The Challenges of Taxing Investments in Offshore Hybrid Entities: A South African Perspective

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1 Introduction

Tax avoidance (by contrast with tax evasion) involves using perfectly legal methods of arranging one’s affairs to pay less tax. This is done by utilising loopholes in tax laws and exploiting them within legal parameters.¹ So, for instance, taxpayers often exploit the fact that there are tax variations across international borders and international tax systems that can be used avoid taxes.² This article deals with the resulting tax avoidance when taxpayers invest in entities that two or more countries classify differently for tax purposes. These entities, often referred to as ‘hybrid entities’, are basically legal relationships in which the entity is treated as a taxable entity (eg, a corporation) in one jurisdiction and as a transparent (non-taxable) entity in another.³ In a treaty context, the different tax treatment of these entities may be used to take advantage of treaty benefits and even to avoid taxes.⁴ Hybrid entities usually take the form of trusts or partnership structures.⁵ This article


³ Brian J Arnold & Michael J McIntyre International Tax Primer 2nd ed (2002) at 144; Lynette Olivier & Michael Honiball International Tax: A South African Perspective 4th ed (2008) at 464-5. Hybrid entities can be located in a high-tax jurisdiction or in a tax haven. But the term ‘hybrid entity’ should not be confused with the term ‘hybrid instrument’, which refers to a situation in which a financial instrument may be treated as debt instrument in one country but as a preferred share in another.

⁴ See Arnold & McIntyre op cit note 3 at 144.

⁵ See the various examples of hybrid entities structures as expounded by Arnold & McIntyre op cit note 3 at 144. Under French law, eg, a société en nom collectif (SNC) has separate legal personality although the partners are jointly and severally liable for its debts. Under French tax law, however, a SNC can elect to be taxed as a corporation. If another country treats the French SNC as a partnership, then residents of that country with interests in the SNC would be treated as partners. Thus, if a French SNC borrows funds for use in its business, the interest will be deductible in computing the SNC’s income. If the owners of the SNC are residents of a country that treats the SNC as transparent, the interest deduction will also be avoidable to those owners in their country of residence. In effect, the SNC can be used to obtain an interest deduction in both countries, significantly reducing the after-tax cost of
covers only partnership structures.

In South Africa, the topic of the taxation of hybrid entities has received little attention, and there is no legislation in place dealing with the taxation of these entities. However, a number of South African residents have been known to invest in offshore hybrid entities whereby it is possible to avoid South African taxes on their income. This article discusses the difficulties of taxing partnership hybrid structures and the methods of manipulating these difficulties to avoid taxes. The challenges of taxing these entities in South Africa are also discussed, and recommendations are provided on how the ensuing tax avoidance can be prevented.

2 Why is it Necessary for Countries to Classify Entities for Tax Purposes?

Whether or not a particular entity is a hybrid entity depends on the domestic laws of the countries involved that classify the entities for tax purposes. Discussing the taxation of hybrid entities, Essers and Meussen note that ‘the taxation of hybrid entities in cross-border transactions has proved to be exceptionally complicated and is perhaps one of the most difficult issues in the application of rules on international tax law’. The difficulties of dealing with hybrid entities arise from the fact that different countries may classify an entity differently in their domestic law.

The classification of an entity for income tax purposes is required by the source state in which another state’s entity is doing business in order to determine issues such as whether to tax the entity or its members, the rate of tax and the taxable income. Classification is required by the residence state of the participators in an entity formed in another state so as determine the nature of the taxable income, the timing of taxation, and the possible availability of a foreign tax credit on the distributed income. In the context of a tax treaty, the classification of an entity is important to determine whether the entity is a resident of the other contracting state. This is necessary, for instance, to ensure that the treaty rates of withholding tax on dividends, interest and royalties apply.

Generally, states have rules for classifying entities in the body of their general law. Thus classification problems seldom arise internally. Dealings with other states’ entities have to be fitted into the internal law classifications.
Often this is done by examining the characteristics of the entity under the general law governing them, and determining the closest equivalent internal law. However, this approach fails to deal with the fact that the other state’s entities may be inherently different from one’s own.

3 The Difficulties of Classifying Partnership/Corporate Hybrid Structures

Most countries recognise the concepts of ‘companies’ and ‘partnerships’ for tax purposes, although the definitions of these two concepts may vary. Yet certain entities may not be uniformly classified in one of these categories. Article 1 of the Organisation for Economic Co-operation and Development (OECD) Model Convention states that

[the domestic laws of the various OECD Member countries differ in the treatment of partnerships. The main issue of such differences is founded on the fact that some countries treat partnerships as taxable units (sometimes as companies) whereas other countries disregard the partnership and tax only the individual partners on their share of the partnership income].

One country may treat the entity as a partnership, for instance, while the other country may treat the entity as a company. The differences in classification may lead to completely different tax results in the countries involved. In countries where an entity is classified as a partnership, it is treated as a transparent (pass-through) entity for tax purposes, with the result that it is not taxable. In the countries where the entity is classified as a company, however, it is normally treated as non-transparent for tax purposes, with the result that is treated as a taxable entity. There is no uniform global

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14 Idem at 10.
16 Even if both countries classify a partnership in the same manner (i.e., transparent for tax purposes), there may be problems regarding the classification and allocation of specific items of income. E.g., some countries may accept that a partner may be a creditor of the partnership and may therefore derive interest income from the partnership, while others consider that no interest may be paid to a partner. This leads to a different tax treatment of the interest because the latter country may classify it as a distribution. See Essers & Meussen op cit note 8 at 416; Jones et al op cit note 10 at 289.
17 Paragraph 3 of the Commentary on art 1 of the OECD Model Convention. See also Arnold & McIntyre op cit note 3 at 144; OECD 1999 Report on Partnerships op cit note 13 in par 24.
treatment of foreign partnerships for tax purposes. At the 1995 Congress of the International Fiscal Association, it was noted that ‘there are almost no laws, rulings or authoritative statements on most of the issues concerning the taxation of partnerships’. In my view, this statement remains largely true even today. Although the OECD issued a Report on Partnerships in 1999, problems still arise if a partnership is situated in one state (the source state) while the partners are resident in another state (the residence state), because in certain circumstances the legal status of the partnership may be alien to the residence state. As domestic laws differ in the treatment of partnerships, difficulties arise in the application of double taxation treaties to partnerships.

4 The Tax Treatment of Partnerships in a Treaty Context

Where two countries have entered into a tax treaty based on the OECD Model Tax Convention, art 1 thereof provides that ‘[t]his Convention shall apply to persons who are resident of one or both of the contracting states’. Thus, only persons who are residents of the contracting states are entitled to the benefits of the treaty. With respect to partnerships, the following questions arise from art 1:

• Is a partnership a ‘person’ for treaty purposes?
• Is a partnership a ‘resident’ of a contracting state?

