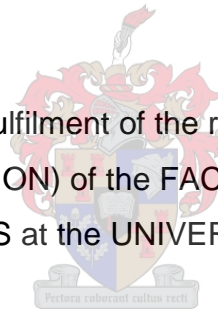


An investigation into the normal tax implications of a carried interest received by fund managers

by

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Thesis submitted in partial fulfilment of the requirements for the degree of
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MANAGEMENT SCIENCES at the UNIVERSITY OF STELLENBOSCH.



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Submission for: March 2016

DECLARATION

Through electronic submission of this thesis, I declare that the entirety of the work contained therein is my own original work, that I am the sole author of it (except to the extent otherwise expressed), that reproduction and publication of the work by the University of Stellenbosch will not give rise to third party liability and that the work has not before, in whole or in part, been offered for the acquisition of any qualification.

Date: March 2016

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LIST OF ABBREVIATIONS AND TERMINOLOGY

CFR	Code of Federal Regulations
CGT	Capital Gains Taxation
GP	General Partner
IFRS	International Financial Reporting Standards
IRS	Internal Revenue Service
ISPI	Investment Services Partnership Interest
LP	Limited Partner
PE	Private Equity
REIT	Real Estate Investment Trusts
SARS	the South African Revenue Service
the Act	the South African Income Tax Act 58 of 1962
the IRC	the Internal Revenue Code of 1986 as amended
the Loonwet	the <i>Wet op de loonbelasting 1964</i>
the Wet	the <i>Wet inkomstenbelasting 2001</i>
USA	United States of America
VC	Venture Capital

EXECUTIVE SUMMARY

The term “a carried interest” - which refers to the right held by a private equity fund manager to share in the future profits generated by the investment fund that it manages - is not defined in the South African Income Tax Act 58 of 1962 (the Act), nor has it been under scrutiny of the South African courts. Consequently, there is uncertainty regarding the classification of the initial receipt of a carried interest and the cash flow from a carried interest for normal tax purposes in South Africa.

Due to this uncertainty this research was undertaken. It consists of a literature review of pure theoretical aspects of published theoretical and descriptive material. The wording of the Act with specific reference to the gross income definition and the phrases “amount received in respect of services rendered” and “of a capital nature” was scrutinized, together with relevant case law and academic articles.

The aim of this study was to determine the nature of a carried interest for normal tax purposes when distributed to the fund manager of an investment fund. In order to address this it was needed to determine:

- whether the initial distribution of a carried interest by an investment fund to a fund manager constitutes a fringe benefit
- whether a carried interest distributed by an investment fund to a fund manager constitutes gross income in terms of other provisions of the Act
- the nature of the cash flow from a carried interest, for normal tax purposes, earned by the investment fund upon the liquidation of the fund
- the effect of section 9C of the Act on the underlying investments of, and consequently on a carried interest in, an investment fund
- the effect of the guidelines formulated by the South African courts on the underlying investments of, and consequently on a carried interest in, an investment fund

It was determined the fund manager performs its services independently of the investment fund. As a result the initial receipt of a carried interest cannot be regarded a fringe benefit.

Furthermore, reference to the definition of gross income and substantiating case law indicated that the receipt of a carried interest does not constitute gross income, because the

fund manager only receives an entitlement to share in future profits of the investment fund, which does not constitute an amount as defined by case law.

Hence the study progressed to the cash flow from a carried interest. It was concluded that the cash flow from a carried interest has a closer relationship with the risking of capital than with the provision of services. Therefore, the amount received is not classified as an amount received in respect of services rendered.

The nature of the underlying investments were investigated and presented the conclusion that the investments are normally held with the dominant intention for resale, and thus are income in nature. However, the overriding effect of section 9C of the Act makes it possible for the underlying investments to be deemed capital in nature if certain requirements are met.

The carried interest regime was examined in the USA and the Netherlands and was compared to South Africa. It was concluded that the lack of specific legislation in South Africa requires thoroughly researched legislation that would provide a clear answer to the method of taxing a carried interest without causing loss of foreign investment.

UITVOERENDE OPSOMMING

Die begrip “*a carried interest*” - wat verwys na die reg wat 'n private aandelefonds bestuurder uitoefen om te deel in die toekomstige winste wat deur die beleggingsfonds wat hy bestuur, gegeneer word - is nie gedefinieer in die Suid-Afrikaanse Inkomstebelastingwet 58 van 1962 (die Wet) nie en is ook nie deur Suid-Afrikaanse howe ondersoek nie. Gevolglik, is daar onsekerheid oor die klassifikasie van die aanvanklike ontvangste van 'n *carried interest*, asook die kontantvloei van 'n *carried interest* vir doeleindes van normale belasting in Suid-Afrika.

As gevolg van hierdie onsekerheid is hierdie navorsing onderneem. Dit bestaan uit 'n literatuurstudie van suiwer teoretiese aspekte van gepubliseerde teoretiese en beskrywende materiaal. Die bewoording van die Wet is onder die loep geneem, met spesifieke verwysing na die omskrywing van bruto inkomste, die frases "bedrag ontvang ten opsigte van dienste gelewer" en "van 'n kapitale aard", asook relevante regspraak en akademiese artikels.

Die doel van hierdie studie was om die aard van 'n *carried interest* te bepaal vir doeleindes van normale belasting, wanneer dit aan die fonds bestuurder van 'n beleggingsfonds uitgekeer word. Ten einde dit aan te spreek, was dit nodig om:

- vas te stel of die aanvanklike uitkering van 'n *carried interest* deur 'n beleggingsfonds na 'n fondsbestuurder 'n byvoordeel uitmaak;
- vas te stel of 'n *carried interest*, uitgekeer deur 'n beleggingsfonds aan 'n fondsbestuurder, bruto inkomste uitmaak;
- die aard van die kontantvloei vanaf 'n *carried interest* vir normale belasting doeleindes, soos verdien deur die beleggingsfonds by likwidasië van die fonds, vas te stel;
- die effek van artikel 9C van die Wet op die onderliggende beleggings van 'n beleggingsfonds vas te stel;
- die effek wat die riglyne, soos deur die Suid-Afrikaanse howe geformuleer, op die onderliggende beleggings van, en gevolglik op 'n *carried interest* in, 'n beleggingsfonds vas te stel.

Daar is vasgestel dat die fondsbestuurder sy dienste onafhanklik van die beleggingsfonds verrig. As gevolg daarvan kan die aanvanklike ontvangste van 'n *carried interest* nie as 'n byvoordeel beskou word nie.

Verdere verwysing na die omskrywing van bruto inkomste en stawende regspraak, het aangedui dat die ontvangste van 'n *carried interest* nie bruto inkomste uitmaak nie. Die rede hiervoor is dat die fondsbestuurder slegs 'n reg ontvang om in die toekomstige winste van die beleggingsfondse deel. Hierdie reg kan nie 'n bedrag, soos gedefinieer in regspraak, uitmaak nie.

Vervolgens fokus die studie op die kontantvloei ontvang vanaf 'n *carried interest*. Die gevolgtrekking was dat hierdie kontantvloei 'n nouer verband het met kapitaalrisiko as met die voorsiening van dienste. Daarom is die ontvangste nie geklassifiseer as 'n bedrag ontvang ten opsigte van dienste gelewer nie.

Die aard van die onderliggende beleggings is ondersoek en die gevolgtrekking was dat die beleggings normaalweg gehou word met die primêre bedoeling vir herverkoop, en dus is dit inkomste van aard. Die oorheersende effek van artikel 9C van die Wet maak dit egter moontlik vir die onderliggende beleggings om as kapitaal van aard geag te word, indien daar aan sekere vereistes voldoen word.

Die *carried interest* regime van die VSA en Nederland is ondersoek en vergelyk met Suid-Afrika. Die gevolgtrekking was dat die gebrek aan spesifieke wetgewing in Suid-Afrika deeglike navorsing ten opsigte van wetgewing, wat 'n duidelike antwoord gee op die metode van belasting ten opsigte van 'n *carried interest*, vereis. Nuwe wetgewing moet egter nie 'n verlies aan buitelandse belegging veroorsaak nie.

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CHAPTER 1

Introduction

1.1. Background

Taxation is a government practice in terms of which it collects money from its citizens to pay for the administration and delivery of its public services (Haupt, 2015:1). The South African Income Tax Act 58 of 1962 (the Act) governs the tax regime in South Africa (Clegg & Stretch, 2015:1-3). The Act makes a definite distinction between receipts that are income in nature and receipts that are capital in nature (Stiglingh, Koekemoer, Van Zyl, Wilcocks, De Swardt, 2015:29). This distinction is important as each of these receipts is treated differently for South African normal tax purposes. Income receipts for individuals are subject to tax up to a maximum rate of 41% and capital receipts are subject to a maximum effective tax rate of 13.65% (SARS, 2015:8). This difference in the normal tax treatment of receipts encourages taxpayers to have receipts classified as being capital in nature, as capital items attract the lower tax. The term “capital” is not defined in the Act and as a result has always been interpreted widely (Swanepoel, 2012). Effectively, the interpretation of this term has been left to the courts (Swanepoel, 2012).

One type of receipt which still needs to be classified as being either income or capital for South African normal tax purposes is a so-called “carried interest” distributed by certain investment funds to their fund managers. Braeken (2012:8) defines the term “carried interest” as the right held by a fund manager to share in the future profits generated by the fund that it manages. Carried interest is a well-known term in the United States of America (USA). Currently a carried interest is taxed in the USA at the capital gain rate of 20% (PWC, 2014:54). However, the nature of a carried interest for tax purposes has been the subject of debate in the USA for a number of years (Rosenzweig, 2009:714; Fleischer, 2008:2; Carman, 2009:111; Cunningham & Engler, 2008:1). The need for reform has also been mentioned in political campaigns as politicians are of the opinion that the fiscus is losing money by taxing a carried interest as a capital gain instead of an income gain. Accordingly, reform proposals for the amendment of tax legislation regarding this issue have been presented to the House of Representatives (Cunningham & Engler, 2008:4). Financial market experts have also expressed their dissatisfaction with the current tax treatment of a carried interest. The American business magnate, Warren Buffet (2011), stated in his article *Stop Coddling the Super-Rich*:

...while most Americans struggle to make ends meet, we mega-rich continue to get out extraordinary tax breaks. Some of us are investment managers who earn billions from our daily labors but are allowed to classify our income as 'carried interest', thereby getting a bargain 20% tax rate.

This view was supported by investment banker and lead advisor to the Obama administration, Steven Rattner (2012), in his article *More chips for tax reform*:

As a beneficiary of the carried interest loophole, I've seen firsthand the lack of any difference between the work involved in generating a 'carried interest' and the work done by millions of other professionals who are taxed at the full 35 percent rate.

Notwithstanding the favourable tax treatment of a carried interest in the USA, other countries like the Netherlands have taken the opposite stance. Legislation in the Netherlands was amended as recently as 2009 so that a carried interest is taxed as income up to maximum marginal rate of 52%. Previously a carried interest was only charged an effective tax of 1.2% on the average value of a carried interest at the beginning of the year (Braeken, 2012:8-9).

Having found that a carried interest is treated differently under the tax legislation of different countries, it is necessary to investigate its normal tax treatment in South Africa.

1.2. Research problem

The term "carried interest" is not defined in the Act, nor has it been under scrutiny in South African case law. Consequently, there is uncertainty regarding the classification of the initial receipt of a carried interest for normal tax purposes in South Africa.

A number of factors need to be taken into account in considering the classification of a carried interest for normal tax purposes. Firstly, it could be argued that there might be an employment relationship between the fund manager and the investment fund. This is due to the fact that the fund manager renders management services to the fund. Thus, the receipt could be classified as a fringe benefit.

On the other hand it might be argued that the fund manager invests its own capital into the fund. Thus the receipt may be seen as a return of the fund manager's investment which

could be taxed as a capital gain. A combination of the two points of view is possible, but the weighting of labour (services rendered) and capital elements seems complicated and not easy to prove (Braeken, 2012:19).

Secondly, uncertainty exists regarding the normal tax treatment of the cash flow from a carried interest once an investment fund is liquidated. Similar to the initial receipt of a carried interest, cash flow from a carried interest could be seen as a receipt of an amount in respect of services rendered or a return on capital invested.

Thirdly, the uncertainty regarding the normal tax treatment of the cash flow from a carried interest might be exacerbated by the varying nature of the underlying investments of the investment fund. If the investments are held on revenue account the receipts might retain its revenue nature when distributed. Consequently the receipts should be taxed as income. However, if the investments are held on a capital account, the distributions will be capital in nature. In order to determine how these investments are held for normal tax purposes the implications section 9C of the Act and the guidelines formulated by the South African courts might provide insight into the matter, specifically when investment funds invest in shares. Section 9C states that the proceeds on the sale of shares become capital in nature after a period of three years. This is not the case with shares held for a period shorter than three years.

It is therefore submitted that uncertainty exists as to the classification of a carried interest, whether it be the initial receipt thereof or cash flow from a carried interest, as either income or capital for normal tax purposes in South Africa. This might indicate the need for specific legislation regarding the taxation of a carried interest in South Africa.

1.3. Research questions

To address the above mentioned uncertainty the following primary research question has been identified:

- What is the nature of a carried interest for normal tax purposes when initially distributed to the fund manager of an investment fund?

In attempting to answer the primary research question, the following secondary research questions are posed:

- Does a carried interest initially distributed by an investment fund to a fund manager constitute a fringe benefit?
- If not a fringe benefit, does a carried interest distributed by an investment fund to a fund manager constitute gross income in terms of other provisions of the Act?
- What is the nature of the cash flow from a carried interest, for normal tax purposes, earned by the investment fund upon the liquidation of the fund?
- What is the effect of section 9C of the Act on the underlying investments of, and consequently on a carried interest in, an investment fund?
- What is the effect of the guidelines formulated by the South African courts on the underlying investments of, and consequently on a carried interest in, an investment fund?

1.4. Research methodology

The research method that will be followed in this study will be the historical method. This will entail a literature review of pure theoretical aspects of published theoretical and descriptive material.

The study will entail an analysis of the wording of the South African Income Tax Act 58 of 1962 with specific reference to the gross income definition and the phrase “amount received in respect of services rendered”. Furthermore, it will be investigated whether there is an employment relationship between the fund manager and the investment fund. Case law relating to the interpretation of the phrase “of a capital nature” with reference to the gross income definition and case law relating to the phrase “amount in respect of services rendered” will be examined. The current view of the taxation of a carried interest in practice will be obtained through interviews with taxation partners at audit firms and law firms and academics in the taxation field.

Foreign legislation regarding a carried interest and published foreign articles will be used to investigate the normal tax treatment of carried interest in foreign countries and to compare it to the current practice in South Africa.

1.5. Aims and objectives of the research

The primary objective of the study is as follows:

- To determine the nature of a carried interest for normal tax purposes when distributed to the fund manager of an investment fund.

A number of secondary objectives will provide context and assist in reaching the primary objective. The secondary objectives are:

- to determine whether the initial distribution of a carried interest by an investment fund to a fund manager constitutes a fringe benefit
- to determine whether a carried interest distributed by an investment fund to a fund manager constitutes gross income in terms of other provisions of the Act
- to determine the nature of the cash flow from a carried interest, for normal tax purposes, earned by the investment fund upon the liquidation of the fund
- to determine the effect of section 9C of the Act on the underlying investments of, and consequently on a carried interest in, an investment fund
- to determine the effect of the guidelines formulated by the South African courts on the underlying investments of, and consequently on a carried interest in, an investment fund

1.6. Significance of the research

The limited number of South African publications as well as limited case law that relate to a carried interest indicates that a carried interest is a rather unknown concept in the South African tax context. The research will shed light on the nature of a carried interest and how it might be classified for normal tax purposes.

The outcome of this research might provide guidance to the private equity industry, tax practitioners and academics on how a carried interest should be taxed in South Africa. It might suggest new legislation that needs to be implemented to ensure the consistent normal tax treatment of carried interest.

1.7. Framework of the research

The research will be presented according to the following chapters:

Chapter 1: Introduction

The current debate regarding the normal tax implications of a carried interest will be described in this chapter. Furthermore, the research problem, research questions, research methodology, research objectives as well as the significance of the research will be discussed.

Chapter 2: Fund structures and carried interest design

The objective of this chapter is to provide context to the study. The chapter will focus on explaining the structure of private equity and venture capital funds as well as how a carried interest and cash flow from a carried interest is derived. Due to the technical nature of the terms used within the private equity industry, a description of how private equity and venture capital funds operate will be presented. Furthermore, important concepts used throughout the study will be explained, including the typical terms found in an investment fund agreement between the various partners involved. The definition of these terms is important as they might aid in determining the tax consequences of the cash flow from a carried interest derived from the investment.

