TAXING PRIVATE EQUITY INVESTMENTS IN SOUTH AFRICA

Introduction

Private equity ('PE') and venture capital ('VC') have emerged as a unique alternative asset class in the investment ecosystem in South Africa and on a global scale. While there has been a relative lag in the growth of the asset class in South Africa relative to global averages (notably a 6% compound annual growth rate in South Africa relative to 11% global compound annual growth rate in the last ten years to 2022)[1], the asset class does continue to contribute to infrastructure investment, job creation and financial inclusion for Small and Medium-sized Enterprises in South Africa. For instance, research commissioned by SAVCA shows that in the last two years, employment growth was higher in companies that had private equity investors.[2] This was particularly clear in 2020, when during the Covid pandemic lockdowns, employment fell sharply nationally, yet grew 4.2% among private equity investees, an 8.4 percentage point difference.[3]

Traditional portfolio theory divides the investment universe into listed equity and debt, and then "alternative" asset classes which include infrastructure, real estate, private equity, and hedge funds. Within the alternative asset class, private equity typically provides long-term capital to private companies in exchange for equity combined with managerial and governance support. Venture capital may be seen as a specific case of private equity, in which investment is focused on early-stage companies, enabling start-ups with great potential to rapidly build scale. Investment may also be focused on more mature businesses that can benefit from a private equity firm's experience in building scale, management and reporting structures and improving the marketing strength of the firm. The investment is generally characterized by a buy-to-sell strategy, where equity interests in portfolio companies are bought, the companies actively managed and value realised by selling or floating the business on a public market.

Taxation is a key consideration in structuring private equity investments in South Africa. There are various areas of impact from a tax perspective in a private equity investment, and this may vary depending on the vehicles used across the investment cycle. The subsequent sections highlight some of these tax considerations across the life cycle of private equity investments based on a typical private equity fund structure.

Typical private equity fund structure in South Africa

In South Africa, private equity funds may be structured as fiscally transparent entities to minimize multiple instances of tax. This may be structured as an *en commandite* partnership or a bewind trust.

An *en commandite* partnership is effectively similar to a limited partnership in other jurisdictions, with a general partner and various limited partners. The general partner would have unlimited liability for the obligations of the partnership to third parties. The liability of the limited partners, on the other hand, is limited to their capital contributions, and they remain passive investors. The general partner, on behalf of the fund, typically appoints a management company to administer the management of the fund. In South Africa, the manager may be a

[1] SAVCA, 'Private equity and venture capital in South Africa: A study of the role of private equity and venture capital in delivering public policy objectives', Public Policy Research Report 2023, 5.
[2] SAVCA, (no 1), 2023.
[3] SAVCA, (no 1), 2023.

limited liability company that is licensed to render intermediary services in terms of the Financial Advisory Intermediary Services Act 37 of 2002 (FAIS Act).

Limited partners typically contribute to approximately 98% to 99% of the capital of the fund, and general partners would contribute to the remaining 1% to 2% which would ensure their interests align with those of the limited partners. Even so, general partners would be entitled to a disproportionately larger share of returns from underlying portfolio companies (commonly around 20% of such returns, which may include dividends, interest, disposal proceeds etc) by way of carried interest, should these returns exceed a minimum hurdle rate or preferred return. The manager would receive a fixed management fee which would cater for operating costs year-on-year and for the remuneration of the technical team.

Through a bewind trust the founder or settlor transfers ownership of assets or property to beneficiaries of the trust, but control over the assets or property, is given to the trustee(s). As such, an investment may be made through the trust and a management company may be appointed to act as a trustee. The trust does not own the capital contributed by the settlors but simply manages it on the settlor's behalf.

The equity/capital structure in a portfolio company may constitute both debt and/or equity (constituting ordinary and/or preference shares), taking into account various commercial factors, as well as tax considerations applicable to the investors. It may comprise a combination of shareholder loans, preference shares and ordinary shares.

Taxation of private equity investments

Taxation of private equity investments will vary depending on the vehicle used as a private equity fund and will have varying areas of impact.

Entity level taxation

At entity-level, en-commandite partnerships are generally preferred because they are fiscally transparent entities, and as such, when the partnership receives investment returns, it is deemed to be received by and accrued to each partner. Moreover, the activities to be performed in South Africa in relation to the local fund would not create a permanent establishment in relation to the limited partner, as long as the limited partner remains a passive investor.

In a bewind trust, the investment returns of the trust would be vested in the beneficiaries of the trust rather than in the trust itself, and the beneficiaries should therefore be taxed on such returns. As such, investments would not be taxed at the level of the trust but on beneficiaries.