In terms of art 3(1)(a) of the OECD Model Convention, the term ‘person’ includes an individual, a company, and any other body of persons. In par 2 of the OECD Commentary on art 3(1)(a), it is stated that ‘this definition is not exhaustive and it should be used in a very wide sense’. Thus, a partnership (being an association of persons for the purpose of sharing benefits from a joint undertaking) can be designated as a body of persons. The term ‘body of persons’ can be interpreted as meaning a unified group or association of

19 Essers & Meussen op cit note 8 at 415.
22 Essers & Meussen op cit note 8 at 415.
23 Paragraph 2 of the Commentary on art 1 of the OECD Model Convention.
24 Although different countries use various models for drafting their double tax agreements, there are three commonly used models for drafting such agreements. In the first place, there is the Model Tax Convention on Income and Capital, published by the Organisation for Economic Co-operation and Development (‘OECD’). This model was prepared by developed countries of the world and embodies rules proposed by capital-exporting countries. Second, there is the UN Model Double Taxation Convention. This Model has been drafted between developed and developing countries and it attempts to reflect the interests of developing countries. Third, there is the US Model that is followed by most treaties that the USA has signed with other countries, including South Africa. See Edward Nathan and Friedland ‘Residence Basis of Taxation: Double taxation agreements’ (October 2001), available at http://www.saica.co.za/integritax/935_Double_taxation_agreements.htm (last visited 27 March 2009).
individuals and/or bodies corporate. In the United Kingdom case of *Padmore v Inland Revenue Commissioners*, the High Court held that the term ‘body of persons’ includes a partnership, because a partnership is a body of persons within the ordinary meaning of the expression. This issue can also be illustrated by reference to a Swiss decision of the Conseil d’Etat in *SA Quartz d’Alsace*. This case concerned a Swiss partnership that owned 54 per cent of a French company. Under Swiss law the partnership had no legal personality. The Swiss partnership sought repayment of dividends under art 11(3) of the France-Switzerland Convention of 9 September 1966. This article applied to natural persons and companies owning less than 20 per cent of French companies. The Conseil d’Etat held that the Swiss partnership was a person within the terms of the Convention since it constituted a body of persons. But it was not a natural person for the purposes of art 11(3) and could not benefit from the repayment of the dividends under that article.

The definition of the word ‘company’ in art 3(1)(b) of the OECD Model Convention also has certain implications for partnerships. In terms of this article, the term ‘company’ is defined as any body corporate or any entity that is treated as a body corporate for tax purposes. Paragraph 2 of the Commentary on art 1 provides that ‘partnerships will also be considered to be “persons” either because they fall within the definition of “company” or because they constitute other bodies of persons’. However, par 3 of the Commentary on art 3 states that the term ‘company’ also ‘covers any other taxable unit that is treated as a body corporate according to the tax laws of the contracting state in which it is organised’. The definition of the term ‘company’ in art 3(1)(b) and the Commentary on this article in par 3 appear to be ambiguous. On the one hand, any legal entity appears to be a company, whether or not the legal entity is a taxable unit. On the other hand, the reference in the Commentary to ‘any other taxable unit’ indicates that a body corporate can only be classified as a company when it is treated as a taxable unit. So it can be concluded that a literal reading of the term ‘company’ implies that any body corporate is a company. According to an interpretation based on par 3 of the Commentary on art 3, however, a partnership would only be a company for treaty purposes if it were treated as a taxable unit ‘according to the tax laws of the contracting state in which it is organised’.

In a treaty context, an entity will only be liable to tax if it is a ‘resident’ of one of the contracting states. Article 4(1) of the OECD Model Convention provides that the term ‘resident of a contracting state’ means any person who,
under the law of that state, is liable for tax therein by reason of his domicile, residence, place of effective management, or any other criterion of a similar nature.

Accordingly, it can be concluded that while the inclusion of a partnership as a ‘body of persons’ makes it a ‘person’ for treaty purposes, this inclusion does not necessarily make a partnership a ‘resident of a contracting state’, though it may be an ‘enterprise’ of a contracting state if it is carried on by residents of that state. A partnership can be considered a resident of a contacting state only if it is liable to tax therein. Generally, a partnership is liable to tax in a contracting state if it is treated as a legal person (a company) that is a resident of that state. In that respect, it is entitled to treaty benefits in terms of art 4(1) of the OECD Model Convention. If, however, a partnership is treated as fiscally transparent in a state, the partnership is not ‘liable to tax’ in that state within the meaning of art 4(1) and so it cannot be a resident thereof for the purposes of the Convention. In such a case the application of the Convention to the partnership as such would be refused, unless a special rule covering partnerships were provided for in the particular convention. It should be noted that the phrase ‘liable to tax’ does not mean that the person must actually be paying tax in the state; entities enjoying a complete exemption from tax are still residents of a state so long as that state could assert jurisdiction to tax the entity.

Yet that does not mean that the actual tax treatment in the state of residence is completely irrelevant. On the contrary, claiming treaty benefits in the state of residence requires being treated as a taxable entity there. So one has to distinguish between the tax treaty treatment in the state of residence and in the state of source. Claiming treaty benefits in the state of source, such as applying a withholding tax reduction there, requires treatment as a taxable entity there. Claiming treaty benefits in the state of residence, such as exempting foreign income or crediting foreign taxes, requires treatment as a taxable entity in that state.

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31 Ibid.
32 In this respect, the French Supreme Administrative Court (Conseil d’Etat) in a decision of 13 October 1999, SA Diebold Courtage, ruled that a Netherlands closed limited partnership (besloten commanditaire vennootschap), because of its fiscal transparency and its lack of legal personality, could not be considered a resident within the meaning of art 4 of the tax treaty between France and the Netherlands. But the Supreme Administrative Court held that the limited partners were residents of the Netherlands within the meaning of the tax treaty and were therefore entitled to the treaty benefits. For details on the discussion of this case, see Engelen & Pötgens op cit note 12 at 251.
35 Lang op cit note 33 at 38-9.
The OECD has admitted, however, that it is not so simple to qualify a partnership as transparent or non-transparent.36 There is a range of different tax treatments applicable to partnerships.37 The determination of whether a partnership is ‘liable to tax’ in a given state may present practical difficulties because countries use different systems to impose tax on partnerships’ income. Thus the OECD considers that the concept ‘liable to tax’ should be understood in the context of the different systems for taxing partnership income.38 In some domestic systems, a partnership is partly treated as a taxable unit and partly disregarded for tax purposes.39

5 The Tax Treatment of Partners in a Treaty Context

As stated above, the domestic laws differ in the treatment of partnerships. Although some states treat partnerships as legal entities that are liable to tax, other states treat partnerships as fiscally transparent (not liable to tax) and thus not entitled to treaty benefits within the meaning of art 4(1) of the OECD Model Convention. In that case, the partners are entitled to the treaty benefits to the extent that the partnership’s income is allocated to them for the purposes of taxation in their state of residence.40 Where a partnership is treated as a resident of a contracting state, the provisions of the treaty that restrict the other contracting state’s right to tax the partnership on its income do not apply to restrict that other state’s right to tax the partners who are its own residents on their share of the partnership income.41