Chapter 3: Taxation of carried interest in South Africa

A brief background of the South African tax system will be provided. Then, the gross income definition, the phrase “in respect of services rendered” and certain other terms and phrases will be examined. Case law that relate to these terms and phrases will be investigated to provide guidance on their interpretation. The chapter will distinguish between the discussion of the receipt of a carried interest and the receipt of cash flow from a carried interest. To determine the capital or income nature of the underlying investments of the investment fund the requirements of section 9C of the Act will be investigated. This will be done together with an investigation into the guidelines formulated by South African courts on the income or capital nature of an item for normal tax purposes. Furthermore the current normal tax treatment of a

carried interest in practice will be discussed from information gathered through interviews with partners at audit and legal firms. The objective is to ascertain the normal tax implications of a carried interest according to South African income tax law.

Chapter 4: Taxation of a carried interest in the United States of America

Due to the extent of its private equity exposure and influence, a discussion of the normal tax implications of a carried interest in the USA provides a good basis to examine the issue. Discussions with South African attorneys and auditors have indicated that the South African private equity industry tends to follow the USA interpretation due to the favourable tax consequences of such treatment.

A brief explanation of the USA tax regime will be provided, followed by the current carried interest tax regime in the USA. The proposals that have been issued to the House of Representatives in the USA will also be examined. The objective is to determine how the USA views the classification of a carried interest for normal tax purposes.

Chapter 5: Taxation of a carried interest in the Netherlands

The Netherlands adopted the opposite stance on the normal tax treatment of a carried interest with the USA. This facilitates an interesting comparison between the USA and the Netherlands. A brief explanation of the Netherlands tax regime will be provided, followed by the old and new current carried interest tax regimes.

Chapter 6: Comparison and conclusion

In this chapter the results of the preceding chapters will be summarised. Subsequently a conclusion is made and the need for legislation to provide an answer to the research questions posed will be discussed.

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CHAPTER 2

Fund structures and carried interest design

2.1. Introduction

The objective of this chapter is to provide context and background to the study. Firstly this will be done by investigating and discussing the following concepts:

- investment
- investment fund
- investment fund structures
- types of investment funds

Secondly the typical fund organisation used by investment funds and the incentives received by the fund manager will be explained. Thirdly it will be shown how a carried interest is derived, illustrated by means of an example. It is important that these concepts are clearly understood before the tax implications of a carried interest can be determined.

2.2. Definition of concepts

2.2.1. Investment

Investment is a technique where a person, called an investor, provides capital (usually in the form of money) to purchase assets that will ensure financial security to the investor in the future. This financial security will be ensured through a constant flow of income from the assets invested in (Webster, 1983). Numerous types of investments are available to investors. These investments include investments in, amongst others, shares, bonds and real estate. Generally, investors seek investment methods that provide a high return with the least amount of risk. In order to reduce the risk, investors have started to combine their capital through the use of investment funds (Naidech, 2011).

2.2.2. Investment fund

An investment fund is a structure in terms of which a number of investors pool their resources together to gain the advantage of mitigating the risk of investing (Braeken, 2012:11). Risks are mitigated by investing the pooled resources of the investors in a more

diversified portfolio of investments (Braeken, 2012:11). This would not be possible if the investors invested in securities directly and for their own account. Thus, the investors can make use of each other's expertise and knowledge, and the fund obtains greater economies of scale (e.g. lower transaction costs) (Braeken, 2012:11). It is generally accepted that the use of investment funds assists the private sector by providing funding and expertise (SARS, 2008:67). It is therefore viewed as a useful method to grow a country's economy. When income is earned from such investments, questions arise around how this investment income will be taxed as well as who will be taxed.

2.2.3. Investment fund structures

In order to shift the tax burden from the fund to the investors, the fund is usually a tax transparent vehicle (Fleischer, 2008: 5). A tax transparent vehicle refers to an entity that is tax neutral. In other words, the entity is not liable for taxation, but serves as a conduit in order to distribute the receipts of the fund to its members. The potential liability for taxation then lies with the members. The most common tax transparent vehicle used worldwide is a partnership, but in South Africa tax transparent vehicles can also take the form of trusts (Darsot & Lok 2012:310). A third investment fund structure, even though it is not a tax transparent vehicle, is a private company. The popularity of a private company is due to it being a separate juristic person. These different investment fund structures will be discussed next.

2.2.3.1 Partnership

According to Clegg & Stretch (2015:16-6), a partnership is not a separate legal entity and allows for two or more persons, known as partners, to enter into an agreement to conduct business together. Each partner makes a contribution to the partnership in the form of money, assets, services, expertise, or a combination of the aforementioned. The partnership agreement stipulates how profits and losses will be shared. The partnership is not a taxable entity for South African income tax purposes as a partnership is not included in the definition of "person" (Republic of South Africa, 1962). Accordingly, the partnership profits and losses flow through to the partner according to the terms of the partnership agreement.

Different types of partnerships exist. Investment funds usually make use of limited partnerships. A limited partnership normally consists of a general partner and a number of

limited partners. The general partners carry the risk, because in the case of financial loss, the general partner will be liable (Persaud & Atkinson, 2012). In South Africa investment funds typically take the form of an *en commandite* partnership (Field, 2008:26-27).

According to Darsot & Lok (2012:310) an *en commandite* partnership consists of two classes of partners: disclosed partners and undisclosed partners or commanditarian partners. The names of the latter partners are not to be disclosed to third parties and hence the partnership is carried on in the name of the disclosed partner. The commanditarian partners contribute a fixed sum of money and will be liable only to the extent of the fixed sum contributed to the partnership. The disclosed partner is fully liable to third parties for the debts of the partnership.

The second type of investment vehicle is a trust.

2.2.3.2 Trust

Stiglingh et al. (2015:874) define a trust as a legal relationship that can be created during the founder's life or at his death by the transfer of assets to a party to be administered for the benefit of a third party (known as the beneficiary) or for a specific objective. Generally two types of trusts are recognized in South African law, namely an ownership trust and a bewind trust. In an ownership trust the founder transfers the rights of assets to the trustee(s) (person who is responsible for the administration of the trust) to be held for the benefit of the beneficiaries. In a bewind trust the rights of the assets are transferred to the beneficiaries, but the control over the property is given to the trustee(s) (Darsot & Lok, 2012:311).

The third type of investment vehicle, the private company, is discussed next.

2.2.3.3 Private company

A private company is an entity of which the shares are not publicly traded. The shares are usually held by a small number of shareholders. A private company is a juristic person and is separate from its shareholders (SAICA, 2009). Holding investments through the use of a private company is not the most popular method, because it is not a tax transparent vehicle (Darsot & Lok, 2012:311). Private companies are taxed as a separate taxpayer (De Koker & Williams, 2015:13-3). Also, distributions by the private company to shareholders are

usually subject to further taxation in the form of dividends tax. However, the use of private companies normally limits the risk of the shareholders, because creditors are unable to hold the shareholders liable for losses suffered (SAICA, 2009).

Having discussed the different types of fund structures or investment vehicles, it is now important to investigate the different types of investment funds.

2.2.4. Types of investment funds

Numerous types of investment funds exist, amongst others, private equity funds, venture capital funds, hedge funds, mutual funds and real estate investment trusts (Getmanenko, 2011:1). The underlying characteristics of these investment funds are relatively similar, but each fund has a distinct difference when it comes to its method of investing. Each type of fund is briefly explained in the following section.

2.2.4.1 Private equity funds

Private equity funds seek to raise capital to invest in the private sector, i.e. in companies that are not listed on public stock exchanges (KPMG & SAVCA, 2014:15). Private equity funds invest in established companies, usually using cash, and seek to improve the acquired business in order to increase the resale value of the company (Knoll, 2008:121). The improvements take the form of a more efficient capital structure, a more efficient management team, an improved compensation structure, operating synergies, or a combination of the aforementioned (Rosenzweig, 2009:717).

2.2.4.2 Venture capital funds

According to Knoll (2008:121), venture capital funds invest in start-up businesses. The venture capitalist looks to exploit a new product or idea during its development phase and therefore invests early in high earning potential companies. Consequently, venture capital investment funds often invest in technology companies. The investments are small, but bear more risk. The venture capital funds normally invest in a larger number of companies than a private equity fund would (Knoll, 2008:121).

2.2.4.3 Hedge funds

Hedge funds invest in short-term liquid assets (e.g. shares, commodities, currencies, etc.) and make use of sophisticated investment techniques to obtain under-valued securities and to sell it at a profit (Braeken, 2012:14). Hedge funds usually make use of derivatives to perform the short term trading (What is a hedge fund, 2015). A derivative is a financial contract with a value that is derived from an underlying asset. Derivatives have no direct value, but the value is based on the expected future price movements of their underlying asset (Rosenzweig, 2009:717).

2.2.4.4 Mutual funds

According to Braeken (2012:14), mutual funds are passive investors that invest in regulated securities like listed shares, bonds, commodities and money market instruments. These investments are usually over a longer term.

2.2.4.5 Real estate investment trusts

Real estate investment trusts (REITs) are passive investors in income-producing real estate and relies on the long term capital appreciation of its investments (Braeken, 2012:14).

Having briefly discussed the different types of funds, the study will focus on the use of private equity (PE) and venture capital (VC) funds. The reason for this is that the current debate regarding the taxation of a carried interest is most relevant within these two investment vehicles. Henceforth these two funds will collectively be referred to as investment funds.

2.3. Typical fund organisation and incentives used by investment funds

2.3.1. Typical fund organisation

The exact structure of investment funds might vary. A typical private equity and venture capital structure, from which a carried interest originates, is explained in Figure 2.1.

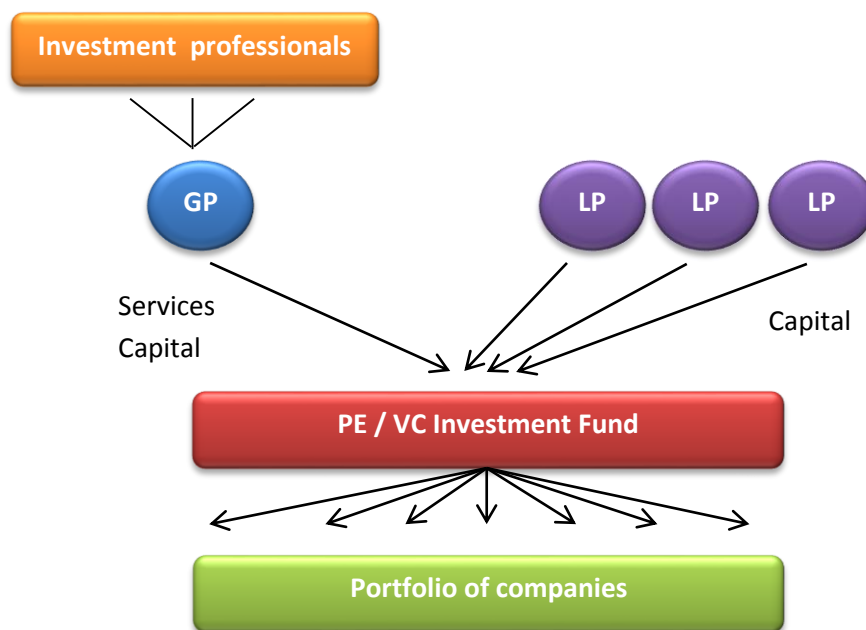


Figure 2.1: Fund structure

Source: Adapted by author from Fleischer, 2008: 6

The investment fund generally takes the legal form of a partnership with a number of limited partners (LP), hereafter referred to as external investors and one general partner (GP), and hereafter referred to as the fund manager.

Common external investors include pension funds, insurance companies, charitable foundations with ample funding, banks, and (to a lesser extent) wealthy individuals (Knoll, 2008:122). The external investors are not involved in the management of the fund, but commit to provide the capital with which the fund will make investments (Braeken, 2012:12). The external investors do not provide all of the capital at once, but commit to invest a certain amount over a period of five to six years. This period is called the investment period (Knoll, 2008: 122). The fund manager will call upon these commitments to make the investment in portfolio companies over the investment period (Knoll, 2008:122). The external investors are liable only to the extent of their capital contributed to the fund (Knoll, 2008:123).

According to The Tax Policy (2012), the fund manager is also required to provide capital, but generally to a lesser extent than the external investors. The fund manager's investment is typically between 1% and 5% of the required capital of the fund. The fund manager commits to managing the fund, which entails performing research on suitable investments and assisting in ensuring that the newly acquired investments provide the best possible returns (Braeken, 2012:13). The fund manager might be a separate partnership with a

number of partners (Fleischer, 2008:6). The partners to this partnership are individuals with the necessary investment and management expertise to identify, acquire and improve the investments of the fund (Cunningham & Engler, 2008:6). Accordingly, investment is done by the fund, using mainly the capital of the external investors, but through the expertise of the fund manager. The external investors and fund manager are collectively the investors in the fund.

Once their funds are invested the investors have little or no liquidity with respect to their investment (Knoll, 2008:122). The investors typically have no right to sell, transfer or redeem their interests (Knoll, 2008:122). Instead, after a certain period of time (usually between two and seven years), the fund liquidates its investment by either selling the investment in the companies and distributing the proceeds to the investors, or by listing the companies and distributing listed shares in the companies to the investors (Braeken, 2012:13). Therefore, private equity and venture capital investments are long term and generally made with the intention of capital appreciation (Knoll, 2008:123).

The typical life span of a private equity and venture capital investment fund is illustrated in Figure 2.2.

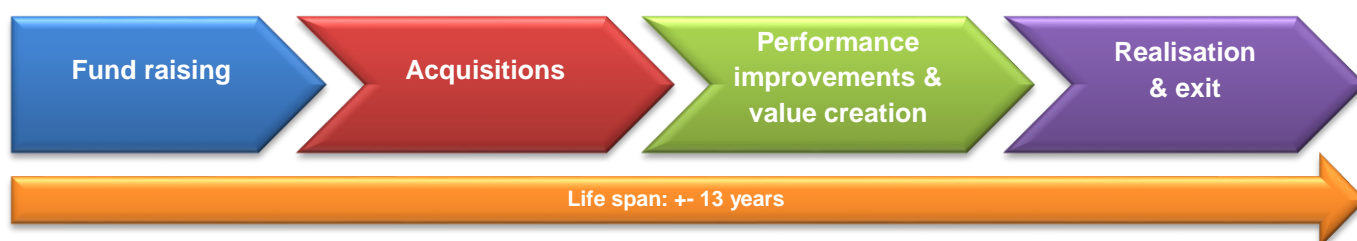


Figure 2.2: Investment fund life cycle

Source: Author - with information gathered from Field, 2008:26 and Grene, 2015

2.3.2. Incentives received by the fund manager

The distribution of proceeds and the allocation of costs are governed by the partnership agreement between the external investors and the fund manager (Braeken, 2012:12). Generally the partnership agreement makes provision for two types of incentives for the fund manager (Knoll, 2008:123), namely an annual management fee and a carried interest. Both of these concepts will be discussed next.

2.3.2.1 Annual management fee

The annual management fee is paid to reimburse the fund manager for costs related to managing the fund, e.g. employee remuneration and other daily expenses (Rosenzweig, 2009:718). The fee is often a fixed percentage of the total capital under management (usually 1% - 2%) (Knoll, 2008:123). The annual management fee is seen as compensation for the services rendered by the fund manager and is therefore classified as income for normal tax purposes (Cunningham & Engler, 2008:6).

2.3.2.2 A carried interest

A carried interest is a right granted to the fund manager to share in future profits generated by the fund (Rosenzweig, 2009:718). Typically the fund manager will be entitled to 20% of the net profits (Fleischer, 2008:5). This is subject to the terms of the partnership agreement and may vary (Knoll, 2008:123). The carried interest received by the fund manager is subject to the conduit pipe principle with regards to the taxation of the partnership. This allows for the proceeds distributed to the investors to retain their nature. Thus, if the proceeds from the realisation of the investment by the fund is capital in nature the partners will receive a capital gain or loss (De Koker & Williams, 2015:11-10).

Having discussed the two types of incentives received by the fund manager, it is necessary to investigate how a carried interest is derived.

2.4. Carried interest design

A carried interest is an incentive to align the interests of the fund manager with those of the external investors (About private equity, 2015). As mentioned previously, the external investors are not engaged in the day to day management of the fund and take the role of passive investors. Consequently, the external investors do not have authority in determining how the fund's capital is invested, or how investments are managed (Braeken, 2012:14). The management fee is an annual fee that covers general expenses of the fund and does not necessarily motivate the fund manager to obtain better returns.