On the other hand, companies may not provide a preferred option as a private equity vehicle, especially where investors are tax exempt, as the company would be taxable at an entity-level on investment returns and dividends tax may again be imposed on distributions to investors (depending on whether an exemption or tax treaty applies). In this respect, South African companies are subject to corporate income tax at a rate of 27%, 20% dividends withholding tax (unless exempted or reduced by a tax treaty) and capital gains tax **('CGT')** at an effective rate of 21.6%.

Areas of impact

By virtue of s 10 (1) (h) of the Income Tax Act 58 of 1962, returns on investments by way of interest income on shareholder loans to a portfolio company would be exempt from normal tax

in the hands of a foreign investor provided the investor does not have a permanent establishment in South Africa to which the debt claim is effectively connected. However, the interest income in such a case would not be tax-free – instead, it may be subject to withholding tax on interest at a rate of 15%, unless otherwise reduced in terms of the provisions of an applicable tax treaty.

Interest income of resident companies is taxed at the normal corporate income tax rate. Interest income attributable to South African pension funds or other South African institutional investors would be exempt from tax in terms of section 10(1)(d)(i) of the Income Tax Act.

Interest expenses would in turn generally be deductible from the taxable income of a portfolio company if they were incurred in the company's production of non-exempt income and in the carrying on of its trade, subject to possible detailed limitations (where the recipient is not subject to tax on the interest income in South Africa or where the debt otherwise relates to acquisition debt). Certain aspects of interest deductibility are currently under consideration by National Treasury and subject to possible legislative amendments and would need to be carefully considered.

Dividends received in respect of equity shares held in a portfolio company that is resident in South Africa would generally be exempt from South African income tax in the hands of both a local and foreign investor, subject to certain fact specific exclusions. However, the dividends from a resident company to a foreign investor would be subject to dividends withholding tax at the rate of 20%, unless otherwise reduced in terms of the provisions of an applicable tax treaty.

Income arising from a divestment or exit would typically be subject to capital gains tax. Private equity funds typically have a maturity exceeding three years and therefore any disposal of equity shares would be deemed to be capital in nature in terms of s 9C of the Income Tax Act, including the disposal proceeds accrued to the general partner as carried interest.

However, the disposal may be subject to **anti-dividend stripping rules** under s 22B and par 43A of the Eighth Schedule to the Income Tax Act. This may apply, for instance, if a resident company is an undisclosed partner in an *en-commandite* partnership. These rules effectively buffer against mechanisms by resident companies to (i) dispose of shares in their portfolio companies on a tax-free basis by way of a subscription buyback, or (ii) following the declarations of large tax-exempt dividends which erode the value of the portfolio company, incurring little to no capital gains tax on a subsequent disposal of the shares in the portfolio company.

Typically, rather than purchase shares directly from the shareholder, an acquiring company may subscribe for shares directly in the portfolio company. The portfolio company would then use the proceeds from the share subscription to repurchase the shares of the existing resident company shareholder. In such a case, and absent the anti-dividend stripping rules, the CGT proceeds are nil, and the resident company does not pay dividends tax as the proceeds from the repurchase would be exempt from dividends tax as they are paid to a resident company.

The anti-dividend stripping rules would re-characterise the ordinarily exempt dividends received by a qualifying shareholder as proceeds (for capital gains tax) or income, in certain circumstances, where such dividends exceed a threshold of 15% of the higher of the market

value of the shares being repurchased (i) 18-months prior to the repurchase and (ii) at the date of the repurchase.

A share is a security and therefore under the Securities Transfer Tax Act 25 of 2007, securities transfer tax is leviable at 0.25% on the taxable amount of the shares transferred. From a CGT perspective, securities transfer tax incurred on the acquisition of shares is included in the base cost of the shares. Moreover, considering shares are identical assets, shareholders would be required to determine the base cost of the assets based on specific methods provided in paragraph 32 of the Eight Schedule to the Income Tax Act.[4] Moreover, any return of capital received prior to the disposal of the shares would reduce the base cost of the shares and ultimately increase the CGT gain on disposal (see par 76B of the Eighth Schedule).

From a Value Added Tax (VAT) perspective, a supply of shares is exempt from VAT (see s 2(1)(d) and 12(a) of the VAT Act 89 of 1991).

Conclusion

Given the various considerations that are relevant to private equity investments and given the long-term nature of the underlying asset, it is important to consider the structure upfront and obtain advice where relevant. Taxation is an important factor to consider and could impact the return on investment if the investments are not efficiently structured. As such, business entities in the PE/VC ecosystem should always consider the taxation landscape, the success of their ventures may depend on it.

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[4] These include the weighted average cost, specific identification or first in first out methods.