the evolution of the "foreign partnership" definition in South Africa

In South Africa, the determination of whether a foreign entity is a company or partnership is an important one, as it subsequently determines the applicable tax treatment of the foreign entity. The issue of whether foreign entities should be recognised as foreign companies or foreign partnerships in South Africa was recently brought into the spotlight once again by the Taxation Laws Amendment Act No. 25 of 2015 (the "**2015 Amendment Act**").

The issue had been one of longstanding uncertainty and was finally thought to be addressed by the introduction of the "foreign partnership" definition into the Income Tax Act No. 58 of 1962 (the "**Act**"), by the Taxation Laws Amendment Act No. 7 of 2010 (the **"2010 Amendment Act**"), which sought to provide certainty to taxpayers. The definition of a "foreign partnership" inserted in section 1 of the Act by the 2010 Amendment Act was as follows:

> "…in respect of any year of assessment, means any partnership, association or body of persons formed or established under the laws of any country other than the Republic if—
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> a) for the purposes of the laws relating to tax on income of the country in which that partnership, association or body of persons is formed or established—
>
> > i) each member of the partnership, association or body of persons is required to take into account the member's interest in any amount received by or accrued to that partnership, association, or body of persons when that amount is received by or accrued to the partnership, association or body of persons; and
> >
> > ii) the partnership, association or body of persons is not liable for or subject to any tax on income in that country; or
>
> b) where the country in which that partnership, association or body of persons is formed or established does not have any applicable laws relating to tax on income—
>
> > i) any amount—
> >
> > > aa) that is received by or accrued to; or
> > >
> > > bb) of expenditure that is incurred by,
> > >
> > > the partnership, association or body of persons is allocated concurrently with the receipt, accrual or incurral to the members of that partnership, association or body of persons in terms of an agreement between those members; and
> >
> > ii) no amount distributed to a member of a partnership, association or body of persons may exceed the allocation contemplated in subparagraph (i) after taking into account any prior distributions made by the partnership, association or body of persons."

In defining a "foreign partnership", the intention of the National Treasury was that the determination of the entity classification should ultimately depend on the law of the country in which such foreign entity is established, with a resultant outcome that would "synchronise the South African tax treatment with foreign tax practice."

Although the focus of the National Treasury was on the tax law of the foreign jurisdiction, it is argued in practice that the determination is one made in terms of the commercial law of the foreign jurisdiction.

This difference in interpretation adds further complexity to the matter of foreign entity classification as it is common knowledge that in many jurisdictions, the classification of entities under commercial and tax law may differ. In other words, the classification, in terms of commercial law, does not determine the subsequent tax treatment in terms of the tax law of the relevant foreign jurisdiction. For example, in the United States, a Limited Liability Company ("**LLC**") incorporated in terms of the commercial law of that country may, where certain conditions are present, elect to be treated as a partnership for tax purposes. Similarly, a Limited Liability Partnership ("**LLP**") incorporated in the United Kingdom is classified as a corporate entity in terms of commercial law, however, such classification is disregarded for tax purposes and it is instead taxed as a partnership.

Recognising that in some foreign jurisdictions, a partnership could be organised in an incorporated vehicle such as a company or corporation for commercial law purposes (as illustrated by the United States LLC and United Kingdom LLP above), the "foreign partnership" definition was amended by the Taxation Laws Amendment Act No. 24 of 2011 to include "partnership, association, body of persons **or entity**" (our emphasis) in all relevant references.

However, the requirement that the partnership vehicle itself (i.e. whether it be a body of persons, company, etc.) should not be subject or liable to tax in its own jurisdiction continued to create inconsistency in the area of classification of foreign entities as "partnerships".

This was illustrated in Binding Private Ruling 178 ("**BPR178**"), which was issued on 14 August 2014. The Limited Partnership in BPR178 was identified as a German "Kommanditgesellschaft" ("**KG**") Partnership, which was effectively managed from Germany. The KG Partnership was treated as transparent for German corporate income tax purposes, but was subject to German trade tax. In the ruling, SARS held that the KG Partnership would be recognised as a foreign company for South African tax purposes. The KG Partnership was then furthermore determined to be a controlled foreign company ("**CFC**"), and to have formed part of a "group of companies" as defined in section 1 of the Act. This ruling clearly went against both the German commercial and tax law classifications of the KG Partnership, as a partnership. The ruling was also not aligned with the intention of the National Treasury as set out in the Explanatory Memorandum to the 2010 Amendment Act.

It is not clear in the final ruling as to why the KG Partnership was treated in this manner, except that the classification facilitated the operation of the company rollover relief provisions which relief was sought by the applicant. It is, however, not disputed that in the case of a German Limited Partnership conducting trade activity, the local trade tax payable would disqualify such a partnership from meeting part a (ii) of the "foreign partnership" definition.

The 2015 Amendment Act directly identified and addressed this issue through the express clarification that the partnership should not be liable for or subject to tax on income, with the exception of any taxes levied by a municipality, local authority or a comparable authority. As a result[1], the outcome in another application ruled upon soon thereafter, which also involved German Limited Partnerships, was very different to that of BPR178.
Binding Private Ruling 222 ('**BPR222**') which was issued on 18 February 2016, involved Limited partnerships conducting business in Germany. The three Limited Partnerships involved were all effectively managed from Germany, and the activities of the two Limited Partnerships, in which the third Limited Partnership was the 100% Limited Partner, created permanent establishments in Germany. All three Limited Partnerships were taxed as Partnerships in Germany, and the two operating Limited Partnerships were further subject to German trade taxes.

In the final ruling, the position and true intention of the National Treasury was restored as SARS regarded the German Limited Partnerships to all be Partnerships subject to flow-through taxation in South Africa for the purposes of making its ruling.

It is evident that the "foreign partnership" definition has seen progressive development since its introduction in 2011. It is believed that these amendments have already, and will continue, to reduce the use of foreign partnerships and other similar flow-through vehicles in South Africa for cross-border tax arbitrage.

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[1]We note that BPR222 currently states that references to sections of the Act are those "applicable as at 3 December 2015". Although the amendment to the "foreign partnership" definition is deemed to have come into operation on 31 December 2015, because this amendment is effective for years of assessment ending on or after 31 December 2015, we believe the ruling made by SARS on 18 February 2016 is consistent with the amended definition as at 31 December 2015.