In order to ensure the alignment of the interests of the fund manager and external investors, the typical carried interest arrangement contains performance-based elements (Braeken,

2012:14). These performance-based elements serve to motivate the fund manager to obtain higher returns in managing the fund. The main performance-based elements are addressed in more detail next.

2.4.1. Hurdle rate

According to Braeken (2012:15) the hurdle rate is a benchmark profit set by the partnership agreement that must be reached by the fund before the fund manager may receive a carried interest. In other words the external investors must first receive their capital and an agreed-upon return before the fund manager may start sharing in the profits. This warrants the external investors a certain return on their investment. The hurdle rate is usually around 10% in South Africa (Darsot & Lok, 2012:310).

2.4.2. Catch-up clause

After the hurdle rate has been achieved, the fund manager is allocated all excess profits until the carried interest percentage is reached (Braeken 2012:16). In other words the fund manager “catches up” with the external investors in terms of profits earned from the investment. This is also known as the waterfall-pay-out-scheme, which is illustrated in Figure 2.3.

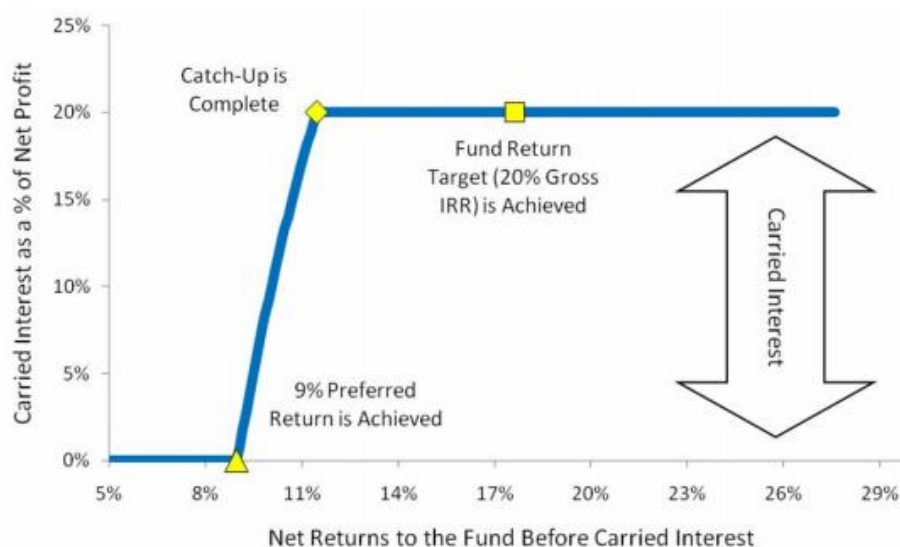


Figure 2.3: Waterfall-pay-out-scheme

Source: Rosenberg, 2009

2.4.3. Claw-back provision

The fund will make a number of investments in different companies over the life time of the fund (Rosenzweig, 2009:718). As the profits are realised (through the sale or listing of investments) the proceeds are distributed to the partners. However, a profitable sale in the short term does not guarantee profitability for the fund in the long term or upon liquidation thereof (Braeken, 2012:16). Therefore the fund manager will be subject to a claw-back provision. Should the fund not be profitable in the long term, this provision obligates the fund manager to repay the fund any excess profits it might have received in earlier years (Rosenzweig, 2009:719).

2.4.4. High watermark provision

According to Braeken (2012:17), the fund manager is only allowed to share in the profits once the cumulative losses incurred by the fund are zero. In other words if the fund has made losses in earlier sales transactions and suddenly makes a profit on a sale, the fund manager will only be allowed to receive cash flow from the carried interest if the profit exceeds the previous losses made. Similar to the claw-back provision this reduces the incentive of the fund manager to partake in transactions with excessive risk. The key difference between the claw-back provision and the high watermark provision is that the former ensures that early payments are repayable if the fund under-performs and the latter ensures that early losses are erased before participation in profits are allowed.

To illustrate how a carried interest and cash flow from a carried interest is derived, and the potentially high returns to be obtained by fund managers, an example is presented next.

2.5. Example (Source: Adapted by author from Rosenzweig, 2009:719-720)

Assume a simplified private equity fund with one fund manager and one external investor. The fund manager contributes R 1 000 000 to the fund and the external investor contributes R 99 000 000. The fund invests the capital by purchasing all the shares of a company, worth R 100 000 000. The fund manager will manage the investment for an annual fee of 2%. The partnership agreement further provides that all proceeds from the investment will first be paid to the external investor until it has received its R 99 000 000 invested and then to the fund manager until it has received its R 1 000 000 invested, after which the remaining profits

are distributed 80% to the external investor and 20% to the fund manager. Assume the partnership earns just enough ordinary income to pay the 2% management fee and no hurdle rate is applicable.

Assume that in years one to four the fund manager receives R 2 000 000 per year as a management fee, which is classified as income. Assume further that in year five the investment of the fund increases in value from R 100 000 000 to R 150 000 000 and the fund sells this investment for cash. Firstly the external investor receives R 99 000 000 (the amount invested), and then the fund manager receives R1 000 000 (the amount invested). The fund manager also receives his management fee for year five of R 2 000 000 (paid out of other normal income of the fund). Next the fund manager receives R 10 000 000 and the external investor receives R 40 000 000, being 20% and 80% of the profit on the investment respectively. The total profit on the investment was R 50 000 000 over the investment period – 20% of which amounts to R 10 000 000 and which is distributed to the fund manager. The external investor receives a return of 40% on its initial capital investment. The fund manager, on the other hand, earned a return of 1 000% on its investment.

This example served to illustrate both how the profit of the investment fund is distributed to the fund manager, as well as the potentially high returns to be obtained from such investments made through an investment fund.

2.6. Summary and conclusion

This chapter provided context to the research by explaining key concepts, including the typical terms found in an investment agreement. The typical fund structures used by investment funds were discussed and it was explained exactly how a carried interest and cash flow from a carried interest is earned. This was illustrated by means of an example.

It was indicated that investment funds provide funding and expertise to growing companies within the private sector. It is therefore viewed as a useful method to grow a country's economy.

It was pointed out that the parties involved in an investment fund structure understand the risk involved in investing in private companies and for that reason the compensation is

structured to reflect this risk. The carried interest is therefore viewed as an effective method to align the interests of the external investors with those of the fund manager.

However, the method of investing and the realisation of profits have led to the classification of a carried interest to be uncertain for South African normal tax purposes. The reason for the uncertainty can be ascribed to the nature of a carried interest once it is realised and whether it will retain its nature once paid to the fund manager. Also, the fund manager's services could be argued to be closely linked to earning the carried interest.

It appears that a carried interest might have a hybrid character because it contains an element of capital and income. The weighting of these elements seem complicated. Furthermore the timing of the receipt is difficult to ascertain due to the possible risk of having to repay the amounts received from the carried interest in later years.

Having discussed typical fund structures, fund types and how a carried interest is derived, it is necessary to consider the nature of a carried interest for normal tax purposes in South Africa in the absence of specific legislation pertaining to a carried interest. This will be done in Chapter 3.

CHAPTER 3

The taxation of carried interest in South Africa

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CHAPTER 3

The taxation of a carried interest in South Africa

3.1. Introduction

The previous chapter explained the structure of a typical investment fund and how a carried interest and cash flow from a carried interest is derived. As discussed in Chapter 2, a carried interest contains an element of both capital and income. The objective of this chapter is to examine the nature of a carried interest for normal tax purposes in South Africa in the absence of specific legislation pertaining to a carried interest.

The chapter will focus on certain provisions of The South African Income Tax Act 58 of 1962 (the Act) and their potential application to carried interest. South African case law will also be examined where necessary. This will be done in order to identify relevant principles that might assist in determining the nature of the cash flow from a carried interest for normal tax purposes. It will be determined if there is a need for specific legislation regarding a carried interest.

3.2 Context and background

A lack of specific legislation in the South African tax policy causes uncertainty on how the receipt of a carried interest and the cash flow from a carried interest should be classified for normal tax purposes.

The South African government is aware of the importance of the private equity and venture capital industries, and supports the idea that these industries help grow an economy. The South African government acknowledges that this growth will only be reached by injecting capital and expertise into small and medium sized companies. These facts are highlighted in the SARS Explanatory Memorandum (2008:67-68):

As announced in the 2008 Budget Review, access to equity finance by small and medium-sized businesses... is one of the main challenges to the growth...of the economy. Setting aside tax consequences, equity financing offers some key advantages for small businesses. Equity financing allows for small businesses to better weather economic downturns. Equity financing also allows small businesses

to use cash surpluses for reinvestment rather than being forced to use that cash for debt servicing. It has been said that equity is patient capital.

The venture capital company is intended to be a marketing vehicle that will attract retail investors. It has the benefit of bringing together small investors as well as concentrating investment expertise in favour of the small business sector.

However, there are no specific provisions in the Act regarding the normal tax implications of a carried interest.

Currently South African investment funds follow the USA interpretation of how a carried interest should be taxed (Van Tubbergh, 2015). The USA interpretation provides for the favourable treatment of taxing it as capital income (Fleischer, 2008:11). However, Field (2008:28) emphasises the need for specific legislation and recommends that a carried interest be treated like an employee share scheme and thus be classified as income.

These different views clearly show the uncertainty that exists on how the receipt of a carried interest should be classified for normal tax purposes. In order to address this issue the following will be investigated in this chapter:

- whether the initial distribution of a carried interest by an investment fund to a fund manager constitute a fringe benefit
- whether a carried interest distributed by an investment fund to a fund manager constitutes gross income in terms of other provisions of the Act
- the nature of the cash flow from a carried interest, for normal tax purposes, earned by the investment fund upon the liquidation of the fund
- the effect of section 9C of the Act on the underlying investments of, and consequently on a carried interest in, an investment fund
- the effect of the guidelines formulated by the South African courts on the underlying investments of, and consequently on a carried interest in, an investment funds

In order to address the uncertainty of the taxation of a carried interest, a brief background of the current South African normal tax regime is necessary. This will be presented next.

3.3 The structure and operation of tax legislation in South Africa

3.3.1 Background to the South African tax regime

The South African tax regime is set by the National Treasury, which is one of the departments of the South African government (Haupt, 2015:2). The tax regime set by the National Treasury is managed by the South African Revenue Service (SARS). SARS was established in 1997 with the objective of efficient and effective collection of revenue in terms of the South Africa Revenue Act 34 of 1997 (Haupt, 2015:2).

The South African tax regime is codified in the Act. According to Clegg & Stretch (2015:1-4), the Act originated from the Income Tax Act No 28 of 1914 (the Old Act), which was adapted from the Australian New South Wales Act of 1895. The Old Act was the first income tax legislation to be introduced in South Africa and has had a number of amendments and consolidations since its introduction (Haupt, 2015:5)

Today the Act consists of 112 sections and 10 appendices and provides for five different forms of taxation, namely normal taxation, turnover taxation on micro businesses, donations taxation, dividend taxation, and withholding taxation (Haupt, 2015:5).

3.3.2 The South African tax regime

In South Africa, normal tax is levied on a taxpayer's taxable income. Taxable income is derived by the inclusion of certain receipts and accruals and the deduction of qualifying expenditure (De Koker & William, 2015:1-9).

South Africa has a progressive income tax system for the taxation of taxable income (Stiglingh et al., 2015:352). This entails that people who earn a higher taxable income are taxed at a higher rate than those who earn a lower taxable income. The progressive tax table is divided into six tax brackets that range from 18% to 41%. The maximum bracket is applicable to taxpayers that have taxable income that is higher than R 701 300 (SARS, 2015:8).

The following framework is used to calculate a person's taxable income:

Gross income (Section 1)
Less: Exempt Income (Sections 10 and 10A)
Income (Section 1)
Less: Deductions and allowances (Sections 11-19, Sections 21-24N, excluding Sections 18 and 18A)
Less: Assessed loss (Sections 20-20B)
Plus: Taxable capital gain (Section 26A)
Plus: Taxable allowances
Less: Deductions (Section 18 and 18A)
Taxable Income (Section 1)

Figure 3.1: Taxable income framework

Source: Stiglingh et al., 2015:15

The Act defines the term “person” as a natural person, legal entity, insolvent estate, deceased estate, trust or portfolio in a collective investment scheme. A partnership is excluded from the definition of a person and the individual partners are liable for normal tax on their respective share of the taxable income earned by a partnership (De Koker & Williams, 2015:11-10). The following subdivisions will discuss relevant sections of the Act in order to be able to assess the normal tax implications of a carried interest.

3.3.3 Gross income versus capital gain

In order to determine taxable income according to the framework in Figure 3.1, gross income must be determined first.

Gross income

The term “gross income” is defined in section 1 of the Act as follows:

...in the case of any resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such resident; or in the case of any person other than a resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such person from a source within the Republic, during such year or period of assessment, excluding receipts or accruals of a capital nature...

It is evident that capital amounts are excluded from the gross income definition. However, certain specific receipts or accruals, even though they might be capital in nature, are included in terms of paragraphs (a) to (n) to the definition in section 1 of the Act (De Koker & Williams, 2015:4-4).

Capital gain

Receipts and accruals of a capital nature that are not specifically included in gross income in terms of paragraphs (a) to (n) will thus be excluded from gross income. Such capital income items may, however, be subject to the so-called “capital gains taxation” (CGT). South Africa does not have a separate CGT system (Clegg & Stretch, 2015:5A-3). Instead taxable capital gains are included in the taxpayer’s taxable income and therefore subject to normal tax (see line 6 of Figure 3.1). The inclusion of the taxable capital gains is subject to a calculation governed by the Eighth Schedule of the Act (De Koker & Williams, 2015:24-9).

In its simplest form a taxable capital gain or capital loss is calculated by subtracting the original purchase price (known as the base cost) from the proceeds received upon the disposal of the capital item. If the calculation results in a loss this amount is carried forward to be set off against future capital gains, but if the amount is a capital gain it is included in the taxable income framework at a rate of 33.3% for a natural person or special trust, or 66.6% for a company or other trust (Stiglingh et al., 2015:911).

The classification of a receipt or accrual as being of a capital nature will result in a lower taxable income, since the maximum effective tax rate for individuals will be 13.65% ($41\% \times 33.3\%$) instead of 41% normal tax charged on ordinary taxable income items. Consequently, a taxpayer will prefer to have an item of income classified as capital as it is taxed more favourably.

As the Act does not provide a definition for the phrase “of a capital nature” reliance is placed on the interpretation given by South African courts (De Koker & Williams, 2015:3-3). However, the Act has been amended over time in order to provide some degree of certainty regarding the capital nature, or not, of certain specific receipts or accruals. One of these amendments is the insertion of section 9C, which deems the proceeds on the sale of shares held for a specific period of time to be of a capital nature (Haupt, 2015:57-58).

Before investigating the interpretation of the phrase “of a capital nature” by South African courts, and the implications of section 9C, attention is given to the term “income in respect of services rendered” in paragraph (c) of the definition of gross income in section 1 of the Act.

3.3.4 Income in respect of services rendered

Paragraph (c) of the definition in section 1 of the Act states that the following must be included in gross income:

any amount, including any voluntary award, received or accrued in respect of services rendered or to be rendered or any amount received or accrued in respect of any employment or the holding of any office...

Certain elements of the paragraph are discussed in more detail below.

The term “amount” is discussed in a number of court cases and it can be deduced that the term must be widely interpreted and does not only include money, but any form of goods, whether corporeal or incorporeal, which has a monetary value (Haupt, 2015:19).

The term “services” is not defined in the Act. This supports the view that the word should be interpreted widely (De Koker & Williams, 2015:4-177). The Oxford Dictionary of Current English (1984:683) defines services as doing of work for another. It is comprised of assistance or a benefit given to someone else. The term “service” has not been defined in South African tax case law, but certain labour law court cases have supported the use of the dictionary definition of “services” in order to ascertain the meaning of the word (*National Union of Metalworkers of SA v Staman Automatic CC* (2003) 24 ILJ 2162 (LC)).

In *Commissioner of Inland Revenue v Crown Mines Ltd*³² SATC 190 (Crown Mines) the phrase “in respect of” was scrutinised. The court held that a payment is made in respect of services if there is a causal link between the services and the payment (Haupt, 2015:67). In *Commissioner for the South African Revenue Service v Kotze*⁵⁴ SATC 149 (Kotze), the court also considered the phrase “in respect of” and held that the payment must be “due to” or “because of” the services. A direct link between the services and the payment is not a

requirement but it is suggested that the payment must have a motive of a reward for services rendered.

