with a number of end-of-lease options. He may thus have the option to

- return the asset to the lessor,
- purchase the asset, or
- enter into a further lease.

If he returns the asset to the lessor there are no tax consequences. If he purchases the asset from the financial institution then depending upon the purchase price charged for the asset there may arise a recoupment, either in the hands of the

financial institution, or where there is a deemed recoupment in terms of s 8(4)(k) in the hands of the client.

If the client wishes, at some stage, to purchase the asset but wishes to delay payment of the recoupment then he may enter into a secondary lease.

The purpose of a secondary lease is to allow the client the cash flow benefit of paying a small monthly rental (which he can deduct against income) to the financial institution for that period that is required to write down the asset to a value, or deemed value, which will, when purchased by the client, not cause a recoupment in the hands of either the financial institution or the client.

Secondary leases should not constitute a breach of s 103 even though they might be entered into for the purpose of avoiding or delaying the payment of the recoupment as, according to the *Duke of Westminster* principle, the taxpayer has the right to structure his affairs in a legitimate way in order that he pays the minimum amount of tax.

Likewise, if the financial institution wished to remain a partner for the rest of the useful life of the asset which the partnership owned then there could be no hint that the partnership was avoiding the recoupment by not selling the asset, as there is no obligation on any taxpayer to structure his affairs in order to pay those taxes that might be legitimately avoided.

Accordingly therefore, it would seem that the structuring of the proposal along the above lines will

- not be abnormal,
- nor will it lack a bona fide business purpose, and
- the avoidance of tax will not be the sole or main object of the structuring.

Accordingly, an attack under s 103 should be capable of defence.

### **Effect of *Ladysmith* Judgment on the Proposal**

In the case of *Erf 3183/1 Ladysmith (Pty) Ltd and another v CIR*<sup>69</sup> the Appellate Division dealt with a 'double lease' property transaction in order to determine what the true intention of the parties was. The court considered two well-known legal principles,

- the one permitting parties to arrange their affairs so as to remain outside the provisions of a particular statute, and
- the other to the effect that courts of law will not be deceived by the form of a transaction and will rend aside the veil in which the transaction is wrapped and examine its true nature and substance.

The facts of the case were briefly that the appellant had entered into a head lease with a pension fund which in turn sub-let the property to a furniture company wishing to erect a factory on the stand. The furniture company was a member of the same group of companies as the Appellant. The sub-lessor erected a factory for which it received a premium from the sub-lessee, the question being whether the appellant, as owner of the land, should be taxed on the value of the right to

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<sup>69</sup> 1958 SATC 229.



have the buildings erected on the land in terms of para (h) of the 'gross income' definition.

The court decided that it was the intention at all times that the appellant would be entitled to have the buildings erected, but that by structuring the transaction in the particular way this right could be 'shifted' to the sub-lessor and so avoid inclusion in the gross income of the appellant.

The court looked past the agreements as they stood and exposed the transaction. It therefore held that the appellant should have the value of the right included in its gross income.

The *ratio* of the judgment was that effect should be given to agreements according to their tenor but that where a disguised or simulated transaction is evident, it must give effect to what is found to be the true agreement between the parties.

In this report, the proposed use of the *en commandite* partnership as a structure to replace the 'Lessor Trust Arrangement', or as a structuring tool generally, does not rely on disguised transactions or false agreements for its efficacy. The partnerships that are proposed would be genuine partnerships entered into for valid commercial reasons and the documentation would reflect this. Accordingly the principles enunciated in the *Ladysmith* judgment should not be applicable.

## Chapter 8

### Conclusion

*En commandite* partnerships provide a ready alternative to the 'Lessor Trust Arrangement'. They combine a financial institution's requirements of non-disclosure of participation, limited liability and the ability of the vehicle to act as a conduit for the channelling of tax deductions and allowances with the attributes of flexibility, ease of application and implementation, and simplicity.

For use in general tax structuring the *en commandite* partnership should be considered more frequently as a vehicle for structuring.

The reason that it is not more widely used by financial institutions as a tax structuring financial tool is primarily due to a lack of understanding of the partnership itself. There is a dearth of authority on the *en commandite* partnership and there is a corresponding scarcity of case law. As a consequence the bounds within which the *en commandite* partnership can be used are shrouded in mystery.

Added to this is the fact that few legal practitioners have practical experience in the structuring and application of these partnerships.

The inevitable result is that the *en commandite* partnership is generally not promoted, in the first instance, as a tax structuring tool.

It is hoped that this report has gone some way to de-mystifying the mystery that is the *en commandite* partnership.

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