When a partner’s share of the partnership’s profits is taxed, art 7 of the OECD Model Convention applies. This article provides that the profits of an enterprise of a contracting state are taxable only in that contracting state, unless the enterprise carries on business in the other contracting state through a permanent establishment situated therein. An enterprise of a contracting state is defined in art 3(1)(d) as an enterprise carried on by a resident of a contracting state. Since the partnership itself is not considered a resident, each participant in the enterprise is considered as a separate enterprise. In terms of art 3(1)(c), an enterprise ‘refers to the carrying on of a business’. So each partner in a partnership is considered as carrying on the business of the partnership. The imputation of the partnership’s business to the partnership implies the imputation of the permanent establishment of the partnership to the partners.42

This principle can be explained by reference to a Dutch decision of the

36 OECD 1999 Report on Partnerships op cit note 13 in par 70. See also Lang op cit note 33 at 37.
37 Lang at op cit note 33 at 38.
39 Ibid.
40 Paragraph 5 of the Commentary on art 1 of the OECD Model Convention; see also Engelen & Pötgens op cit note 12 at 251; Lang op cit note 33 at 35.
41 Paragraph 6.1 of the Commentary on art 1 of the OECD Model Convention.
42 Daniëls op cit note 26 at 145.
Hoge Raad of 10 March 1993. This case concerned a partnership – a commanditaire vennootschap (CV) – formed between a Swedish company and two Dutch companies. The Swedish company was a limited or silent partner; one of the Dutch companies was the general partner. The CV was a closed CV, which is treated as fully transparent under Dutch fiscal law, and the general and limited partners are taxed directly on their share of the profits. The Swedish company argued that its share of the income was exempt from tax in the Netherlands under the business profits article of the Netherlands-Sweden double taxation convention of 12 March 1968. Noting that the Swedish company held its participation in the CV as part of its worldwide business, the Hoge Raad concluded that the income was derived through a permanent establishment in the Netherlands and so it was not exempt under the convention.

6 The Problems That Can Arise From the Different Classification of Partnership/Corporate Hybrid Structures

The tax treatment of partnerships (as corporate structures) and the taxation of partners create possibilities of tax avoidance, double taxation and non-taxation of income.

6.1 The Possibility of Avoiding ‘Controlled Foreign Company’ Legislation

If one country classifies an entity as a partnership for tax purposes (with the result that the members or partners are taxable on their share of the entity’s income) and another country classifies the entity as a legal person (with the result that the entity itself is subject to tax on its income), the different treatment of the entity in the two countries creates many tax-planning opportunities. Taxes can be avoided by exploiting the differences between the tax treatment of taxpayers or transactions in the two countries. When an entity is classified as a corporation, the taxation of income may be deferred if the company does not distribute dividends to its shareholders. The deferral of taxes can be curbed when a country has controlled foreign company (CFC) legislation. Where the foreign entity is classified as a partnership, CFC legislation may not be applied to the entity if it is not classified as a company. Instead, the partners are taxed on their share of the

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44 Arnold & McIntyre op cit note 3 at 144.
46 CFC legislation ensures that the undistributed income of a controlled foreign company is not deferred but is taxed in the hands of its domestic shareholders on a current basis. See Olivier & Honiball op cit note 3 at 429; Brian J Arnold The Taxation of Controlled Foreign Corporations: An International Comparison (1986) at 131; Richard Jooste ‘The Imputation of Income of Controlled Foreign Entities’ (2001) 118 SALJ 473 at 473-4. See also Silke op cit note 1 in par 8.10.2; Arnold & McIntyre op cit note 3 at 91.
The different tax treatment of the entities in the relevant countries can then be manipulated to avoid taxes.

6.2 The Differences in the Entitlement to Treaty Benefits May be Manipulated to Avoid Taxes

Where the entitlement to treaty benefits is different for the partnership and for the partners, this can be manipulated to avoid taxes. Daniëls gives the following example: EP is a partnership organised under the laws of State E and is treated as a taxable corporation under the laws of that state. EP carries on a business and receives income sourced from State S. Under the classification rules of State S, EP is classified as a transparent partnership, with the result that State S regards the partners of EP as taxpayers. In terms of the treaty between State S and State E, EP is considered a resident of State E. Consequently, EP will be entitled to the benefits of the tax treaty for its income from State S. So, eg, interest arising in State S and paid to EP would be subject to the reduced 10 per cent rate of withholding tax under art 11(2), provided that EP is the beneficial owner of the interest and the interest is not effectively connected with a permanent establishment of EP in State S. But the perspective of State S under its domestic tax laws will be completely different. Under the income attribution rules of State S, the business profits are attributed to the partners of EP, not to EP itself. Similarly, interest income arising in State S will be attributed to the partners of EP. The differences in the treaty benefits in the above scenarios can be manipulated to avoid taxes.

Clarifying these differences, the Commentary on art 1 of the OECD Model Convention also points out that if the state of source treats a partnership as fiscally transparent, a partner resident in a state that treats the partnership as a company would not be able to claim the benefits of the treaty between the two states with respect to his share of the partnership’s income that the state of source taxes in his hands. Although this income is allocated to the person claiming the benefits of the treaty under the laws of the source state, that income is not similarly allocated for the purposes of determining the liability to tax on that item of income in the state of residence of that person.

There are also differences in the entitlement to treaty benefits if partnership cases involve three states. These differences can also be manipulated to avoid taxes. This often happens if a partner is a resident of one state, the partnership is established in another state, and the partners share in partnership income arising in a third state. In such cases, the Commentary on art 1 of the OECD Model Convention provides that a partner may claim the benefits of the treaty between his state of residence and the state of source of the income to the extent that the partnership’s income is allocated to him for the purposes of taxation in his state of residence. If the partnership is taxed as a resident of the

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47 Daniëls op cit note 26 at 50.
48 Ibid.
49 Paragraph 6.2 of the Commentary on art 1 of the OECD Model Convention.
state in which it is established, then the partnership may also claim the
benefits of the treaty between the state in which it is established and the
state of source. In such a case of ‘double benefits’, it is possible to take
advantage of the different tax rates provided in the two treaties to avoid
taxes.50