The phrase “rendered or to be rendered” indicates that the year of the services and the year of the payments do not have to coincide. The payment is taxed in the year that the amount accrues to the taxpayer and not in the year that the services are provided (Stiglingh et al., 2015:51).

These concepts are relevant to the discussion of the structure and operation of tax legislation in South Africa which will next be applied to the incentives received by fund managers.

3.4 Application of tax legislation in South Africa to the incentives received by fund managers

The fund manager is incentivised in two forms, namely an annual management fee and a carried interest. Both of these concepts have been discussed in Chapter 2.

Annual management fee

The annual management fee is paid in order to reimburse the fund manager for costs related to managing the fund (Rosenzweig, 2009:718). It is accepted by Cunningham & Engler (2008:6), as well as Field (2008:28), that the management fee should be classified as gross income. By applying paragraph (c) of the gross income definition to management fee, it is submitted that this classification is correct by virtue of the following:

- The management fee meets the requirement of being an amount, because the management fee is received in cash.
- Braeken (2012:13) explains that the fund manager “assists” the newly acquired investments in order to achieve the best possible returns. The Oxford Dictionary of Current English (1984:683) defines services as “assistance or a benefit given to someone else”. This assistance thus meets the definition of a service.
- According to Knoll (2008:123), the management fee is paid for the assistance and other general administration provided to the investment fund and for this reason the payment of the management fee has a causal link to the managing of the fund.

A carried interest

A carried interest, on the other hand, cannot be as easily classified (Rosenzweig, 2009:715). It can be argued that a carried interest is received for management services rendered, or for the reward for the risking of capital (Braeken, 2012:8). In order to assess the normal taxation of a carried interest it will be necessary to investigate the initial receipt of a carried interest and the cash flows from a carried interest.

Field (2008:28) states that the initial receipt of a carried interest should be regarded a fringe benefit of an employee from an employer. Furthermore, in order to assess the classification of the cash flows from a carried interest, the receipt must be applied to paragraph (c) of the gross income definition, section 9C of the Act, and to the guidelines set by South African courts. The initial receipt of a carried interest will be addressed first.

3.4.1 The nature of the initial receipt of a carried interest

3.4.1.1 Fringe benefit

Field (2008:28) states that the initial receipt of a carried interest should be regarded a fringe benefit received by an employee from an employer. Stiglingh et al. (2015:380) explains that a fringe benefit is a payment by an employer to an employee, usually in a form other than cash. A fringe benefit exists if a taxable benefit is present.

A taxable benefit is defined in the Seventh Schedule to the Act as follows:

... taxable benefit shall be deemed to have been granted by an employer to his employee in respect of the employee's employment with the employer, if as a benefit or advantage of or by virtue of such employment or as a reward for services rendered or to be rendered by the employee to the employer...

It is clear from the definition that an employer employee relationship must be present for a taxable benefit to be present (De Koker & Williams, 2015:4-29). Thus, it is necessary to investigate the definition of the terms "employer" and "employee".

3.4.1.2 Employer/employee relationship

The term “employee” is defined in the Fourth Schedule to the Act as follows:

... any person (other than a company) who receives any remuneration or to whom any remuneration accrues...

The term “employer” is defined in the Fourth Schedule to the Act as follows:

any person (excluding any person not acting as a principal, but including any person acting in a fiduciary capacity or in his capacity as a trustee in an insolvent estate, an executor or an administrator of a benefit fund, pension fund, pension preservation fund, provident fund, provident preservation fund, retirement annuity fund or any other fund) who pays or is liable to pay to any person any amount by way of remuneration, and any person responsible for the payment of any amount by way of remuneration to any person under the provisions of any law...

It is evident from the above definitions that an employee is someone who earns remuneration and an employer is the person who pays the remuneration.

3.4.1.3 Remuneration

The term “remuneration” is defined in the Fourth Schedule as:

any amount of income which is paid or is payable to any person by way of any salary, leave pay, wage, overtime pay, bonus, gratuity, commission, fee, emolument pension, superannuation allowance, retiring allowance or stipend, whether in cash or otherwise and whether or not in respect of services rendered...

The definition continues to list a number of specific inclusions in paragraphs (a) to (f) and four receipts that are specifically excluded from the definition. One of these exclusions is amounts paid to a resident person who is an independent contractor.

3.4.1.4 Independent contractor

Stiglingh et al. (2015:465-463) simplifies the classification of an independent contractor by stating that a person is deemed to be an independent contractor if throughout the year he employs three or more employees, other than any employee who is a connected person in relation to the independent contractor (three or more employees test). If the person does not fulfil this requirement then he will not be deemed an independent contractor if:

- the services are required to be performed mainly at the premises of the person by whom payment is made (mainly at the premises test); and
- the person rendering the services is subject to the control or supervision of any other person as to the manner in which the duties are performed (control or supervision test).

Apart from the tests set out above, the common law dominant impression test can be applied to determine the dependence or independence of a person (Stiglingh et al., 2015:463). According to Interpretation Note 17 issued by SARS, the common law dominant impression test is essentially an analytical tool that is designed for application in the employment environment to establish the dependence or independence of a person. In the discussion that follows, it will be determined whether the fund manager meets the definition of an independent contractor.

Chapter 2 explained that the fund manager is usually a separate partnership. For this reason none of the partners are regarded to be employees of the partnership. The “mainly at the premises test” and “control and supervision test” must therefore be investigated, because the fund manager does not employ three or more employees who are not connected persons.

The fund manager performs the management of the fund at its own premises (Van Tubbergh, 2015). No need exists for the fund manager to perform the duties of managing the fund at the premises of the investment fund.

The fund manager renders the management free of any control or supervision (Van Tubbergh, 2015). The external investors do not actively partake in the management of the fund and place faith in the skill and expertise of the fund manager (Braeken, 2012:12). There is thus no supervision by external investors or the investment fund.

It follows that by applying the tests to the characteristics of a fund manager it might be found that the fund manager performs his/her duties independently from the investment fund. Consequently, neither the yearly management fee nor the initial receipt of a carried interest falls within the definition of remuneration. Thus, the fund and the fund manager do not meet the definition of an employer and employee respectively. The absence of an employer-employee relationship results in the granting of a carried interest to the fund manager not to be regarded a fringe benefit. If not a fringe benefit, one has to consider whether it might be included in gross income in terms of other provisions of the Act.

3.4.1.5 Conclusion

It is submitted that a carried interest does not constitute gross income when initially received by the fund manager. This is as a result of the principle laid out in *Commissioner of Inland Revenue v Butcher Bros (Pty) Ltd* 13 SATC 21. In this case Judge Feetham states:

... the word "amount" ...must also mean an amount having an ascertainable money value ...

On the date that a carried interest is granted to the fund manager (date of initial receipt), the fund manager and the external investors have only committed themselves to provide capital to the fund. At this point, the profitability of the fund is still uncertain. This uncertainty is further aggravated by the hurdle rate and claw-back provision which permits the external investors to share in profits (if any) first. A carried interest only provides the fund manager with an entitlement to share in future profits of the investment fund. The carried interest's value is thus unquantifiable. This is because the market value of the carried interest cannot be determined at the date of initial receipt. For this reason the carried interest cannot be seen to constitute an "amount" because an amount refers to something with a determinable value (*Commissioner of Inland Revenue v Butcher Bros (Pty) Ltd* 13 SATC 21).

The value of a carried interest will only be determinable once the fund manager's management services have led to the improvements to the investments of the fund and to growth in the fund value. Once these investments are realised the fund manager will be able to receive cash flows from a carried interest. Since the investment fund is a partnership, the amount distributed to the fund manager will retain its nature. It is therefore necessary to

determine the nature of the underlying assets upon realisation by the fund. This will be discussed next.

3.4.2 The nature of cash flows from a carried interest

The initial receipt of a carried interest has been determined not to be gross income. As the investment fund moves through its life span, it may become more profitable through the increase in value of the investments of the fund. The fund manager is actively involved in the improvement of the investments acquired by the fund. The increase in the value of investments places the fund manager in a position to share in the profits of the investment fund if the investments were realised. This creates the value for a carried interest upon realisation of the fund investments. The first alternative to consider is whether the cash flow from a carried interest can be classified as an amount received or accrued in respect of services rendered. This is considered next.

3.4.2.1 Amount received in respect of services

In application of the definition of paragraph (c) of gross income in section 1 of the Act, as discussed in section 3.2, the following is concluded:

The cash flow from a carried interest meets the definition of an “amount”, because this term includes any form of goods with a monetary value (*WH Lategan v Commissioner of Inland Revenue* 2 SATC 16). The provision of management services to the investments will meet the definition of “services” as this is a form of assistance that is given to the acquired investments as well as the investment fund.

However, the element which causes debate is whether or not the cash flow from a carried interest is received “in respect of” services rendered (Braeken, 2012:8). The core of this debate lies in whether or not there is a causal link between the management services rendered and the cash flow from a carried interest. On the other hand the cash flow from the carried interest can be viewed as a reward for the risking of capital.

It is submitted that cash flow from a carried interest has a closer relationship with the fund manager risking capital than with the provision of services (Van Tubbergh, 2015). This is considering the fact that the fund manager already receives an annual management fee.

The management fee is paid irrespective of performance and reimburses the fund manager for expenses relating to the services it performs. This is undisputedly for the rendering of services (Field, 2008:28). The fact that the fund manager invests his/her own money argues that the receipt of cash flow from a carried interest relates to a capital return (Braeken, 2012:8). Without a form of reward, the fund manager would rethink the acceptance of the position of general partner as this places unnecessary high risk for a minimal return.

In order to better explain why the cash flow from a carried interest is not in respect of services, consider the following scenario:

Person A has a new idea for a business but in order to start his new venture he has to obtain capital. Person A obtains a loan from a bank and invests the money into his new business. This is his start-up capital. As the years progress Person A uses the start-up capital to further research the idea and to build a prototype. During this time the business pays him a monthly salary. The prototype is a success and manufacturing of the product commences. In the tenth year of business the company is producing the product at maximum capacity. Person A obtains an offer for the existing business. He accepts the offer, repays the bank the money he loaned (including interest), and distributes the remaining profit to himself.

Person A has taken a risk and was rewarded by making a profit on the sale of the business. During this time he was remunerated by way of a salary for the services he performed for the business.

Regard Person A as the fund manager, the business as the fund, the salary as the management fee, the bank as the limited partners, and the interest on the loan as the hurdle rate. Owing to the similarity of the facts, to tax the fund manager and Person A differently seems unfair. Similarly, it contradicts the principal of horizontal equity, which declares that taxpayers in similar positions should pay the same amount (or rate) of tax (Rosenzweig, 2009:725).

It follows from the above example that the cash flow from a carried interest does not constitute an amount as envisaged in paragraph (c) of the gross income definition.

The fact that the investment fund is usually a tax transparent vehicle shifts the focus of the classification of cash flow from a carried interest to the underlying receipt by the investment

fund upon realisation of the fund's investments. The amount distributed to the members of the investment fund will retain its nature, whether capital or income. In order to determine the capital or income nature, the effect of section 9C and tests formulated by the South African courts will be investigated. Section 9C has an overriding effect over the interpretations provided by South African courts on the definition of "a capital nature" (Haupt, 2015:693). For this reason this section will be investigated first before the interpretations provided by South African courts will be examined.

3.4.2.2 Discussion of section 9C of the Act

According to SARS (2007:16), section 9C of the Act was introduced as the substitute for section 9B. Originally section 9B was introduced to eliminate the uncertainty of the classification of proceeds on the sale of listed shares and hence the taxation thereof. Continued reliance on case law often led to unintended differences in application (SARS, 2007:16).

Section 9C was introduced to expand on section 9B and provide a greater degree of certainty with respect to share transactions on a more generalised basis (SARS, 2007:16). This was due to some sectors of the economy applying one standard while other sectors were applying a different standard. The use of objective rules eliminated this uneven playing field (SARS, 2007:16).

Section 9C of the Act reads as follows:

Any amount other than a dividend or foreign dividend received by or accrued to a taxpayer in respect of a qualifying share shall be deemed to be of a capital nature.

The section defines a 'qualifying share' as:

... an equity share, which has been disposed of by the taxpayer or which is treated as having been disposed of by the taxpayer in terms of paragraph 12 of the Eighth Schedule, if the taxpayer immediately prior to such disposal had been the owner of that share for a continuous period of at least three years...

Furthermore, in terms of section 9C of the Act, a qualifying share specifically excludes companies which are non-residents, except if the company is listed in South Africa. Additionally, paragraph 3 states that section 9C will not be applicable if at the time of the disposal the taxpayer (shareholder) is a connected person to the company that issued the shares and more than 50% of the market value of the equity share is attributable to immovable property at the time of disposal, except if:

- the immovable property is indirectly held by a person who is not connected to the taxpayer, and
- the immovable property has been held for a period exceeding three years.

Therefore if an ordinary share meets the requirements of section 9C, the proceeds on the sale of such share will automatically be classified as capital in nature. This is done even if the share is held as trading stock and irrespective of whether a gain or loss is made on disposal of the share (Stiglingh et al., 2015:735).

If the share does not meet the definition of a qualifying share (i.e. the share is not held for a period exceeding three years, or is held in a non-resident company not listed in South Africa), or is subject to the anti-avoidance provision of paragraph 3, the disposal of the share will not necessarily be deemed income in nature. The normal guidelines as provided by South African courts should be applied to the facts of the case in order to determine the nature of the proceeds (SARS, 2012:12).

It will now be shown how the requirements of section 9C apply to investment funds.

3.4.2.3 Application of Section 9C to investment funds

Investment funds aim to obtain a controlling share in a company in order to have the regulatory power to initiate various changes to improve it (Knoll, 2008: 121). This is done in furtherance of a higher resale value. To obtain a controlling interest, the funds will invest in the ordinary shares of the company (Braeken, 2012:13). These ordinary shares are equity shares.

The life expectancy of an investment fund (as illustrated in Figure 2.2) is approximately 13 years (Greene, 2015). This includes the investment period as well as the time that the investments are held up to realisation (Field, 2008:26). Knoll (2008:122) states that the

investment period is usually between five to six years and Fleischer (2008:6) adds that the shares are consequently held for a period of between two and seven years before realisation.

If the above is applied to the definition of a qualifying share as defined in section 9C, it seems that, more often than not, the investments made by investment funds will meet the requirements of investing in a qualifying share. Thus, the receipt upon realisation of the investments will be of a capital nature and this nature will be retained upon the subsequent distribution to the fund manager.

However, this is not always the case. As mentioned by Fleischer (2008:6), the investments are sometimes held for a period not exceeding three years. Furthermore, investment funds will always seek to find underperforming entities, and will therefore sometimes consider companies that are not residents of South Africa (KPMG & SAVCA, 2014:15).

If one of the two aforementioned circumstances arises, section 9C will not be applicable. When this is the case, the interpretation given to the phrase “of a capital nature” by South African courts must be investigated. Over the years a number of guidelines have been formulated by South African courts and they will now be explained.

3.4.2.4 Discussion of the phrase “of a capital nature” and the guidelines formulated by South African courts

It is often very complicated to distinguish between receipts that are ‘capital’ and receipts that are ‘income’ in nature. Even though a large number of court cases debating this issue exist, a universal approach does not exist. This is emphasized by Judge Smalberger in *Commissioner of Inland Revenue v Pick ‘n Pay Employee Share Purchase Trust* 54 SATC 271 (Pick ‘n Pay):

There are a variety of tests for determining whether or not a particular receipt is one of revenue or capital nature. They are laid down as guidelines only – there being no single infallible test of invariable application.

Instead, each case should be investigated individually based on its own set of facts. The use of prior judgments would only serve as guidelines. These guidelines are essentially descriptive rather than definitive (Swanepoel, 2012).

Swanepoel (2002:277-402) has identified the following guidelines, derived from South African case law, which will be addressed briefly in the following section:

- 1) source of the receipt
- 2) income is revenue derived from capital productively employed
- 3) carrying on of a business
- 4) operation of a business in carrying out a scheme of profit-making
- 5) fixed versus floating capital
- 6) substitution
- 7) subjective attitude of the taxpayer

The universal test that courts will use before applying any of these guidelines is “causality”. This is the opinion of Emslie & Jooste (1989), where the following statement is made:

...being made simply that it is the underlying causa which triggers the application of the tests for capital or revenue.

