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Tax & Exchange Control ALERT

IN THIS ISSUE

P.O.V: Your partner ends the partnership but at least there's no tax payable: BPR 391

At common law, a partnership is not considered to be a legal entity or *persona* with legal personality separate from its partners. Rather, a partnership has been defined as a legal relationship between two or more persons who carry on a lawful business or undertaking, to which each contributes either money or labour, or anything of value with the object of making a profit, and of sharing that profit between them. As such, all legal consequences flowing from a partnership accrue to the partners in their personal capacities. This is also the position under the Income Tax Act 58 of 1962 (Act). Therefore, any property of the partnership is co-owned by the partners in undivided shares. Each partner therefore has a proportionate interest in the partnership, and by acquiring an interest in the partnership, each partner acquires an undivided share in the assets of the partnership.



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In SARS' Comprehensive Guide to Capital Gains Tax (Guide), it is explained that as a result of the unique legal nature of partnerships, the taxation thereof can pose a number of practical difficulties. For example, the common law principle is that when a new partner joins or a partner leaves, the existing partnership is dissolved, and a new partnership comes into existence. The Guide notes that if one was to strictly follow this common law principle, the effect would be to trigger a disposal of the entire interest of each partner each time a partner joins or leaves.

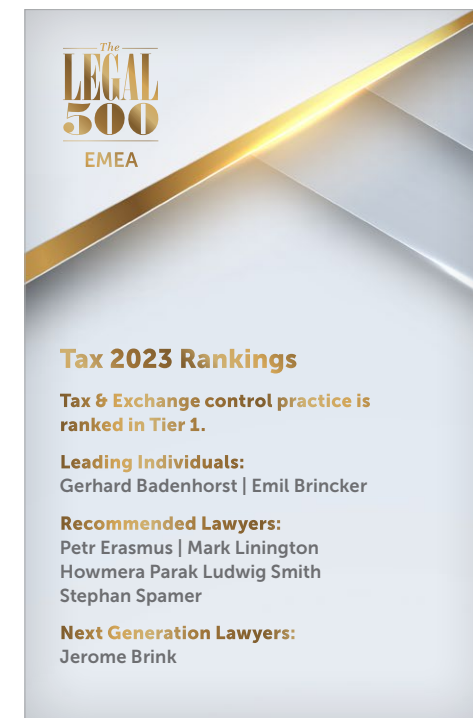
Practically, however, it is not intended that partners be regarded as disposing of their entire interests in the partnership assets every time a new partner is admitted or an existing partner leaves. Instead, each partner must be regarded as having a fractional interest in each of the partnership assets. To the extent that a partner's fractional interest in the partnership assets remains unchanged following the introduction of a new partner or the withdrawal of an existing partner, there will be no disposal. A disposal should occur

only when a partner's fractional interest in an asset of the partnership is diminished.

What about the dissolution of a partnership? Does a disposal occur when the partnership terminates and distributes the partnership assets in accordance with the respective partner's interests in the partnership? This was the question that was determined in binding private ruling (BPR) 391, specifically in relation to an *en commandite* partnership.

En commandite partnerships

Similar to a general partnership, a partnership *en commandite* is carried on in the name of one or more partners. However, in an *en commandite* partnership one or more of the partners' names remain undisclosed, i.e. the limited partner(s). A limited partner will generally contribute a fixed sum to the partnership which will entitle it to receive a certain share of the profits, if any. However, unlike a general partnership, in the event that the partnership realises a loss, a limited partner will only be liable to the extent of its capital contribution to the partnership.



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CONTINUED

Facts of BPR 391

The applicant in BPR 391 was a resident private company and the limited partner in the partnership. The general partner (GP) was also a resident private company.

In terms of the ruling, the purpose of the partnership was to acquire and hold shares (Investco Shares) in the share capital of Investco. The applicant and the GP held the investment in the Investco Shares via the partnership as capital assets.

Each partner's interest in the partnership was as follows:

- The GP held a 15% interest in the partnership, i.e. a 15% undivided share in the Investco Shares.
- The applicant held an 85% interest in the partnership, i.e. an 85% undivided share in the Investco Shares.