6.3 The Possibility of Double Taxation of Income

Conflicts of classification can also result in the double taxation of income.
When partners reside in a state different from that in which the partnership has
been established, those partners may face being liable for tax both in the
residence state and in the source state.51 Take the example above, where EP
set up in State E is recognised as a company but in State S it is recognised as a
partnership. Since the taxation of business profits is governed by art 7, then
from the perspective of State S, business profits may be taxed by State S to
the extent that they can be attributed to a permanent establishment of the
participators in State S. According to art 23 of the OECD Model Convention,
State E has to provide double taxation relief to the entity for the income that,
under art 7, may be taxed by State S. If there is a permanent establishment in
State S, and State E does not provide for double taxation relief at the level of
EP, the participators in the entity in State S could be subjected to double
taxation because the income of EP would not be subject to tax in State S in the
hands of the entity itself, but in the hands of the participators instead.52

An example of a case in which the possibility of double taxation arose is
the Dutch decision of the Hoge Raad of 23 March 1994.53 The case concerned
a Belgian resident individual who was a limited partner in a Dutch closed
partnership. This resident was entitled to a share of the profits and to interest
on his capital and current accounts; he contended that these were exempt from
tax in the Netherlands. The Belgian-Netherlands double taxation convention
of 19 October 1970 expressly provided that limited partnerships formed under
Netherlands law, whose place of management was in the Netherlands, were
regarded as residents of the Netherlands. Reasoning from this provision, the
Hoge Raad concluded that the Netherlands could tax the profit share and
interest on the capital of the silent partner since these were profits of an
enterprise carried on by a Netherlands resident.

6.4 The Possibility of Non-taxation of Income

Furthermore, conflicts of classification can result in the non-taxation of
income.54 From the above example, non-taxation of income could arise if
State E were to apply the exemption method to provide for double taxation

50 Paragraph 6.5 of the Commentary on art 1 of the OECD Model Convention.
51 Essers & Meussen op cit note 8 at 416.
52 Daniëls op cit note 26 at 155.
54 Engelen & Pötgens op cit note 12 at 252.
relief. Under this method, the country of residence taxes its residents on their domestic source income and exempts them from domestic tax on their foreign source income. In effect the jurisdiction to tax rests exclusively with the state of source. If EP carries on a business in State S through a permanent establishment, the profits that may be allocated to such a permanent establishment may be taxed in State S and State E will provide double taxation relief. If EP, for instance, finances the business carried on in its permanent establishment in State S, with loans taken from the participators, it is likely that State S will allow the interest expense as a deduction in computing the profits that may be allocated to the permanent establishment in State S. But from the perspective of State E, the interest income of the participators resident in State E could be treated as interest income effectively connected with the permanent establishment in State S. So, although interest would not be subject to taxation in State S, it could still be exempt from taxation in the hands of the participators resident in State E.

To resolve problems of double non-taxation of income, the OECD Partnerships Report suggested that a provision should be added to art 23A of the OECD Model Tax Convention that reads as follows:

> The provisions of par 1 shall not apply to income derived or capital owned by a resident of a contracting state where the other contracting state applies the provisions of the convention to exempt such income or capital from tax applies the provision of par 2 of art 10 or 11 to such income.

7 Solutions to Resolve the Classification Problems

Commentators on this topic have pointed out three possible solutions to reduce the problems of classifying entities. The first solution is that the partner’s residence state should follow the partnership state’s tax classification. This solution implies that the partner’s residence state should accept that the partnership should be treated in the way in which it would be treated in the state in which it is resident. If this suggestion were to be followed, so the argument goes, then no significant difficulties would arise in applying the treaty. Furthermore, CFC rules would prevent tax avoidance if the choice to be treated as non-transparent would lead to no corporate income tax or only a nominal corporate income tax. Following this approach accords with the 1999 OECD Report on Partnerships stating that in the case of conflicts of classification (owing to differences in the domestic law between the state of

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55 The exemption method is provided for under art 23A of the OECD Model Convention.
56 Arnold & McIntyre op cit note 3 at 33.
57 Daniëls op cit note 26 at 156.
59 This provision now appears in art 23A(4) of the OECD Model Convention.
60 Jones et al op note 10 at 288; Engelen & Pötgens op cit note 12 at 253; Daniëls op cit note 26 at 169.
61 Daniëls op cit note 26 at 169; Engelen & Pötgens at 253.
62 Daniëls op cit note 26 at 169.
63 Jones et al op note 10 at 314.
source and the state of residence), the classification under the law of the source state should be binding upon the residence state. This solution appears to be based on the wording of art 23 of the OECD Model Convention requiring that double taxation relief should be granted, either through the exemption or credit system, where an item of income may be taxed, ‘in accordance with the provisions of the convention’. Thus, the state of residence has a treaty obligation to apply the exemption or credit methods vis-à-vis any item of income where the tax convention authorises taxation of that item of income by the state of source. The OECD Report states that the meaning of the phrase ‘in accordance with the provisions of this convention’ implies that where due to differences in the domestic law between the state of source and the state of residence, the former applies, with respect to a particular item of income, the provisions of the convention that are different from those that the state of residence would have applied to the same item of income, the income is still being taxed in accordance with the provisions of the convention, in this case as interpreted by the state of source. In such a case, therefore, art 23 requires that relief from double taxation be granted by the state of residence notwithstanding the conflict of qualification resulting from these differences in domestic law.

Engelen and Pötgens, however, contend that this approach, to be effective, would require the inclusion of a specific provision to that effect in a tax treaty. The Netherlands also subscribes to this view. Its Observation to the OECD Report on Partnerships in respect to this solution is that it can only be applicable to the extent that it is explicitly stated in a specific tax treaty. The second solution that some commentators suggest is to rely on the tax treaty to provide for the classification of the partnership. This suggestion would, however, require amending the OECD Model Tax Convention in order to make a clear distinction between companies (non-transparent) and partnerships (transparent). It is argued that this approach may not be feasible as treaty classification needs to be sufficiently flexible towards changes in national tax laws.

The third solution is the acceptance of the source state’s classification, but also to include in the treaty specific provisions that require the source state to follow the classification of the partner’s residence state. This is in line with paragraphs 6.3 and 6.4 of the Commentary on article 1 of the OECD Model Tax Convention, which provides that regardless of the source state’s internal law classification, the source state should apply the classification of the partner’s residence state if that state treats the partnership as transparent.