It is therefore necessary that causality is addressed before the guidelines are discussed. According to the Oxford Dictionary of Current English (1984:110), “causality” is defined as the relationship between cause and effect. In other words a court will firstly look at the purpose of the transaction (what the taxpayer wanted to achieve) and what the effect of the transaction was (what was actually achieved), before determining which guideline is applicable. Causality is not completely necessary in every case, but it betters the stance of the court (Emslie & Jooste, 1989).

Judge Watermeyer explained the principle of causality a little bit differently in *New State Areas Ltd v Commissioner of Inland Revenue* 14 SATC 155 (New States Areas) by referring to the true nature of the transaction:

The conclusion to be drawn from all these cases seems to be that the true nature of each transaction must be enquired into in order to determine whether the expenditure attached to it is capital or revenue expenditure. Its true nature is a matter of fact and

the purpose of the expenditure is an important factor; if it is incurred for the purpose of acquiring a capital asset for the business, it is capital expenditure, even if it is paid in annual instalments; if, on the other hand it is in truth no more than part of the cost incidental to the performance of the income-producing operations, as distinguished from the equipment of the income-producing machine, then it is revenue expenditure, even if it is paid in lump sum.

Causality is used where the facts of the case make it difficult to determine the nature of the receipt (Emslie & Jooste, 1989). The guideline is well illustrated in *Tuck v Commissioner of Inland Revenue* 50 SATC 98 (Tuck). In the Tuck case, a taxpayer received money upon his retirement, subject to certain restrictions. One of the restrictions was that the taxpayer would not enter into direct competition with his employer company after retirement. The commissioner argued that the amount received was taxable because the source of income was the services the taxpayer had rendered. However, the court ruled that the true source of the amount was the restraint of trade by the employer, which is capital in nature.

The application is largely up to the courts to decide, because the substance of the transaction must be looked at instead of its form. Having discussed causality, the guidelines established by the South African courts can be explained.

1) *Source of the receipt*

The source of a receipt refers to the originating cause of the receipt (Swanepoel, 2002:278). In other words, the courts will look at what caused the receipt to be created (or to originate). The originating cause looks at the reason why the taxpayer is receiving the amount (Swanepoel, 2002:278). So, it should be investigated what work or activity the taxpayer did to receive the amount. In *Commissioner of Inland Revenue v Lever Bros and Unilever* 14 SATC 1 (Lever Bros), Judge Watermeyer explains it as follows:

...that the source of receipts, received as income, is not the quarter whence they come, but the originating cause of their being received as income and that this originating cause is the work which the taxpayer does to earn them, the quid pro quo which he gives in return for which he receives them. The work which he does may be a business which he carries on, or an enterprise which he undertakes, or an activity in which he engages and it may take the form of personal exertion, mental or physical,

or it may take the form of employment of capital either by using it to earn income or by letting its use to someone else. Often the work is some combination of these.

2) *Income is revenue derived from capital productively employed*

This guideline was originally coined in *Commissioner of Taxes v Booysens Estates Ltd* 32 SATC 10 (Booyens Estates). In this case Judge Wessels states:

Income is, as a rule, revenue derived from capital productively employed. It is true that there is no definite test that can always be applied in order to determine whether a gain or profit is income or not, but it may safely be asserted that the revenue or profit which is derived from a thing without its changing owners is rather to be considered income than as capital.

This guideline is best described by using the tree and its fruit principle created by Judge Maritz in *Commissioner for Inland Revenue v Visser* 8 SATC 271 (Visser):

'Income' is what 'capital' produces, or is something in the nature of the interest of fruits as opposed to principal or tree.

In this case it was explained that the tree is the capital and like a tree produces fruit, capital produces revenue, which will be seen as income (De Koker & Williams, 2015:3 - 92-2).

The guideline consists of two elements, namely the revenue or funds and the capital from which it flows. The revenue is the actual proceeds that are received by the taxpayer and the capital from which it flows is the source. By looking at the economic definition of capital, the source seems to be a tangible asset or business, but it must be remembered that capital can also include a person's labour or wits (Swanepoel, 2002:284).

The two elements are connected by the word "derived". According to the Oxford Dictionary of Current English (1984:196) "derive" is defined as obtaining something from a specific source. The specific source in this case is the capital. This shows that the actual use of the capital employed must result in a flow of funds before this guideline will be applied.

3) *Carrying on of a business*

In order to explain the concept “carrying on of a business” one first has to define the term “business”. The word business has a very wide definition. This wide interpretation is emphasized in *Burgess v Commissioner of Inland Revenue* 55 SATC 185. In essence business is a type of trade, even though the words are often used as synonyms (Swanepoel, 2002:312).

Activities must have a degree of continuity before it can be classified as a business, otherwise it would just be a number of unrepeatable transactions, which could have been done by any person in his/her own capacity (Swanepoel, 2002:312). Judge Wessels reiterates this in *Commissioner for Inland Revenue v Stott* 3 SATC 253 (Stott):

As a general rule one or two isolated transactions could not be described as the carrying on of a business.

In the Pick ‘n Pay case the distinction is made between the carrying on of a business and a scheme of profit-making by the number of transactions:

... a distinction is drawn between the carrying on of a business and the pursuance of a profit-making scheme. The basis for such distinction is that it is more appropriate to refer to a profit-making scheme where a single transaction is involved. I accept that a series of transactions is characteristic of the carrying on of a business. But irrespective of the number of transactions, whether the receipts that flow from the carrying on of a business are revenue still depends on whether the business was conducted with a profit-making purpose, i.e. as part of a profit-making venture or scheme.

Therefore, the two important elements within this guideline are business and the goal to make a profit through that business (Swanepoel, 2002:312). This shows that it is important that there is a link between the income received and the purpose of the business carried on.

4) *Operation of a business in carrying out a scheme of profit-making*

This guideline is an English tax law concept in *Californian Copper Syndicate v Inland Revenue* (anno 1904) 41 Sc. L. R. 691 brought into South African tax law through *Overseas Trust Corporation Ltd v Commissioner for Inland Revenue* 2 SATC 71 (Overseas Trust):

But where the profit was, in the words of an eminent Scotch Judge, (Californian Copper Syndicate v Inland Revenue), 'a gain made by an operation of business in carrying out a scheme for profit making,' ... it must be income... the profit resulted from the acquisition of an asset at a price less than the benefit which automatically flowed from it. There was no difference between the realisation of an asset and the fructification of an asset, if the benefits received amounted to a gain made by an operation of business in carrying out a scheme of profit making. And this transaction came within that description.

This guideline is often used in instances where there is only a single transaction, when a taxpayer is not seen as carrying on a business (Swanepoel, 2002:340). In *Elandsheuwel Farming (Edms) Bpk v Sekretaris van Binnelandse Inkomste* 39 SATC 163 (Elandsheuwel) Judge Corbett (dissenting) states:

Where a single transaction is involved it is usually more appropriate to limit the enquiry to the simple alternatives of a capital realization or a profit-making scheme. In its normal and most straightforward form, the latter connotes the acquisition of an asset for the purpose of reselling it at a profit.

The guideline broadly consists of two elements. The first element is the business operations. An operation of business shows that the transaction entered into must have some sort of commercial substance and is intentionally entered into by the taxpayer to achieve a certain goal (Swanepoel, 2002:338).

This goal is the second element, namely the scheme of profit-making. A scheme refers to a plan (The Oxford Dictionary of Current English, 1984). A plan shows that the idea was present before the actual activity was commenced. This repeats the importance of intention within this guideline. If a plan is sought for and worked for and not accidental, then the receipt from such a plan will be income in nature (Swanepoel, 2002:338).

If a taxpayer has more than one intention, the dominant intention will be chosen (De Koker & Williams, 2015:3-12). The intention must be to make a profit. If both elements are present it can be said that a scheme of profit-making was entered into.

5) *Fixed versus floating capital*

To understand the difference between fixed and floating capital, one must look at the economic and accounting definitions of the words. Fixed capital is invested in a business to be held for a reasonable amount of time and to generate income through its use (Swanepoel, 2002:374). A fixed capital asset will only be disposed of in special circumstances or when it needs to be replaced (Haupt, 2015:44).

Floating capital is capital used with the intention to repeatedly use and dispose of it in the course of business (Swanepoel, 2002:374).

In each case it is important that the capital is used within a business context. Therefore, the operation of a business is a prerequisite for this guideline. The nature of the business will also play a large role in the distinction between the two types of capital (Swanepoel, 2002:374).

6) *Substitution*

Essentially the substitution guideline entails that the consideration received for the replacement of an item will take the income or capital nature of the item that it replaced or substituted (Swanepoel, 2002:381). For this reason this guideline is mostly used in instances where the taxpayer receives a payment from an insurer, or is compensated for damages. Nonetheless, the guideline is also useful when consideration is received for the transfer of rights (Swanepoel, 2002:382).

The substitution guideline has two essential elements. Firstly it must be determined what the function of the consideration received for the replacement is to the taxpayer (Swanepoel, 2002:383). In other words the purpose for which it was intended. Secondly, the true nature, capital or income, of the item replaced in the hands of the taxpayer must be determined (Swanepoel, 2002:383).

7) *Subjective attitude of the taxpayer*

De Koker & Williams (2015:3-7) describes the intention of the taxpayer to be the “golden rule” of determining the nature of a receipt. Section 102 of the Tax Administration Act 28 of 2011 makes it clear that the onus is on the taxpayer to prove that an amount is capital. When a taxpayer provides his subjective view of the events which led to a transaction, we refer to it as the taxpayer’s “*ipse dixit*”. This is a Latin phrase which is defined as “a dogmatic and unproven statement” (Stiglingh et al., 2015:33).

As a general rule courts have adopted the policy that a taxpayer’s *ipse dixit* is viable in court, as long as objective evidence is provided that will substantiate it. Stiglingh et al. (2015:33-34) agrees and comments as follows:

Because of subjectivity, self-interest, the uncertainties of recollection and the possibility of mere reconstruction, the evidence given by a taxpayer will not be decisive. The court will test that evidence against the surrounding facts and circumstances (in other words, objective factors) in order to establish his true intention.

Stiglingh et al. (2015:33-34) goes on to list a number of objective factors that the court will consider, some of which include the frequency of similar transactions, the length of time for which an asset was held, etc.

Commissioner for the South African Revenue Service v NWK Ltd 73 SATC 55 (NWK), a recent case, provides a very good example of the court’s approach in this regard. In this case NWK entered into an arrangement with First National Bank (FNB) and through a number of clever transactions NWK was able to disguise the true nature of a loan as a sale of maize, thereby receiving a large deduction as per s11(a). The court often referred to the statements made by Mr. E Barnard, the financial director of NWK. Barnard provided the intention of the transaction, but his lack of objective factors (e.g. the lack of transport or storage costs, no mention of what type of maize was to be transferred, etc.) led the court to decide that the true nature of the transaction was in fact a loan.

3.4.2.5 Application of South African court guidelines to investment funds

Each of the guidelines as set out above will be applied to the receipt from the realisation of the investments of the investment fund in order to ascertain the nature of the receipt. It must be noted, however, that each set of facts could have a different result if applied to the guidelines of South African courts. Consequently different cases could have different outcomes.

1) *Source of the receipt*

In order to determine the source of the receipt, it has to be identified what caused the receipt to be created (Swanepoel, 2002:278). A carried interest gives the fund manager an opportunity to share in the profits after the realisation of the investment fund's investments. The investments are obtained in order to restructure and extract value from them (Braeken, 2012:13). It is submitted that the source is the realisation of the investments (Field, 2008:28). Therefore, it must be determined what the nature of the investment is for normal tax purposes. The objective factors indicate that the investments are obtained for resale (Field, 2008:26). Even though developing the investment to a condition for resale may take a number of years, the intention of the taxpayer never changes. The investment is held on revenue account and consequently is income in nature.

2) *Income is revenue from capital productively employed*

The guideline consists of two elements. It must first be established what is capital and whether or not income was derived from this capital (Swanepoel, 2002:284). The term capital must not only be used in its economic sense, but can also include a person's labour (Swanepoel, 2002:285-286). A classic example of *income is revenue from capital productively employed* is the purchase of investment property. The investment property is purchased for two reasons, namely the rental income and capital appreciation. The investment property acts as the capital, because from this income in the form of rental income is earned. Thus, the eventual sale of the investment property would be the sale of the capital as this formed the income producing structure.

In an investment fund the investments are usually undervalued companies (Braeken, 2012:13). After acquisition the fund manager provides management services to these

companies (Cunningham & Engler, 2008:6). Over time the companies become more profitable and are able to distribute dividends (Rosenzweig, 2009:718). The dividends received from the investments are income, but this does not necessarily mean that the source from whence it came is capital. The dominant intention of the holding of the investment must be examined (*Commissioner of Taxes v Levy 18 SATC 127*). The onus will be on the taxpayer to prove what the dominant intention was for investing in the company, and thus capital in nature (De Koker & Williams, 2015:3-12). If it can be shown that the company was purchased to derive dividend income, the eventual realisation of the company would be capital in nature. But if the company was obtained in order to eventually sell it at a higher price, the receipt would be income in nature.

3) *Carrying on of a business*

In order for the investment fund to be carrying on a business, the activities that it performs must have some degree of continuity (Swanepoel, 2002:312). The fact that the investment fund usually purchases a number of investments and tries to increase the investments' resale value through the provision of management services indicates that it is not just a number of unrepeatable transactions (Knoll, 2008:121). A similar method is used with all of the investments owned. In addition, the investments are entered into with the main goal of making a profit (Field, 2008:28). The investments therefore take the form of assets that are purchased with the intention of resale.

4) *Operation of a business in carrying out a scheme of profit-making*

This guideline is more prevalent in the case where the nature of a single transaction is being determined (Swanepoel, 2002:340). In the case of an investment fund, numerous investments are realised in order for the limited partners and fund manager to share in the profits (Knoll, 2008:121). However, it could still be relevant to investigate this guideline if only one investment is realised and subsequently the investment fund is liquidated.

In that case two elements must be met. Firstly, it must be determined whether the taxpayer carried on business operations (Swanepoel, 2002:340). The fact that an incentive was received by the fund manager indicates that there was some sort of commercial substance to the transaction. Secondly, the goal that the taxpayer wanted to achieve must be established (Swanepoel, 2002:340). The transaction would have been entered into by the

taxpayer in order to make a profit on the eventual realisation. The initial purchase of the investments would only take place if the fund manager has reason to believe that the investment is undervalued, or could be greatly improved with certain management services. The taxpayer would thus have intentionally entered into the transaction to achieve the goal of making a profit and therefore entered into a scheme of profit-making.

5) *Fixed versus floating capital*

Even though the underlying investments of the investment fund do generate income in the form of dividends, this is not the sole reason that the investments were acquired. By providing management services to the investments these investments increase in value and this value is released through their eventual realisation (Knoll, 2008:121). The investment thus takes the form of trading stock. Trading stock falls within the description of a floating capital as it is used and disposed of in the ordinary course of business (Swanepoel, 2002:374).

6) *Substitution*

The substitution guideline will not be applicable in this instance. The substitution guideline is relevant when there is an item that is being replaced (Swanepoel, 2002:381). In this instance the investment is realised and the proceeds are distributed to the various investors. Usually after all the investments have been realised the investment fund is liquidated (Field, 2008:28).

7) *Subjective attitude of the taxpayer*

It is up to the taxpayer to describe the intention of the transaction. The *ipse dixit* is completely subjective and open to interpretation. Even though intention is described by De Koker & Williams (2015:3-7) as the golden rule, obtaining the true intention of the taxpayer is sometimes problematic. It is easy for the taxpayer to hide the true intention of the transaction by describing it in a more favourable manner (Stiglingh et al. 2015:33). It is thus up to the taxpayer to also provide objective factors. To objectively show that the investment fund investments are held for capital appreciation could be troublesome for the taxpayer, especially in the case that it is held for a period less than three years. Even though the length of time an asset is held is not conclusive of the nature of the income, it could indicate that

the taxpayer knew of a certain fault in the valuation, or gap in the market that would see the taxpayer enter into carrying out a scheme of profit-making. Each set of facts will have to be evaluated separately and objective factors must support these facts.

3.4.2.6 Conclusion

It was determined that the receipt of cash flow from a carried interest is not in respect of services rendered. The investment in the equity shares of companies by the investment fund results in the application of section 9C of the Act. The overriding power of this section of the Act results in the proceeds from the sale of shares held for a period exceeding three years to be classified as capital income. Consequently, when these investments are realised, either by sale or listing, the proceeds from the same will result in CGT consequences.