The partnership agreement provided that all amounts received by the partnership from time-to-time, net of expenses and provisions for anticipated

expenses, should be apportioned among the partners in terms of the above ratio.

In terms of the ruling application to SARS, the applicant intended to dissolve the partnership so that each partner could obtain a direct investment in Investco rather than holding its investment through the partnership.

It was noted that there would not be any change to each partner's bundle of rights in the Investco Shares pre- and post-dissolution of the partnership. Subsequent to the dissolution of the partnership and the division of the Investco Shares between the partners, the applicant would hold 22,96% of the Investco Shares directly and the GP would hold 4,05% of the Investco Shares directly.

Tax considerations

Paragraph 1 of the Eighth Schedule to the Act defines a "disposal" as an event, act, forbearance or operation of law envisaged in paragraph 11 or an event, act, forbearance or operation of law which is, in terms of the Act, treated as the disposal of an asset. Paragraph 11 of the Eighth Schedule

states that a "disposal" includes anything which results in the creation, variation, transfer or extinction of an asset, including instances where a disposal occurs.

One of the instances listed in paragraph 11 is the decrease in value of a person's interest in a company, trust or partnership as a result of a "value shifting arrangement". A "value shifting arrangement" is defined in paragraph 1 of the Eighth Schedule, in relevant part, as –

- an arrangement;
- by which a person retains an interest in a partnership;
- but following a change in the rights or entitlements of the interests in that partnership, the market value of that interest decreases; and
- there is a change in the direct or indirect interest held by a connected person in relation to the person; or
- a connected person acquires a direct or indirect interest.

P.O.V: Your partner ends the partnership but at least there's no tax payable: BPR 391

CONTINUED

The Guide provides an example of the tax consequences that would ensue where a partnership dissolves. The example notes that:

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

As noted above, the applicant submitted that post dissolution, there would not be any change to each partner's bundle of rights in the Investco Shares. Therefore, no disposal should be triggered upon the termination of the partnership.

SARS' decision

SARS' ruling, which corresponds with the above principle, noted that:

- The dissolution of the partnership pursuant to the termination of the partnership agreement, which will result in the applicant taking ownership of 85% of the Investco Shares, will not be treated as a "disposal" as defined in Paragraph 1 of the Eighth Schedule to the Act.
- The proposed dissolution of the partnership will not constitute a "value shifting arrangement", as defined in Paragraph 1 of the Eighth Schedule to the Act – i.e. the market value of the interest of each partner would not decrease but would remain unchanged.



Cliffe Dekker Hofmeyr

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Emil Brincker ranked by **Chambers Global 2003 - 2023** in **Band 1: Tax**.

Gerhard Badenhorst was awarded an individual spotlight table ranking in **Chambers Global 2022 - 2023** for **Tax: Indirect Tax**.

Mark Linington ranked by **Chambers Global 2017 - 2023** in **Band 1: Tax: Consultants**.

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P.O.V: Your partner ends the partnership but at least there's no tax payable: BPR 391

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Although the Eighth Schedule does not expressly deal with this question, SARS' decision is consistent with what is noted in the Guide in relation to the dissolution of partnerships.

The Guide provides a secondary example that illustrates when a disposal can be said to occur. It states that where:

"The partnership assets comprised 50 shares in Company X and 50 shares in Company Y and partner A took over the 50 shares in Company X and partner B took over the 50 shares in Company Y. In that event partner A has disposed of 25 shares in Company Y to partner B in return for 25 shares in Company X. Likewise, partner B has disposed of 25 shares in Company X in return for 25 shares in Company Y."

From the above example, it is clear that the specific facts of a matter must be analysed to determine whether there is a variation of interests to determine whether a disposal has occurred. SARS' ruling may have been different if the facts were similar to the above example in the Guide. It is, therefore, always advisable to seek the advice of a tax practitioner to determine the capital gains tax (CGT) consequences, if any, or, like the applicant in BRP 391, obtain a ruling from SARS confirming the CGT consequences.

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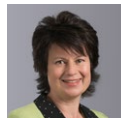
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BBBEE STATUS: LEVEL ONE CONTRIBUTOR

Our BBBEE verification is one of several components of our transformation strategy and we continue to seek ways of improving it in a meaningful manner.

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