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64 OECD 1999 Report on Partnerships op cit note 13 in par 105; see also par 32.2 of the Commentary on art 23 of the OECD Model Tax Convention.
65 Lang op cit note 33 at 40.
67 Engelen & Pötgens op cit note 12 at 252.
68 Ibid.
69 Jones et al op note 10 at 316.
70 Essers & Meussen op cit note 8 at 424.
71 Jones et al op cit note 10 at 316.
72 The Netherlands holds the view that this solution is only applicable to the extent that it has been explicitly laid down in a specific tax treaty provision or in an internal rule of policy. If this is not the case, then reliance has to be placed on mutual agreement procedure. See Netherlands’ Observation on art 1 in par 27.1 of the Commentary on art 1.
Of the three solutions pointed out above, the third appears to be the most feasible in resolving the partnership classification problem. Under this approach, the country where the partnership is situated is determinative.\(^73\) In support of this approach, Essers and Meussen\(^74\) state that the country where the partnership is situated has the strongest position in determining the tax position of the partnership. Although part of the tax authority of the country of residence of the partners would be removed (since it has to follow the classification of the state of residence of the partnership), this may be appropriate in the light of the goal of preventing double taxation or double non-taxation of income.\(^75\)

One can see the approach of a country of source to a foreign partnership in the decision of the French Conseil d’Etat in SA Diebold Courtage.\(^76\) The French company made rental payments to a Dutch limited partnership – a commanditaire vennootschap (CV) – in respect of an agreement for the sale and leaseback of computer equipment. The limited partner and the general partner of the CV were both companies (BVs – limited liability companies) resident in the Netherlands. Approximately 65 per cent of the rental payments were paid on to a Swiss company. The French company contended that the rental payments were exempt from French tax under art 12 of the France-Netherlands double taxation convention of 16 March 1973. The Conseil d’Etat held that as the CV was fiscally transparent under Dutch tax law, it could not be a resident of the Netherlands for treaty purposes. However, the rental income was to be treated as paid to the two BVs, which were residents of the Netherlands and could benefit from the Convention. There was insufficient evidence to conclude that the BVs were not the beneficial owners of the rental income. This case shows the state of source examining the tax treatment in the country of residence, and also operating a flow-through or derivative-benefits approach by looking through the transparent entity to its associates; all this is consistent with the Partnerships Report (though not with the French Government’s reservations on the Report).\(^77\)

Another case in which the partner’s state of residence gave up jurisdiction to tax to the state of source is NV Immo-Part v Belgium.\(^78\) Here the Court of Appeal of Brussels had to consider a Belgian resident that owned a share in a United States general partnership (which in turn owned a share in a United States limited partnership). The limited partnership owned land in the United States of America. The Court concluded, by examining provisions of the general partnership agreement, that the partnership was fiscally transparent. The income was therefore derived from land in the United

\(^{73}\) Essers & Meussen op cit note 8 at 425.
\(^{74}\) Ibid.
\(^{75}\) Ibid.
\(^{76}\) Decision of 13th October 1999, No.191, reported in RJF 12/99 No.1492; also reported (with translation) in (1999) 2 ITLR 365.
\(^{78}\) Decision of 30th April 1998, reported in (1998) 1 ITLR 463.
States, the taxpayer also having a permanent establishment at the office of the partnership in the United States: the income was therefore exempt from tax in Belgium.

8 The Tax Treatment of Partnership/Corporate Hybrid Entities in the United Kingdom

In the United Kingdom, partnerships are governed by the Partnership Act 1890.79 In terms of this Act, partners in a firm are jointly and severally liable for all the debts and obligations of the partnership. The problem with partnerships is that an individual partner’s personal assets are at risk from claims arising out of actions of partners that may exceed not only the firm’s insurance cover, but also the ability of the firm to meet the quantum of the claim from its own resources.80

To counteract the disadvantages of partnerships, the ‘limited liability partnership’ (LLP) structure was created. The LLP comes into existence upon incorporation.81 It is a body corporate with legal personality separate from that of its members.82 It combines the organisational flexibility and taxation treatment of a partnership but with limited liability for its members.83 It is thus seen as a ‘hybrid creature’ based substantially on the corporate model.84 Explaining the intricacies of the LLP in the United Kingdom, Morse85 states:

‘In essence it is a body corporate with limited liability in the sense that its members are not personally liable for its debts beyond their financial interests in the LLP itself, but with unlimited capacity. It is incorporated by registration with an incorporation document thus fulfilling the role of memorandum of association and subject to many of the accounting and disclosure requirements and other controls applicable to companies. But it has no shareholders or share capital, no directors, and no specific requirements as to meetings or resolutions’.

In general, partnership law in the United Kingdom does not apply to a limited liability partnership, but the arrangements between the partners may closely follow a traditional partnership agreement.86 For example, LLPs are run like general partnerships and they have a similar degree of management flexibility.87 However, the LLP’s existence as a corporate entity means that the effect of the general law is different in comparison with a partnership. Members of an LLP benefit from the limited liability, and so their own personal assets will be protected whilst those of the LLP will be at risk, as is

79 53 & 54 Vict ch 39.
81 Judith Freedman ‘Limited Liability Partnerships in the United Kingdom: Do They Have a Role for Small Firms?’ in: McCahery, Raaijmakers & Vermeulen op cit note 8 293 at 304.
82 Section 1(2) of the Limited Liability Partnerships Act 2000 (c 12).
83 Armour op cit note 80 at 295.
85 Idem at 323.
the case with a limited company. But unlike a limited company, in an LLP there is no distinction between the owners of the company (its shareholders) and its managers (directors). The participators in an LLP are referred to as members, who are free to regulate their internal affairs as they see fit.

For the purposes of taxation, the LLP is treated not as a corporation but as a partnership. Section 10 of the Limited Liability Partnerships Act 2000, which inserts ss 118ZA to 118ZD in the Income and Corporation Taxes Act 1988, provides that an LLP is treated as though it were a partnership for the purposes of this Act. Thus, unlike corporate bodies, the profits or gains made by an LLP are not subject to corporations tax assessed on the LLP. Since the LLP is transparent for tax purposes, each member is assessed on his shares of the income or gain of the LLP in accordance with s 111 of the Income and Corporation Taxes Act 1988, and corporate members of the LLP (such as clubs and societies) are liable to corporations tax in accordance with s 114 of that statute. The tax treatment of the LLP creates opportunities for tax avoidance, especially in a treaty context.

The approach of the United Kingdom to the taxation of partnerships with respect to its double taxation conventions was dealt with in Padmore v Inland Revenue Commissioners. In that case, a United Kingdom resident partner of a partnership managed and controlled in Jersey sought exemption from his share of the partnership profits under the terms of the 1952 double taxation treaty between the United Kingdom and Jersey. The High Court held that a partnership was a ‘body of persons’ capable of satisfying the definition of ‘resident’ and could benefit from the treaty. The Court pointed out that although the treaty used the phrase ‘body of persons, corporate or not corporate’, this expression did not have the meaning given to it by the Income and Corporation Taxes Act 1988. It was held that the partnership income was exempt under the treaty and that the profits were similarly exempt in the hands of the individual partners. This decision was upheld on appeal. The decision in Padmore v Inland Revenue Commissioners has now been reversed by s 112(4) and (5) of the Income and Corporation Taxes Act 1988. Those subsections provide that if a partnership resident outside the United Kingdom is relieved from United Kingdom tax on income or capital gains by virtue of a double taxation convention, a resident partner shall be taxed without regard to such convention. Thus these subsections reverse the specific impact of the

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88 Jones et al op note 10 at 292.
89 Armour op cit note 80 at 2.
90 Freedman op cit note 81 at 304.
91 Armour op cit note 80 at 2.
92 Section 118ZA of the Income and Corporation Taxes Act 1988 (c 1) reads: ‘For the purposes of the Tax Acts, a trade, profession or business carried on by a limited liability partnership with a view to profit shall be treated as carried on in partnership by its members (and not by the limited liability partnership as such); and, accordingly, the property of the limited liability partnership shall be treated for those purposes as partnership property.’
93 Freedman op cit note 81 at 304.
95 Section 526(5) of the Income and Corporation Taxes Act 1970 (c 10), now s 832(1) of the Income and Corporation Taxes Act 1988, indicates that ‘body of persons’ does not include a partnership.
Padmore decision without overruling the general holding that a partnership may be a body of persons.