However, if one of three other situations arise the use of section 9C will not be applicable. These situations are:

- 1) The shares are held for a period not exceeding three years.
- 2) The shares are held in a company that is not a resident company in South Africa.
- 3) The fund is a connected person to the company that issued the shares and more than 50% of the market value of the equity share is attributable to immovable property at the time of disposal, excluding:
 - a. immovable property which is indirectly held by a person who is not connected to the taxpayer, and
 - b. the immovable property has been held for a period exceeding three years.

In such circumstances the taxpayer would have to look at the facts of each case and apply this to the guidelines set by South African courts. The guidelines help South African courts to determine the capital or income nature of receipts. From the application of the guidelines, and if section 9C is not applicable, it is submitted that the cash flow from a carried interest would be income in nature.

3.5. Summary and conclusion

In this chapter the taxation of a carried interest and cash flow from a carried interest in South Africa was explained.

It was determined that the receipt of a carried interest cannot be a fringe benefit, unless it can be proven that the fund manager is not an independent contractor in relation to the investment fund. The receipt of a carried interest was found not to be gross income, because the fund manager only receives an entitlement and that entitlement is unquantifiable prior to the investments of a fund being realised.

When the receipt of cash flow from a carried interest was applied to paragraph (c) of the gross income definition, it was found that the cash flow from a carried interest has a close relationship with the risk undertaken by the fund manager. The cash flow from a carried interest therefore does not meet the requirements of paragraph (c) of gross income. As a result of this conclusion, it was necessary to determine the nature of the underlying investments of the investment fund to determine whether it meets the general definition of gross income.

The underlying assets are income in nature, because they are held with the dominant intention for resale, namely as trading stock. However, the inclusion of section 9C into South African tax legislation has made it possible for fund managers to deem all receipts from the sale of these investments to be capital. Thus, all investments that meet the requirements of section 9C will be deemed capital and the return earned from these investments are capital returns.

The lack of legislation in South African tax regarding a carried interest begs the question whether there is a need for specific tax legislation. The fact that it seems that fund managers are providing a service, but obtaining capital returns indicates a possible gap in legislation. Although the South African private equity and venture capital markets are small compared to developed countries like the USA, it can become significant very quickly. The reasoning behind this is twofold:

Firstly, South Africa is viewed as the gateway into Africa (Stiglingh et al., 2015:589). For this reason, foreign investors in search of high returns invest in South African companies with African exposure (KPMG & SAVCA, 2014:15). Investment funds assist these investors as the investors often do not have knowledge of the markets and require local management expertise to extract the best return from its investments. Higher foreign investment leads to growth in the private equity and venture capital industry (KPMG & SAVCA, 2014:15).

Secondly, South Africa is in search of growth for its economy and to subsequently decrease its unemployment figure (KPMG & SAVCA, 2014:15). The fact that the use of investment funds is a good way to grow a country's economy is widely accepted (SARS, 2009:67). The Small- and Medium-sized Entity (SME) sector in which private equity and venture capital investment funds primarily operate is usually perceived as risky by banks. Also, generally, many forms of surety are needed before banks will lend money to SMEs (KPMG & SAVCA, 2014:15). Investment funds bridge this gap by providing a platform for SMEs to obtain cheap capital. It is therefore believed that the South African government would support the growth of the private equity and venture capital industry. The support of venture capital companies by the South African government is evident through the introduction of Section 12J in the Act in 2009. This section provides a taxpayer with a tax incentive in the form of a deduction for investing in approved venture capital companies.

It is important that the South African National Treasury provide certainty as to the method that a carried interest will be taxed. This might have an effect on how the private equity and venture capital markets of South Africa are perceived. Consequently, the South African National Treasury will have to determine what effect a change in legislation would have on foreign investment and a possible exodus of resident investment funds should a carried interest be taxed as normal taxable income and not capital. Thus, additional tax revenue should be compared to the possible loss of future tax revenue, foreign investment or job creation.

In the USA carried interest is currently taxed as capital income. The USA is trying to close this gap through amendments to legislation as the feeling amongst the public is that abnormal returns are generated by a select few. The USA tax interpretation of a carried interest will be discussed in more detail in Chapter 4.

CHAPTER 4

The taxation of a carried interest in the United States of America

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CHAPTER 4

The taxation of a carried interest in the United States of America

4.1. Introduction

The previous chapter considered the South African tax regime and how a carried interest and cash flow from a carried interest might be classified for normal tax purposes.

In this chapter the current taxation of a carried interest in the United States of America (USA), together with the reform proposals, will be discussed.

Herewith a brief background in order to explain the significance of this chapter.

4.1.1. Background

Fuelled by public scrutiny, the taxation of a carried interest in the USA has been the subject of debate for a number of years (Cunningham & Engler, 2008:1). The debate has received considerable attention from scholars, politicians, businessmen and the media (Rosenzweig, 2009:714). This results from the fact that, under current law, fund managers are able to classify the receipts from holding a carried interest at the low 20% capital gains rate (Cunningham & Engler, 2008:1). The fact that these fund managers are usually already wealthy individuals has provoked outrage amongst ordinary workers, since their salaries are subject to regular tax rates up to 39.6% (Cunningham & Engler, 2008:1).

According to Knoll (2008:1) the United States Congress held hearings on the tax treatment of the private equity industry in 2007. Except for representatives from the private equity industry, most of the witnesses urged Congress to tax the managers of private equity funds more heavily (Knoll, 2008:1). Since 2007 legislation that entails the reform of the carried interest taxation regime has been pending (Braeken, 2012:29). American President, Barack Obama, has as recently as May 2015 renewed his call for eliminating the favourable tax treatment of carried interest (Tau, 2015).

4.1.2. Structure

The objective of this chapter is to obtain an understanding of how the taxation of a carried interest is viewed in the USA. This will be addressed by investigating and discussing the following topics:

- motivation for the use of the USA as subject for this research
- the structure and operation of tax legislation in the USA
- the current carried interest regime in the USA
- the proposed reforms to the carried interest regime in the USA

The motivation for the USA as subject for this research will be addressed first.

4.2. Motivation for the use of the USA as subject for this research

The USA is a developed, or a so called First World country (First, Second and Third World, 2015) and was specifically chosen as a subject for this research due to the magnitude of its private equity and venture capitalist markets. According to the Private Equity Growth Capital Council (2014), the USA is by far the largest private equity market with over 3 300 firms headquartered in the USA. These firms have backed 11 130 companies in the USA, which results in total employment of 7.5 million individuals by US private equity backed companies.

Furthermore, according to the ranking system of *The Venture Capital & Private Equity Country Attractiveness Index* (Biesinger, Groh, Liechtenstein & Lieser, 2015:24), the USA ranks first amongst 120 countries surveyed. The index takes into account the economic activity, depth of the capital market, taxation, investor protection (corporate governance), human and social environment, and entrepreneurial opportunities to assess the attractiveness of each country for private equity and venture capital investment.

The USA is also a member of the Organisation for Economic Co-operation and Development (OECD). The members of this organisation are regarded as trendsetters in the establishment of international standards (OECD Member Countries, 2015). The mission of the OECD is to establish policies that promote the economic and social well-being of people around the world. The OECD also proposes certain international standards for, among other

things, taxes, social security, as well as a platform that can be used by the governments of countries to share information (About the OECD, 2015).

Another reason for the study to focus on the USA is because in the USA a clear distinction is made between the tax of capital gains and the tax of income, which results in a large tax saving if the receipt can be classified as capital in nature (PWC, 2014:54). This is also the case in South Africa (De Koker & Williams, 2015:3-2).

Generally a carried interest in the USA is governed by the capital gains tax regime (Braeken, 2012:29). The South African private equity industry tends to follow the American interpretation of the taxation of a carried interest, owing to the favourable tax consequences that it offers (Van Tubbergh, 2015).

For the above reasons a study of the American carried interest tax regime is deemed appropriate. However, before the taxation of a carried interest in the USA can be addressed, a brief background of the current USA normal tax regime is necessary. This will be discussed next.

4.3. The structure and operation of tax legislation in the USA

The USA Federal tax law is administered primarily by the Internal Revenue Service (“IRS”) (Tax Law, 2015). The IRS has its roots in the American Civil War when President Lincoln created the position of commissioner of Internal Revenue and enacted an income tax to fund the war (IRS, 2015). Today, the US tax regime is governed by the Internal Revenue Code of 1986 as amended (“the IRC”) and published in title 26 of the US Code (Tax Law, 2015). The IRC is divided into 11 subtitles, numbered A to K. Each subtitle is further divided into various subchapters.

Other federal tax laws are found in the following: title 26 of the Code of Federal Regulations (“CFR”); proposed regulations issued by the IRS; temporary regulations issued by the IRS; revenue rulings issued by the IRS; private letter rulings issued by the IRS; revenue procedures, policy statements, and technical information releases issued by the IRS; and federal tax court decisions (Tax Law, 2015).

The relevant aspects of the IRC and CFR will be addressed in the following discussion of the USA personal income tax regime.

4.3.1. USA personal income tax regime

Inspection of the IRC indicates that income taxes are primarily regulated by Subtitle A: Income taxes. The USA levies tax on residents on their worldwide income, whereas non-residents are taxed on USA-source income (PWC, 2014:50).

The discussion will be split into three categories, namely ordinary income versus capital income, services income, and interest in a partnership. The point of departure will be ordinary income versus capital income as this also forms part of the other two categories and will be discussed next.

4.3.1.1 Ordinary income versus capital income

The treatment of ordinary income (income from employment) differs from the treatment of capital income (Braeken, 2012:29). The USA has a progressive income tax system for the taxation of ordinary income. Thus people who earn more ordinary income are taxed at a higher rate than those who earn less. For the 2015 tax year the progressive tax table is divided into seven tax brackets that range from 10% to 39.6% where the upper bracket starts at \$ 413 200 for a person with a “single” filing status (IRS, 2015).

Long term capital gains as well as qualified dividends are generally taxed at a maximum fixed rate of 20% (PWC, 2014:54). A capital gain is labelled as long-term if the underlying asset is held for a period exceeding 12 months. Short term capital gains (capital gains on assets that are held for a period not exceeding 12 months) are treated as ordinary income and therefore the progressive tax rates apply to this form of receipt (Braeken, 2012:29).

A dividend is designated as qualified if it is received from a USA corporation (Braeken, 2012:29). However, dividends paid by certain foreign corporations could also qualify. Distributions from partnerships and real estate investment trusts are typically not characterized as qualified dividends (Tax treatment of dividend income, 2015).

4.3.1.2 Services income

Section 61 of the IRC defines gross income as:

...all income from whatever source derived, including (but not limited to) the following items: Compensation for services, including fees, commissions, fringe benefits, and similar items...

The above definition does not indicate the timing of gross income recognition or the value of gross income. According to Braeken (2012:29), the timing and value of services income is subject to two specific tax principles. These principles (or doctrines) are namely the doctrine of constructive receipt and the doctrine of economic benefit. Both will be addressed briefly.

The doctrine of constructive receipt is found in the CFR and entails that the taxpayer is required to recognise gross income as soon as it is under the control of the taxpayer, unless the receipt is subject to significant constraints (Braeken, 2012:30). Therefore, even if the income is not actually received by the taxpayer, but the amount was available to him or her, the amount is constructively received.

The doctrine of economic benefit essentially arose from the *Sproull v Commissioner of Internal Revenue*, 16 TC 244 (1951) decision (Braeken, 2012:30). It specifically applies to taxpayers who receive compensation for services. It implies that the value of any economic or financial benefit or property received in exchange for services should be included in the taxpayer's gross income (Braeken, 2012:30).

The above mentioned doctrines are encompassed in Section 83 of the IRC, which specifically deals with property transferred in connection with performance of services (Braeken, 2012:30). According to Section 83:

... the excess of the fair market value of such property... over the amount (if any) paid for such property, shall be included in the gross income of the person who performed such services in the first taxable year in which the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture...

From the above definition it can be deduced that property received by virtue of services is recognised in the year in which it vests. The income vests once the property is no longer subject to substantial risk of forfeiture (Braeken, 2012:30). According to Section 83(c) substantial risk of forfeiture is present if:

...full enjoyment of such property are conditioned upon the future performance of substantial services by any individual.

Nonetheless, the taxpayer may make use of the so-called “Section 83(b) election”. This provides the taxpayer with the option to recognise non-vested income immediately. According to Braeken (2012:30) this option is granted to the taxpayer because the benefit of deferral might be outweighed by the appreciation of the asset between the time of receipt of property and the time of vesting. Braeken (2012:30) goes on to explain that the logical downside is that the taxpayer cannot claim a tax deduction if the property is subsequently forfeited.

4.3.1.3 Interest in a partnership

The taxation of the interest in a partnership has been focused on the rules under Subchapter K of the IRC (Carman, 2009:113). In Subchapter K of the IRC, Section 721(a) provides the general rule that:

...no gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership.

In other words, formations of partnerships and contributions of property to partnerships are not taxable (Weisbach, 2008:728). The tax transparency of this transaction is based on the rationale that the transfer of property in exchange for a partnership interest is considered a mere change of form in the partner’s investment (Getmanenko, 2011:6-7).

The tax treatment of the receipt of an interest in a partnership for services depends on whether the interest is a capital or profits interest. Both of these concepts will be addressed next.

Capital interest

In Revenue Procedure 93-27 (IRS, 1993), capital interest is defined as:

...an interest that would give the holder a share of the proceeds if the partnership's assets were sold at fair market value and then the proceeds were distributed in a complete liquidation of the partnership.

The receipt of a capital interest in exchange for a partner's services is a taxable event under Section 83 (Braeken, 2012:31). As explained under 4.3.1.2 above, the fair value of the property that exceeds the amount paid for the property will be included in gross income.

Profits interest

Profits interest is defined as "*an interest other than a capital interest*" (IRS, 1993). In other words, as explained by Carman (2009:111), a profits interest is an interest which a person has paid nothing for and would get nothing from if the entity were liquidated immediately after issuing the interest. A profits interest share can be a constant share, or it may involve a formula that increases or decreases the holder's share with the level of profits (Braeken, 2012:31).

The taxation of a profits interest was clarified after the court decisions of *Diamond v. Commissioner* 56 TC 530 (1971) and *Campbell v. Commissioner* 943 F.2d 815 (1991) (Carman, 2009:113). After the before mentioned cases the IRS promulgated Revenue Procedure 93-27 (Weisbach, 2008:728). This safe harbour states that:

If a person receives a profits interest for the provision of services to or for the benefit of a partnership in a partner capacity or in anticipation of being a partner, the Internal Revenue Service will not treat the receipt of such an interest as a taxable event for the partner or the partnership.

The Revenue Procedure added that the rule does not apply if:

- the profits interest relates to a substantially certain and predictable stream of income from partnership assets, or;
- within two years of receipt, the partner disposes of the profits interest, or;

- the profits interest is a limited partnership interest in a publicly traded partnership.

According to Carman (2009:14), the IRS introduced Revenue Procedure 2001-43 in order to obtain conformity on when the partnership interest must be classified as either capital or profits interest. It states that:

Where a partnership grants an interest in the partnership that is substantially non-vested to a service provider, the service provider will be treated as receiving the interest on the date of its grant, provided that:

- 1) The partnership and the service provider treat the service provider as the owner of the partnership interest from the date of its grant and the service provider takes into account the distributive share of partnership income, gain, loss, deduction, and credit associated with that interest in computing the service provider's income tax liability for the entire period during which the service provider has the interest;*
- 2) Upon the grant of the interest or at the time that the interest becomes substantially vested, neither the partnership nor any of the partners deducts any amount (as wages, compensation, or otherwise) for the fair market value of the interest; and*
- 3) All other conditions of Rev. Proc. 93-27 are satisfied.*

Hence, unvested partnership interests will be classified at grant date and not the day that it actually vests (Weisbach, 2008:728). If all the requirements above are met the receipt of a profit interest is not a taxable event, even if it is deemed a capital interest at the date of vesting (Braeken, 2012:33). Taxpayers usually structure the partnerships to meet all of the above mentioned characteristics in order to remove the scope of taxation at the point of issuance (Carman, 2009:114).

The general background of the structure and operation of tax legislation in the USA has been provided in order to assist in understanding the current carried interest regime in the USA. This regime will now be examined.

4.4. The current carried interest regime in the USA

As explained in Chapter 2, a carried interest is generally structured as an interest in a partnership. The interest in the partnership is earned due to a combination of capital contribution and the rendering of services (Braeken, 2012:30). The receipt of a capital

interest in exchange for a contribution of capital is commonly a zero-sum transfer, therefore no tax is due (Braeken, 2012:30-31). The interest is only taxable if the fair value of the contribution exceeds the amount paid for the interest (Carman, 2009:114).