As a result of the Padmore case, the United Kingdom has begun to include specific references to partnerships in treaties recently negotiated.97 If neither state regards a partnership as a taxable entity separate from its partners, partnerships are excluded from the definition of a person.98 But if the other treaty state recognises a partnership as a separate entity, that partnership is regarded as a person but a specific provision similar to the following is included:99

‘Where, under any provision of this Convention, a partnership is entitled, as a resident of [ ], to exemption from tax in the United Kingdom on any income or capital gains, that provision shall not be construed as restricting the right of the United Kingdom to tax any member of the partnership who is a resident of the United Kingdom on his share of the income and capital gains of the partnership; but any such income or gains shall be treated for the purposes of Article . . . (Elimination of Double Taxation) of this Convention as income or gains from sources in [ ].’

The English Court of Appeal in Memec Plc v IRC100 had to consider income derived by a United Kingdom company that was a silent partner in a German silent partnership. ‘Silent partnerships’ are generally arrangements that are contractual in nature. These arrangements are not recognised in the United Kingdom but they are recognised in some countries such as Germany.101 In terms of these arrangements, the silent partners contribute assets to a managing partner in consideration for a share of the profits from the business. Silent partnerships are not treated as entities. The managing partner owns the assets transferred by the silent partners. The payments made to the silent partners are usually deductible when computing the income of the managing partner, although they may be subject to withholding tax. If the country in which the silent partner is resident treats the silent partnership as a partnership and if it taxes business income on a territorial basis, then there will be no tax, except possibly withholding tax, in either country.102

In the Memec case, Memec, a United Kingdom company, owned shares in a Germany company, which in turn owned shares in two Germany operating companies. The operating companies paid German trade taxes that could not qualify for tax-treaty credit relief against United Kingdom tax when Memec received dividends from its two-tier German subsidiary. Memec therefore entered into a silent partnership with the German corporation and then claimed that it had received dividends as a partner directly from the operating

97 Some earlier treaties also dealt expressly with partnership. Eg, art 3(1)(h) of the 1974 convention with Cyprus and art 3(1)(e) of the 1987 convention with Bulgaria expressly exclude partnerships from the scope of the treaty, while art 3(1)(c) of the 1975 convention with the USA expressly included partnerships. For details, see Baker op cit note 25.
98 See, eg, art 3(1)(e) of the UK/Ghana Convention of 1993, which states: ‘the term “person” comprises an individual, a company and any other body of persons, but does not include a partnership’. For details, see Baker op cit note 25.
99 See art 25(1) of the UK/India Convention 1993; art 24 of the UK/Ukraine Convention 1993. For details, see Baker op cit note 25.
100 [1998] STC 754.
101 Arnold & McIntyre op cit note 3 at 146.
102 Ibid.
companies and that it was entitled to a credit for the taxes payable. The Court of Appeal in England held that the German silent partnership was not a partnership under United Kingdom law and that the source of the dividend income was the contractual agreements. The Court held further that the income was indeed a dividend for the purposes of withholding tax under the treaty but that it was not a dividend for the purposes of a tax credit.

9 The Tax Treatment of Partnership/Corporate Hybrid Entities in the United States of America

The ‘limited liability company’ (LLC) in the United States of America has been described as a hybrid form of business organisation with some attributes of a partnership and other attributes of a corporation. Such LLCs are recognised as corporate entities in the United States but are treated as partnerships for tax purposes. This tax treatment implies that the taxable income of the LLC passes through to owners, thus making it possible to avoid corporate tax.

United States income tax laws generally recognise only two types of business entities: corporations and partnerships. For instance, the rules that deal with the taxation of controlled foreign corporations contained in subpart F of the Internal Revenue Code of 1954 are largely premised on the assumption that for non-tax reasons, business will be carried on in a corporate form. This makes it possible to avoid these provisions by using planning techniques that exploit their corporate focus. Planning techniques have been encouraged by measures such as the United States ‘Check-the-Box Regulations’ introduced in 1996. These regulations have allowed United States multinational enterprises to reduce the effective rates of tax on their non-United States income significantly, thus facilitating tax avoidance techniques that generally involve the use of hybrid entities that are

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103 For a detailed discussion of the operation of silent partnerships, see John Dixon & Malcolm Finney Tolley’s International Corporate Tax Planning (2002) in pars 4-4-4.9.
105 Ibid.
109 TD 8697, 61 Fed Reg 66,584 (Dec. 18, 1996); Robert J Peroni, J Clifton Fleming & Stephen E Shay ‘Getting Serious About Curtailing Deferral of United States Tax on Foreign Source Income’ (2005) 52 Southern Methodist University LR 455 at 515-6; Rosanne Atdshuler & Harry Grubert ‘The Three Parties in the Race to the Bottom: Host Governments, Home Governments and Multinational Companies’ (2005) 7 Florida Tax Review 153 at 158 state that the Check-the-Box regulations gave companies the freedom either to identify an entity as a separate corporation or to ‘disregard’ it as an unincorporated branch of another corporation by simply checking the box on a tax form. See also Lokken op cit note 106 at 195; US Treasury Department Policy Study op cit note 107 at 6; Boris I
recognised as corporations under foreign tax laws, but are partnerships or disregarded entities for United States tax purposes.\textsuperscript{110} By exploiting the differences in the United States tax treatment of corporations and disregarded entities, as well as differences in entity classification between different countries, a United States person is able to deflect operating income from a high-tax jurisdiction to a low-tax jurisdiction while avoiding the application of subpart F rules. A number of hybrid arrangements involve related party payments, which are used to deflect income from a high-tax jurisdiction to a low-tax jurisdiction, while avoiding subpart F rules.\textsuperscript{111}

The check-the-box regulations have facilitated these arrangements because they often allow a foreign entity to be treated, at the taxpayer’s election, as a corporation, or as a branch or a partnership. For example, taxpayers can elect to treat entities organised under foreign equivalents of the United States limited liability company laws as branches or partnerships for United States tax purposes, even if they are taxed as separate corporate entities under foreign laws.\textsuperscript{112} These regulations are inconsistent with the policies and rules intended to prevent the shifting of passive income to lower-tax jurisdictions for tax avoidance purposes.\textsuperscript{113}

It is, however, worth noting that the United States is one of the few countries to have adopted a provision in its Model tax treaty and domestic legislation dealing with the application of double tax conventions to hybrid entities.\textsuperscript{114} Broadly, this initiative adopts a ‘flow-through’ approach. Article 4(1)(d) of the Income Tax Treaty 1996 provides as follows:\textsuperscript{115}

‘An item of income, profit or gain derived through an entity that is fiscally transparent under the laws of either Contracting State shall be considered to be derived by a resident of a State to the extent that the item is treated for purposes of the taxation law of such Contracting State as the income, profit or gain of a resident.’

\footnotesize{\textsuperscript{110} Bittker & Lokken op cit note 109 in par 65.3.6 at 65-55; also in par 69.13.1; Avi-Yonah op cit note 108 at 219; Sweitzer op cit note 108 at 7-8.}

\footnotesize{\textsuperscript{111} Take the following scenario adopted from the US Treasury Department Policy Study (2000) at 63 as an example. A US person wholly owns a CFC in Country A, a high-tax jurisdiction. To deflect operating income from Country A to Country B, a low-tax jurisdiction, the US person could cause the CFC to establish an entity in Country B that would be treated as a corporation in Country A but would be disregarded for US tax purposes. The US person would then cause the hybrid entity to make a loan to the CFC. Because Country A treats the hybrid entity as a corporation, the interest payments from the CFC to the hybrid would be deductible in Country A and therefore would reduce the amount of CFC operating income that would have been subject to high-tax in Country A. Because Country B is a low-tax jurisdiction, the interest payments received by the hybrid from the CFC would be subject to little or no tax in Country B. Since the US would treat the hybrid as a disregarded entity for US tax purposes, the taxpayer would take the position that the interest payment between the CFC and the hybrid should be disregarded for US tax purposes and thus not be part of subpart F income. See other examples described by Lokken op cit note 106 at 198-9 and by Bittker & Lokken op cit note 109 at 69-87.}

\footnotesize{\textsuperscript{112} Bittker & Lokken op cit note 109 in par 69.13.1 at 69-87.}

\footnotesize{\textsuperscript{113} Ibid.}

\footnotesize{\textsuperscript{114} See the Regulations under s 894(c) of the Internal Revenue Code.}

10 The Tax Treatment of Partnership/Corporate Hybrid Entities in South Africa

Generally, the foreign structures in which South African residents invest are largely driven by commercial considerations or by the tax interests of non-resident foreign investors (eg, in the case of a minority stake in a joint venture). South African taxpayers often have little choice regarding the legal form of the entity in which they invest.116 Many jurisdictions, especially tax havens, have legislation providing for flexible corporate structures (such as structures combining a partnership with corporate characteristics that may not be fiscally transparent).117

In South African law, a partnership is not a legal person distinct from the individual partners who comprise the partnership.118 Neither is a partnership a taxable person for the purposes of the Income Tax Act.119 The general rule on the taxation of partnerships (whether local or foreign) is that if a South African resident has an interest in a tax-transparent foreign partnership, he is taxed in South Africa on his share of the partnership income. The income of the partnership is taxed in the hands of the individual partners at the time that it accrues to or is received by the partnership.120 Each partner is separately and individually liable for rendering the joint return.121 The partners are liable to tax in their separate individual capacities, and separate assessments are made upon each partner.122

10.1 The Classification of Hybrid Entities in the Income Tax Act: Anomalies Created by the Definition of ‘Company’

The definition of the word ‘company’ in s 1 of the Income Tax Act creates certain anomalies with respect to the taxation of foreign incorporated partnerships. This definition covers both companies incorporated in South Africa and those incorporated outside South Africa. In terms of s 1(b) of the Income Tax Act, a company is defined to include ‘any association, corporation or company incorporated under the law of any country other than the Republic or any body corporate formed or established under such law’. From the wording of this definition, it appears that Parliament could have intended to establish consistent treatment for entities that would otherwise be recognised as corporate entities under South African law by virtue of their being recognised as separate legal personalities under foreign law. But this definition is so wide that it gives rise to interpretational problems in relation to foreign entities falling within the South African tax definition of a company. This is the case with respect to certain partnerships with corporate personality

116 Olivier & Honiball op cit note 3 at 464-5.
117 Freedman op cit note 81 at 293.
118 R v Levy & Others 1929 AD 312; Müller en ’n Ander v Pienaar 1968 (3) SA 195 (A).
119 58 of 1962; see Meyerowitz op cit note 1 in par 16.61.
121 Section 66(15) of the Income Tax Act.
122 Section 77(7) of the Income Tax Act.
that are incorporated under the company law of certain jurisdictions. An example is the United Kingdom LLP (described above)\textsuperscript{123} that is becoming popular internationally but is foreign to South African law.\textsuperscript{124} It has been noted that several South African tax residents have interests in United Kingdom LLPs.\textsuperscript{125}

Since the definition of ‘company’ in s 1(b) of South Africa’s Income Tax Act covers companies incorporated under foreign law, the legal status of a foreign entity has to be determined according to foreign law. It is irrelevant whether the foreign entity qualifies as a company under South African law.\textsuperscript{126} For example, whether a particular LLP may be incorporated in the foreign jurisdiction must be determined under the relevant law of that foreign jurisdiction. The result of the application of s 1(b) of the Income Tax Act is that a United Kingdom LLP qualifies as a company in South Africa.

10.2 Challenges of Applying South Africa’s CFC Legislation to Partnership/Corporate Hybrid Entities

If a South African resident and a United Kingdom resident decide to incorporate an LLP in the United Kingdom, it is not clear whether South African CFC rules should be applied to tax the South African shareholder. South Africa’s CFC rules are contained in s 9D of the Income Tax Act. These rules prevent the deferral of taxes by ensuring that the undistributed income of a controlled foreign company is not deferred, but is taxed in the hands of its domestic shareholders on a current basis. Section 9D(1) defines a CFC as a foreign company in which one or more South African residents, directly or indirectly, hold more than 50 per cent of the total participation rights of the company or more than 50 per cent of the voting rights of that foreign company are held (or exercisable) directly or indirectly by one or more residents.