The tax treatment of the receipt of an interest in a partnership in exchange for services depends on whether the interest is a capital or profits interest (Braeken, 2012:31). A carried interest does not qualify as a capital interest by reason that if the fund was liquidated on the day that a carried interest is granted to the fund manager, the fund manager will receive nothing from the fund (Carman, 2009:114).

Rather, a carried interest that relates to the rendering of services meets the requirements of being a profits interest (Carman, 2009:111). It is widely accepted that the application of the two revenue procedures (93-27 and 2001-43) will be applicable in order to assess the taxability of a carried interest as a whole (Getmanenko, 2011:9). Although this is technically incorrect, representatives of the IRS have informally indicated that they would not challenge such a classification (Carman, 2009:114).

By virtue of a carried interest being classified as a profits interest, the receipt of a carried interest will not be a taxable event (Braeken, 2012:34). This is because the carried interest meets the safe harbour provided by Revenue Procedure 93-27. The exemptions to the Revenue Procedure are not applicable because:

- 1) The carried interest does not relate to a predictable stream of income. In most cases a private equity fund cannot guarantee profitability, let alone predict the rate of return (Getmanenko, 2011:7-8).
- 2) The carried interest is usually held for a period exceeding the two year limit.
- 3) The investment fund is generally not a publicly traded partnership.

Exceptions mentioned in 2) and 3) are highly factual in nature and can therefore easily be avoided (Braeken, 2012 32).

For this reason the grant of a carried interest is not a taxable event. The partner receives a partnership interest in the form of a profits interest and is thus deemed a partner of the fund and should be taxed just like any other partner (Weisbach, 2008:729). The partnership is a tax transparent vehicle and so the distribution of income and expenses retain its nature. In

other words the nature of the transaction is established at partnership level and passed through to the individual partners (Weisbach 2008:729).

A long-term capital gain is applicable when the underlying asset is held for a period exceeding 12 months (Braeken, 2012:29). The holding of investments by the investment fund easily exceeds this timeframe (Knoll, 2008:122). Therefore the investments in which the investment fund has invested will produce a long-term capital gain once it is realised. The gain will retain its nature when it is distributed to the partners and will be taxed at the preferential capital gains rate of 20% (PWC, 2014:54).

This preferential treatment is viewed by many as unfair and has resulted in reform proposal for the amendment of tax legislation regarding this issue being presented to the House of Representatives (Cunningham & Engler, 2008:4). The next section will focus on these reform proposals.

4.5. Reform proposals

Widespread criticism exists over the current tax treatment of a carried interest in the USA (Getmanenko, 2011:9). Critics explain that the current treatment violates the norm of horizontal equity (Rosenzweig, 2009:725). Horizontal equity is an economic theory that states that individuals with similar income and assets should pay the same rate of tax, regardless of the tax system that is in place (Getmanenko, 2011:21).

As a result of the criticism, reform proposals have been submitted to the House of Representatives. According to Cunningham & Engler (2008:7-8), the two most often proposed changes are: (i) treating all amounts received under a carried interest as ordinary compensation income ("The Levin Proposal"), and (ii) imputing compensation to the manager each year in the amount equal to the rate of interest times the amount of capital subject to the carried interest ("The interest charge approach"). Fleischer (2008:46) has also unveiled a third proposal, the so-called "Talent-revealing election", which combines both of the above proposals. The details of the three proposals will now be addressed.

4.5.1. The Levin Proposal

The most popular proposal for dealing with a carried interest is to characterise all amounts received as compensation income and thus tax it as ordinary income (Cunningham & Engler, 2008:8). The proposal was introduced by Member of Congress, Sander M. Levin, in 2007. Hence, the proposal is widely known as the Levin Proposal (Braeken, 2012:34).

The proposal compromises an amendment to the taxation of partnership interest by the inclusion of a new section 710 in the IRC, and a slight amendment to section 83 (Braeken, 2012:34). It deals only with the character of the income and not the timing of when that income should be reported and taxed (Cunningham & Engler, 2008:8).

Section 710 introduces the concept of an investment services partnership interest (“ISPI”). An ISPI is explained in Getmanenko (2011:28) as an interest in an *investment partnership* that is acquired or held by any person in connection with the conduct by that person (or a related person) of a trade or business primarily involving the performance of certain services with respect to assets held (directly or indirectly) by the investment partnership. These services are:

- advising as to the advisability of investing in, purchasing, or selling any specified asset
- managing, acquiring, or disposing of any specified asset
- arranging financing with respect to acquiring specified assets
- any activity in support of any of the foregoing services

An investment partnership is one in which substantially all of the assets of the partnership are *specified assets*. Furthermore, more than half of the contributed capital of the partnership must be attributable to contributions of property by one or more persons in exchange for interests in the partnership which constitute property held for the production of income (Getmanenko, 2011:28).

Specified assets are inter alia shares in companies, real estate, commodities and various other securities (Braeken, 2012:35).

Any net income in respect of an ISPI is classified as ordinary income and subject to ordinary income tax rates, instead of a lower capital gains tax rate. This is also the case when the ISPI is disposed of (Getmanenko, 2011:29).

An ISPI can consist of a capital interest, profits interest, or both. Any income that can be attributed to the capital interest component can escape classification as income from an ISPI. This component is known as the qualified capital interest. A qualified capital interest is a capital interest for which the taxpayer has made a section 83(b) election on receipt, in the case that the capital interest has not vested (Braeken, 2012:35).

The standard carried interest arrangement consists of both a capital and a profits interest. The profits interest is higher than the capital contributed. Therefore the section 83(b) election can only apply to part of a carried interest acquired. For example, if a fund manager contributes 5% of the fund's total capital in exchange for a 20% profits interest, only 25% (5 / 20) of the income accruing to the fund manager is regarded a qualified capital interest (Braeken, 2012:35).

In 2010 an additional amendment was introduced by Senate Finance Committee Chair Max Baucus. He proposed that interest allocations be taxed at a "blended rate" (Getmanenko, 2011:32). In other words an applicable percentage of income from an ISPI would be taxed as compensation income at ordinary rates and the remaining percentage attributable to ISPI would be taxed as capital income. There have been various proposals with regard to the split ratio; the most recent proposal entailed a 65:35 split (65% relates to income and 35% to be treated as capital) (Braeken, 2012:36).

4.5.2. The interest charge approach

This proposal requires fund managers to report compensation annually, regardless of whether the fund makes a profit. This reduces the deferral of payment of income tax, but allows some conversion of a carried interest into capital gain (Cunningham & Engler, 2008:9).

The underlying justification for this approach is that the fund manager effectively borrows a portion of the fund's capital for their own account free of interest, and this interest-free benefit should be taxed as compensation (Fleischer 2008:44).

Under this proposal the amount of compensation that the managers must report annually is determined by multiplying the rate of interest with the amount of capital subject to carried interest.

As explained in Fleischer (2008:45) this approach results in a modified form of accrual taxation. The fund manager would be taxed on the current value of the use of the external investors' capital. To the extent that the investment fund appreciates, however, those gains would not be recognised until the income is realised by the partnership. The character of the gains would be preserved as capital gains.

4.5.3. The talent-revealing election

Fleischer (2008:46) has also unveiled a third proposal, the so-called talent-revealing election. The talent-revealing election makes the Levin proposal the default rule, but allows partnerships to elect the interest charge approach. This election would be attractive to fund managers who expect to achieve high investment returns and unattractive to fund managers who are unsure about the return on investment. This would accelerate current income, but allow conversion of any additional income into capital gain (Fleischer, 2008:46).

4.6. Summary and conclusion

In this chapter the current taxation of a carried interest in the USA, together with certain reform proposals were discussed.

In the USA the typical investment fund structure causes the receipt of a carried interest to be designated as a profits interest. The receipt of a profits interest is not a taxable event. For this reason the initial receipt of a carried interest does not result in any taxes being paid. Instead, any receipt from the profits interest will retain its nature. Since investments held for a period exceeding 12 months are capital in nature, the realisation and subsequent distribution will also be capital in nature and result in it being taxed as a capital gain. This is the overall treatment irrespective of whether the receipt carries an employment component.

A number of proposals have been debated by academics. The Levin proposal tries to tax a carried interest as income. This would make sense if all the interests held by each partner

was the same, but this is not the case. The fund manager's interest is subject to various restrictions and risks.

The interest charge approach tries to change the timing of when tax should be paid. Many commentators have indicated that this piece of legislation has a number of shortcomings and will be difficult for the taxpayer and IRS to administer.

Having investigated the taxation of a carried interest in the USA, it will be interesting to investigate the opposite stance taken by the Netherlands, where a carried interest is taxed as income and not capital. This will be done in Chapter 5.

CHAPTER 5

The taxation of a carried interest in the Netherlands

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CHAPTER 5

The taxation of a carried interest in the Netherlands

5.1. Introduction

In the previous chapter the taxation of a carried interest in the USA was investigated. The research was performed to identify how a developed country would interpret the classification of a carried interest. The chapter concluded that the USA treats the receipt of a carried interest as a capital gain.

In this chapter the current taxation of a carried interest in the Netherlands will be discussed. The Netherlands adopted the opposite stance on the normal tax treatment of a carried interest with the USA. This facilitates an interesting comparison between the USA and the Netherlands, and might provide some guidance for the normal tax treatment of a carried interest in South Africa. A brief overview of the Dutch tax regime will be provided first in order to place the discussion into context.

5.1.1. Background

In different countries different interpretations of the taxation of a carried interest have been implemented. In the Netherlands the *Belastingheffing Excessieve Beloningsbestanddelen* (Act of Taxation of Excessive Remuneration) has come into force as recently as 2009 (Braeken, 2012:20). This piece of legislation resulted in amendments to the *Wet op de loonbelasting 1964* (Wage Tax Act of 1964) and the *Wet inkomstenbelasting 2001* (Income Tax Act of 2001) (Pötgens, 2011:465). The implementation of the Act was aimed at directors and private equity fund managers. It had specific consequences for owners of a carried interest and beneficiaries of golden handshakes and high-paying retirement schemes (Braeken, 2012:20).

5.1.2. Structure

The objective of this chapter is to obtain an understanding of how the taxation of a carried interest is viewed in the Netherlands. This will be addressed by investigating and discussing the following:

- motivation for the use of the Netherlands as subject for this research

- the structure and operation of tax legislation in the Netherlands
- the old carried interest regime in the Netherlands
- the current carried interest regime in the Netherlands
- summary and conclusion

The motivation for the use of the Netherlands as subject for this research will be addressed first.

5.2. Motivation for the use of the Netherlands as subject for this research

The Netherlands, like the USA, is a First World country (First, Second and Third World, 2015). Its long history of being a trading nation has given the Netherlands one of the most extensive and advanced tax treaty networks in the world (PWC, 2014:5-6).

The exceptional amount of bilateral investment treaties makes the Netherlands a secure place from which to make investments (PWC, 2014:5). It is therefore one of the top five European countries when it comes to private equity and venture capital investment as per *The Venture Capital & Private Equity Country Attractiveness Index* (Biesinger, Groh, Liechtenstein & Lieser, 2015:24). According to the ranking system the Netherlands has an overall position of 14 amongst 120 countries surveyed, which confirms its important position in the private equity industry.

Similarly to the USA, the Netherlands is a member of the OECD (OECD Member Countries, 2015).

The fact that the Netherlands carried interest regime treats a carried interest as income facilitates an interesting comparison with the USA (PWC, 2014:22).

For the above reasons a study of the Dutch carried interest tax regime is deemed appropriate.

Before the taxation of a carried interest in the Netherlands can be addressed, a brief background of the current Dutch normal tax regime is necessary. This will be presented next.

5.3. The structure and operation of tax legislation in the Netherlands

The *Wet inkomstenbelasting 2001* (the *Wet*) regulates income tax of Dutch residents in the Netherlands (Braeken, 2012:20). The *Wet* consists of 11 chapters. The *Wet* came into force in 2001 as a replacement of the *Wet inkomstenbelasting 1964* (PWC, 2014:15). The implementation of the *Wet* is overseen by the *belastingdienst* (Braeken, 2012:20).

A brief discussion of the Dutch tax regime is provided in order to put the current taxation of carried interest into context.

Dutch residents are taxed on their worldwide income. Non-residents are subject to tax only on income derived from specific sources in the Netherlands (PWC, 2014:21). The worldwide income of residents are divided into separate 'boxes' and is hence referred to as the box-regime (Braeken, 2012:20). Each box is taxed differently, each having its own tax schedule (PWC, 2014:21).

Box 1

Income from employment and activities linked to employment (like fringe benefits) are taxed in this box, together with personal enterprise profits as an entrepreneur (Wesselink, 2008:3). The definition of income from employment is governed by the *Wet op de loonbelasting 1964* (the *Loonwet*). The definition can be widely interpreted and according to Braeken (2012:21) includes anything enjoyed on account of employment, including reimbursements or grants in the context of employment.

According to De Bats (2009), *inkomen uit overige werkzaamheden* (income from other activities) is also taxed under box 1, and falls between:

- income from normal asset management, with no more labour than would be fitting to realise a return that may on average be expected from investment of capital (which would normally be taxed under box 3), and
- income from an enterprise, whereby labour and capital is employed on a regular basis and it can be reasonably expected that it is aimed at a profit.

Apart from the above a deemed income is also applicable from home ownership of a principal residence, but this will not be elaborated on since it is irrelevant to this research (PWC, 2014:22).

Box 1 is the only box of which the income is taxed at progressive rates. The rates are divided into four brackets that range from 36.5% to 52%, with the highest bracket starting at € 57 585 (PWC, 2014:22).

Box 2

According to Braeken (2012:20), income included in this box is receipts received from an *aanmerkelijk belang* (substantial interest). A substantial interest is defined as holding shares, or right to acquire shares, equal to at least 5% of a company. The income from this substantial interest is usually dividends or gain on sale of the shares or rights (Braeken, 2012:20).

Box 2 is taxed at a flat rate of 25%. This results in an effective tax rate of 43.25%, owing to the fact that companies are taxed at 25% (PWC, 2014:16).

Box 3

All income from savings and investments are grouped in box 3 (Wesselink, 2009:3). These are assets that are not for daily use and that are not taxed in box 1 or 2 (PWC, 2014:23). The actual income from savings and investment is not taxable (PWC, 2014:22). Instead the average net assets at the beginning of the year are deemed to generate a fixed return and this fixed return is subject to tax. The net assets, which are the assets less liabilities, are deemed to provide a return of 4% per year (Wesselink, 2009:3). This return is taxed at a flat rate of 30% (PWC, 2014:22). This results in an effective tax rate of 1.2% on the net amount of savings and investments (Braeken, 2012:21). Box 3 does not tax returns above 4% on these assets, nor does it provide a deduction if the actual return is below the 4% (Wesselink, 2009:3).

Before the new Dutch carried interest regime can be discussed, the old regime needs to be investigated. This is addressed in the ensuing section.

5.4. The old carried interest regime in the Netherlands

As discussed in Chapter 2 the investment by fund managers is usually between 1% and 5%. It is thus clear that the income derived from a carried interest will usually fall outside of box 2 of the Dutch tax regime. The receipt should therefore be placed in either the first or third box. The broad definition of income from employment in the *Loonwet* makes it plausible that a carried interest can be classified in box 1, to the extent that the consideration paid is lower than the fair value of the interest (Braeken, 2012:21).

According to Braeken (2012:21), this resulted in debate amongst the *belastingdienst* and the fund managers. The *belastingdienst* argued that the 'excessive part' of the return made on the realisation of the investments should have been deemed income and taxed in box 1, since the interest was provided for management services supplied to the fund and its investments. On the other hand, the fund managers stated that the amount could only be remuneration if the fund managers were able to acquire the investments for a price below its fair value. However, this is not usually the case as the value is only unlocked once the management expertise are applied to the company. Hence fund managers had the receipt taxed in box 3 at the favourable 1.2% effective tax rate (Braeken, 2012:21).

In practice, the two parties often met each other halfway by classifying the income into box 2 as this was approximately an average between boxes 1 (52%) and box 3 (1.2%) (Braeken, 2012:22). This was not the case for all taxpayers, but the lack of case law indicates that the *belastingdienst* did not have confidence that the courts would rule in its favour. The *Ministerie van Financiën* (Ministry of Finance) consequently changed the legislation to eliminate uncertainty and the taxation of carried interest became subject to the Act of taxation of excessive remuneration (Wesselink, 2008:4).

The Act of excessive remuneration and its effect on the taxation of carried interest in the Netherlands will be discussed next.

5.5. The current carried interest regime in the Netherlands

The Act of excessive remuneration introduced a new tax regime for so-called '*lucrative belagen*' (lucrative interest) (Pötgens, 2011:465). As per the legislation the income from lucrative interest is taxed under the category income from other activities (as explained

under box 1 above) (Braeken, 2012:22). According to Pötgens (2011:465), by placing it in this category the legislator is targeting excessive income earned by private equity fund managers or managing partners. It is deemed excessive because it gives these managers an opportunity to substitute their remuneration for shares, debt claims or other property that result in returns that are out of proportion with the capital invested (Pötgens, 2011:465). Wesselink (2008:4) goes on to add that the legislator has not chosen to include this under the income from employment category, because the income received is not exclusively received by employees and the employee might no longer work for the fund manager at the date of receipt.

5.5.1. Lucrative interest

A lucrative interest is divided into four groups in section 3.92(b) of the Wet. It is broadly defined as a form of reward granted to a person with the intention to be remuneration for services rendered by that person or related persons (Wesselink, 2008:4). If the reward is received in exchange solely for investment of capital, there is no lucrative interest (Braeken, 2012:22).

If the reward is classified as a lucrative interest, the lucrative interest is deemed to form an activity generating box 1 income (Braeken, 2012:22). This results in the receipts or benefits derived from the lucrative interest to be subject to box 1 tax rates, which entails progressive rates up to 52% (Wesselink, 2008:4).

The four categories of a lucrative interest will be discussed below.

5.5.1.1 Categories of a lucrative interest

Category 1: Subordinated shares (Section 3.92(b), paragraph 2a)

The first category is aimed at a taxpayer that holds a class of share which is subordinate to another class of share. These subordinate shares are lucrative if it does not account for more than 10% of the value of all issued shares (Braeken, 2012:23).

Category 2: Shares with high dividend (Section 3.92(b), paragraph 2b)

This category is aimed at a taxpayer that holds a class of shares that generate a particularly high return. A return is deemed high if it is 15% or higher per year (Wesselink, 2008:5).

Category 3: Contingent loans (Section 3.92(b), paragraph 3)

The third form of a lucrative interest is profit sharing loans (Wesselink, 2008:5). These are loans with a value or interest rate depending on *enigszins belangrijke mate* (to some important extent) on the realisation of management targets (Braeken, 2012:24). These management targets can include variables such as inter alia profit, sales, or the extent of cost reduction (Wesselink, 2008:5). According to Braeken (2012:24) the general premise in Dutch tax law is that *enigszins belangrijke mate* is quantified as 15%.

Category 4: Other rights (Section 3.92(b), paragraph 4)

The final category aims to widen the lucrative interest net. It increases the range by including instruments that would otherwise have fallen outside of the first 3 categories but still result in excessive profit (Braeken, 2012:24). In essence, rights which resemble the characteristics of the previous mentioned categories, or rights which have a value contingent on management targets (as in category 2), fall into this category (Wesselink, 2008:6). However, the right must still be related to employment. The legislation can be very widely interpreted, and this is to prevent complex structures in the fast paced, always changing private equity environment (Wesselink, 2008:6).

The lucrative interest principle is next applied to a carried interest.

5.5.1.2 Application of the lucrative interest principle to a carried interest

A carried interest will fall into category 1 of the lucrative interest regime (Pötgens, 2011:465). According to Braeken (2012:23), if one type of share is subordinate to another, it usually means that there is another class of share with a preferred return. The preferred return is usually limited, which makes it possible for the taxpayer to realise unlimited returns on his subordinated shares.

Category 4 encompasses any similar arrangement with the same characteristics, such as when a carried interest is held by the fund manager of a partnership. In that case the limited partners hold a share in the partnership that provides a preferred return (the hurdle rate) and the fund manager holds a share in the company that is subordinated to the limited partner's share (and is only allowed to share in profits once the hurdle rate has been achieved). This, together with the fund manager's investment of less than 10%, results in the fund manager's right to be deemed a lucrative interest and thus the returns from a carried interest to be taxed under box 1.

According to Braeken (2012:23), the State Secretary argues that this legislation will give the *belastingdienst* an additional opportunity to levy taxation on the carried interest. The wording of the legislation results in the income derived from a carried interest being taxed upon realisation of the income. This removes the valuation disputes at the time of receipt of a carried interest, since the *belastingdienst* can levy tax at a later stage. This addresses the situation where income from lucrative interest is paid directly to an individual. The question arises what the effect will be when income from lucrative interest is paid to an individual via a holding company.

5.5.2. Indirect lucrative interest (Section 3.95b)

The lucrative interest regime is still applicable even if the income from the lucrative interest is paid to an individual via a holding company (Braeken, 2012:25). If this is the case the holding company is treated as a pass-through entity and the lucrative interest is deemed to be held directly in the hands of the indirect owner of the lucrative interest (holding company) (Wolftring & Daniels, 2015). Therefore, instead of decreasing the tax liability to an effective rate of 44%, the total effective taxation paid is 64% (assuming that the individual has a substantial interest and therefore the holding company is liable for 52% tax and the individual 25% on the distributions by the holding company).

According to Wolftring & Daniels (2015), the indirect holding does however provide an opportunity to lower the tax burden. According to paragraph 5, if at least 95% of the income from the lucrative interest passes through the holding company to the individual, the individual can classify the income from the holding company as box 2 income. The taxpayer is therefore able to reduce the taxation of the income from the lucrative interest from 52% to an effective rate of 43.25%.

As is the case in the example of a private equity structure in Chapter 2, private equity investment funds often make use of partnerships. This is also applicable in the Netherlands where a *commanditaire vennootschap* is very popular within the private equity industry (Wolftring & Daniels, 2015). It is thus possible that the fund manager is a partnership of which the fund managers are partners. From a Dutch law perspective, such a situation does not result in indirect holding of the lucrative interest, because the partnership is a tax transparent vehicle and for this reason the lucrative interest is deemed to be held by the individual(s) directly (Braeken, 2012:25).

5.6. Summary and conclusion

The Netherlands have had significant changes made to the taxation of a carried interest recently. Before 2009 the Netherlands taxed a carried interest as box 3 income and it was thus subject to a favourable effective tax rate of 1.2%.

The change in legislation brought about a complete overhaul of the current carried interest regime and resulted in a carried interest being taxed in box 1, up to a maximum marginal rate of 52%.

The current carried interest regime does not account for a method to separate the capital and labour elements that exist within a carried interest. Instead, all components are treated the same and taxed as income.

Taxing a carried interest at such a high rate seems somewhat excessive, as this could discourage fund managers to take on risk in order to obtain higher proceeds. If South Africa was to follow a similar method of taxation it could result in an outflow of foreign investment. South Africa would have to investigate what effect this would have on the local economy.

With the results of this chapter, along with Chapters 2, 3 and 4, the three carried interest regimes will be compared and a final conclusion will be made in the next chapter.

CHAPTER 6

Comparison and conclusion

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CHAPTER 6

Comparison and conclusion

6.1. Introduction

The previous chapter explained the structure and operation of Dutch tax legislation and used this to investigate the current carried interest regime in the Netherlands. It was concluded that the Netherlands taxes a carried interest as income and not as capital.

In this chapter the final findings of the study are presented. The research in this study was undertaken in an effort to determine the nature of a carried interest for South African normal tax purposes when distributed to the fund manager of an investment fund.

In order to address this, the following secondary research questions were discussed first:

- Does a carried interest initially distributed by an investment fund to a fund manager constitute a fringe benefit?
- If not a fringe benefit, does a carried interest distributed by an investment fund to a fund manager constitute gross income in terms of other provisions of the Act?
- What is the nature of the cash flow from a carried interest, for normal tax purposes, earned by the investment fund upon the liquidation of the fund?
- What is the effect of section 9C of the Act on the underlying investments of, and consequently on a carried interest in, an investment fund?
- What is the effect of the guidelines formulated by the South African courts on the underlying investments of, and consequently on a carried interest in, an investment fund?

Subsequently the taxation of a carried interest in other countries was discussed.

The different methods of the taxation of a carried interest in the USA, the Netherlands, and South Africa now facilitate an interesting comparison. For this reason a comparison of the main differences between these tax regimes is made, along with the current normal taxation implications of a carried interest. Lastly, the final conclusion is presented and recommendations are made.

6.2. Fund structures and carried interest design

In order to provide context and background to the study, important concepts and definitions were discussed in Chapter 2. The typical fund structures used by investment funds were discussed and it was explained exactly how a carried interest is earned. A carried interest was described as the right held by a fund manager to share in the future profits generated by the fund that it manages. It was found that the granting of a carried interest to a fund manager is an effective method to align the interests of the external investors with those of the fund manager. This is because both the fund manager and external investors will aim for maximising of profits with the least amount of risk.

It was deduced that a carried interest has both the character of income and capital, because a carried interest is received for the provision of management services to the fund as well as in return for a capital investment by the fund manager.

6.3. The taxation of a carried interest in South Africa

In Chapter 3 the taxation of a carried interest in South Africa was discussed. The chapter highlighted the operation and structure of South African tax legislation. The objective of the chapter was to examine the nature of a carried interest for normal tax purposes in South Africa without specific legislation in this regard.

The application of the Act resulted in the conclusion that the fund manager does not perform its services mainly at the premises, nor under the supervision of the person by whom payment is made. For this reason the fund manager performs its services independently of the investment fund. As a result the initial receipt of a carried interest is not regarded a fringe benefit, as the prerequisite of an employee-employer relationship does not exist.

Furthermore, reference to the definition of gross income and substantiating case law indicated that the receipt of a carried interest does not constitute gross income. This is owing to the fact that the fund manager initially only receives an entitlement to share in future profits of the investment fund. The market value of this entitlement cannot be determined at the initial receipt of a carried interest. Thus, a determinable value cannot be placed on the entitlement. For this reason a carried interest cannot be seen to constitute an amount, and consequently, not gross income.

Next, it was necessary to shift the focus of the study towards the cash flow from a carried interest upon realisation of the investments of an investment fund. It was concluded that the cash flow from a carried interest has a closer relationship with the risking of capital than with the provision of services by the fund manager. Therefore, the amount received as cash flow from a carried interest is not classified as an amount received in respect of services rendered.

The cash flow originating from the realisation of the underlying investments of the investment fund was discussed next. The use of a tax transparent vehicle in the typical investment fund organisation results in the application of the conduit pipe principle, where receipts retain their nature when they are distributed. Thus, the nature of the underlying investments were investigated. The application of relevant case law indicated that the investments of such investment funds are normally held with the dominant intention for resale. It was thus established that the underlying investments are income in nature and would result in the proceeds from their realisation being included in gross income.

However, the overriding effect of section 9C of the Act also required consideration. The application of section 9C of the Act makes it possible for the underlying investments to be deemed capital in nature if certain requirements are met. Thus, it was concluded that the cash flow from a carried interest and its subsequent distribution to fund managers is capital in nature, except for where the assets meet one of the following exceptions:

- The equity shares of the underlying investments are held for a period not exceeding three years.
- The underlying investments consist of equity shares in non-resident companies that are not listed in South Africa.
- At the time of the disposal the taxpayer (shareholder) is a connected person to the company that issued the shares and more than 50% of the market value of the equity share is attributable to immovable property at the time of disposal, except if:
 - the immovable property is indirectly held by a person who is not connected to the taxpayer, and
 - the immovable property has been held for a period exceeding three years.

6.4. The taxation of a carried interest in the United States of America

In Chapter 4 the taxation of a carried interest in the USA was discussed. The chapter commenced with a brief background of the current USA normal tax regime.

In the USA the initial receipt of a carried interest is not a taxable event. The partner receives a partnership interest in the form of a profits interest and is deemed a partner of the fund and is taxed just like the other partners. Since a capital gain is labelled as long-term if the underlying asset is held for a period exceeding 12 months, the cash flow from a carried interest is normally deemed capital in nature and subject to taxation at a rate of only 20%.

According to Braeken (2012:69), this treatment was initially aimed to spur innovation and entrepreneurial spirit, as it was aimed as a subsidy for the pooling of capital and labour. This encouraged risky entrepreneurial activity by partnerships. However, lately, investment funds are able to obtain billions in capital from large institutional investors and hold mature companies in their portfolios that bear less risk. For this reason there have been a large number of proposals to rather tax a carried interest as income. These proposals were discussed in Chapter 4 but are subject to regulatory approval before they will be implemented.

6.5. The taxation of a carried interest in the Netherlands

In Chapter 5 the current taxation of a carried interest in the Netherlands was discussed. The Netherlands adopted the opposite stance on the normal tax treatment of a carried interest with the USA. A brief overview of the Dutch tax regime was examined first in order to place the discussion into context.

In the past the Netherlands generally taxed the cash flow from a carried interest as box 3 income. Currently, a carried interest and the cash flow from a carried interest are treated as if it was a wage. It is specifically taxed under the category *income from other activities* in box 1 of the Dutch tax regime.

Taxing a carried interest as income from employment might seem plausible since the cash flow from a carried interest is correlated with the fund's performance for which the fund

manager is responsible. However, a carried interest still has a hybrid character of both the provision of services and a capital investment by the fund manager. The investment fund entails an element of risk, considering that the external investors are willing to provide a carried interest of 20% to the fund manager. Furthermore, if the external investors had no risk and invested, knowing in advance that the hurdle rate would be achieved, they might not provide the fund manager such a high carried interest (Braeken, 2012:67). Therefore, the taxation of carried interest as income for services rendered, and at such a high rate, seems excessive.

6.6. Comparison of carried interest regimes

Neither South Africa, nor the USA or the Netherlands separate the labour and capital elements contained in a carried interest. South Africa and the USA do not tax a carried interest on initial receipt, whereas the Netherlands will tax the difference between the fair value and purchase price as ordinary income. Furthermore South Africa, in certain circumstances, and the USA both tax the cash flow from a carried interest as capital income. South Africa has more requirements for the cash flow to be treated as capital income than the USA. The Netherlands takes the complete opposite stance on the cash flow from a carried interest. All cash flows from a carried interest are taxed as ordinary income. Table 6.1 illustrates the different tax regimes together with the tax treatment of a carried interest.

Table 6.1: Comparison of carried interest and tax regimes

	South Africa	USA	Netherlands
Ordinary income: top marginal tax rate	41%	39.60%	52%
Capital income: effective tax rate	13.65%	20%	1.20%
Difference in percentage points	27.35%	19.60%	50.80%
Percentage difference	66.70%	49.49%	97.69%
Receipt of carried interest (upfront income)	No taxable event	No taxable event	Ordinary income: The amount that fair value exceeds the purchase price
Receipt of cash flow from carried interest (backend income)	Capital income: If underlying asset meets requirements of section 9C	Capital income	Ordinary income

Source: Adapted by author from Braeken, 2012:66

6.7. Conclusion and recommendations

In this study it has been shown that there is a complete opposite approach as to the normal tax treatment of a carried interest by the USA compared to the Netherlands. Braeken (2012:76) views the complete opposite treatment of a carried interest and the cash flow from a carried interest as a consequence of the countries' incompetence in establishing an adequate method to disentangle the labour and capital elements.

Given the illiquid and speculative nature of a carried interest it is hard to assess the value thereof upon initial receipt by the fund manager, and to separate such value between the two different components of labour and investment (Braeken, 2012:79).

When the receipt of cash flow from a carried interest was applied to paragraph (c) of the gross income definition of the Act, it was found that the cash flow from a carried interest has a close relationship with the risk undertaken by the fund manager. The cash flow from a

carried interest therefore does not meet the requirements of paragraph (c) of gross income. Therefore, it was necessary to determine the nature of the underlying investments of the investment fund to determine whether it meets the general definition of gross income.

The underlying assets were found to be income in nature, because they are held with the dominant intention for resale, namely as trading stock. However, the inclusion of section 9C into South African tax legislation has made it possible for fund managers to deem all receipts from the sale of these investments to be capital. Thus, all investments that meet the requirements of section 9C will be deemed capital and the return earned from these investments are capital returns.

The author is of the opinion that the lack of specific legislation regarding the normal tax implications of a carried interest in South Africa causes the unequitable tax treatment of a carried interest. The reasoning behind this is that the capital or income nature of the cash flow from a carried interest depends on several factors. These factors include the length of time of the investment, and the hybrid character (labour and investment) of a carried interest. It is suggested that specific legislation is considered for the taxation of a carried interest in South Africa.

However, it is important that the effect of new legislation is thoroughly researched in order to ensure that this will not result in unintended consequences. Some of these unintended consequences may be the withdrawal of foreign investment from South Africa, a decrease in new foreign investment or an exodus of current resident investment funds.

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