It may be argued that since s 1(b) of the definition of ‘company’ in the Income Tax Act covers foreign companies, the CFC legislation could potentially apply to the LLP. But it is worth noting that, for the CFC legislation to apply, it is required that South African residents should hold more than 50 per cent of the total participation or voting rights in the foreign company.\textsuperscript{127} The unique nature of the United Kingdom LLP makes this aspect of the South African CFC legislation difficult to apply. Although the LLP comes into existence upon incorporation,\textsuperscript{128} the participators in an LLP are referred to as members.\textsuperscript{129} The LLP has no shareholders or share capital.\textsuperscript{130}

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\item \textsuperscript{123} Freedman op cit note 81 at 293.
\item \textsuperscript{124} Olivier & Honiball op cit note 3 at 464.
\item \textsuperscript{125} Ibid.
\item \textsuperscript{126} Ibid.
\item \textsuperscript{127} Section 9D(1) of the Income Tax Act.
\item \textsuperscript{128} Freedman op cit note 81 at 304; Jones et al op note 10 at 292; Armour op cit note 80 at 2.
\item \textsuperscript{129} Freedman op cit note 81 at 304.
\item \textsuperscript{130} Morse op cit note 84 at 324.
\end{itemize}
\end{footnotesize}
this respect, it is doubtful whether CFC legislation could be applied to the members of a United Kingdom LLP.\footnote{131} It is submitted that this anomalous situation could be manipulated to avoid taxes.

It should, however, be noted that there are other jurisdictions that have LLPs that are not incorporated. One example is the Cayman Islands.\footnote{132} In terms of the definition of ‘company’ in s 1(b) of the Income Tax Act, the Cayman Islands LLP cannot be considered a company; it is a transparent partnership.\footnote{133}

As stated above, another example of an offshore hybrid entity is the United States LLC that is recognised as a corporate entity in the United States but is treated as a partnership for tax purposes.\footnote{134} This tax treatment implies that the taxable income of the LLC passes through to its owners, thus making it possible to avoid corporate tax.\footnote{135}

It is important to note that even though the LLC is disregarded for the purposes of United States tax, it is still regarded as a company for the purposes of South African tax. In South Africa there is no specific law that characterises a hybrid entity on the basis of its tax treatment in another country.\footnote{136} Since the definition of ‘company’ in s 1(b) of the Income Tax Act recognises foreign companies, the relevant United States law that has to be considered is company law, not tax law.\footnote{137} As the LLC qualifies as a foreign company in South Africa, it is arguable that CFC legislation can potentially be applied to South African residents who hold more than 50 per cent of the total participation or voting rights of the LLC.

Although a United States LLC is regarded as a company for the purposes of South African tax, this domestic-law interpretation is overridden by the application of the United States tax treaty that specifically provides that for the purposes of the application of the tax treaty, the United States tax treatment of the entity must determine the tax treatment in South Africa.\footnote{138}

\subsection*{10.3 Challenges of Determining the Residence Status of a Partnership/Corporate Hybrid Entity}

In terms of s 1 of the Income Tax Act, a person other than a natural person (eg, a company) is considered a ‘resident’ of South Africa if it is incorporated, established or formed in the Republic of South Africa, or if it has a place of effective management in South Africa. This means, eg, that a company incorporated in South Africa is a resident irrespective of where its place of effective management may be located. Conversely, a company that has its...
place of effective management in South Africa is a resident irrespective of where it is incorporated.139

When an entity such as the United Kingdom LLP is considered a company in South Africa in terms of s 1(b) of the definition of ‘company’ in the Income Tax Act, it is not clear whether this LLP can be considered a South African resident if it is effectively managed in South Africa. This is because the concept of the LLP is foreign to South African law. It is submitted that this anomalous situation requires that the definition of the term ‘company’ in the Income Tax Act should be amended.140

There are hardly any cases in South Africa that have dealt with the problem of the hybrid entity. One case that comes close to explaining how this situation could arise is ITC 1819.141 Although the case was based on the implications of the double taxation agreement between South Africa and Lesotho, and not specifically hybrid entities, its facts illustrate how the different tax treatment of entities in two countries can be manipulated to avoid taxes. The appellant was a partner in a firm of attorneys registered as a partnership in Lesotho and carrying on business from a permanent establishment in Lesotho. The firm was registered in Lesotho as a tax entity and was required to file a partnership return, but the profits of the partnership were taxed in Lesotho in the hands of the individual partners. The South African Revenue Service included those profits in the appellant’s taxable income for the years 2002 and 2003, but credited him with the amounts of tax paid thereon in Lesotho. The appellant contended that his share of the profits from the Lesotho firm was taxable only in Lesotho and was exempt from tax in South Africa in terms of art 7.1 of the double taxation agreement between the two countries. This article states:

‘The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment.’

It was held that the appellant’s reliance on article 7.1 to claim that the profits of the Lesotho firm were taxable only in Lesotho was unacceptable, and that a proper application of article 7.1 led to a conclusion different from the appellant’s contention. The Court explained that this article dealt specifically with the profits of an enterprise. An enterprise of a contracting state meant an enterprise carried on by a resident of a contracting state. In addition, a resident of a contracting state in Lesotho was a person who was liable to tax in Lesotho. The question therefore was whether the firm was liable to tax in Lesotho. The facts showed that although the firm was registered as a tax entity, it was not liable to tax in Lesotho. The Court

[140] Olivier & Honiball op cit note 3 at 434.
[141] 69 SATC 159.
pointed out that the position in respect to the taxation of partnerships in Lesotho appeared to be similar to the position of partners in the South Africa Income Tax Act. In terms of article 7.1 of the double taxation agreement, the appellant carried on an enterprise in respect of a firm in Lesotho, together with others. Section 24H(2) of South Africa’s Income Tax Act provides that where any trade or business is carried on in partnership, each member of such partnership shall be deemed to be carrying on the trade or business of the partnership. Since the appellant was a resident of South Africa, his involvement in the firm was considered to be an enterprise of South Africa that carried on business in Lesotho through a permanent establishment therein. Therefore in terms of article 7.1, the profits of the enterprise carried on by the appellant might be taxed in Lesotho, but taxes so paid should be deducted from taxes due by the appellant in South Africa, in terms of article 23 of the double taxation agreement. It was thus held that the assessments in question could not be deducted. The appeal was dismissed and the assessments were confirmed.

Although this case deals mainly with the implications of double taxation agreements, its facts portray the difficulties arising from the different classification and tax treatment of entities in two different countries.

11 Conclusion and Recommendations

In conclusion, it can be said that there are a number of uncertainties about the taxation of hybrid entities in South Africa. The unique nature of some foreign incorporated entities creates anomalies based on the current wording of the definition of ‘company’ in the Income Tax Act.

It is recommended that the definition of the term ‘company’ in the Income Tax Act should be amended to correct the anomalies that open up loopholes for tax avoidance.142 It is further recommended that, in order to create legal certainty, South Africa’s tax legislation should be amended to provide specifically for the treatment of hybrid entities as tax-transparent limited partnerships under the Act.143 However, this proposal should not be implemented without careful analysis and consideration. Specific mechanisms exist in other jurisdictions (such as the United Kingdom and the United States) that ensure the equitable tax treatment of the partners of these entities144 – no such mechanisms are to be found in South Africa’s tax law.

142 Olivier & Honiball op cit note 3 at 434.
144 Ibid.