



Issues Relating To Organizational Forms And Taxation

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- 1. Identify the forms of organization available in your jurisdiction and discuss the advantages and disadvantages of each (eg., corporation, limited liability company, partnership, limited partnership, co-operative, etc.), describing which type of legal entity is mostly used or is of special interest, namely by foreign investors.**

There are various legal entities or organizations available to conduct business in South Africa. These are the company, external company (local branch of a foreign company), close corporation, partnership, business and sole proprietorship.

Companies are the most common investment vehicles for foreign investors in South Africa. A company has a separate legal personality from its members who enjoy limited liability, and continues to exist despite changes in shareholding. There are two types of companies, a private company (with between one and seven members) and a public company (with 50 or more members). The right to transfer shares in a private company is restricted and offers to the public for the subscription of shares or debentures are prohibited. Both natural and juristic persons can hold shares in a company.

An external company presents a unique investment vehicle for foreign investors in South Africa. This is discussed further in 2 below.

A close corporation is not appropriate for foreign investors as only natural persons (a maximum of ten) may hold an interest in it. Close corporations are cheaper and quicker to establish and maintain than companies. A close corporation also has a separate legal personality from its members who enjoy limited liability, and continues to exist despite changes in membership. There is no statutory audit requirement for close corporations however the accounting officer must report that the annual financial statements accord with the accounting records.

Partnerships are often used to create joint ventures. There are no specific formalities required to set up a partnership which is governed by common law and may be formed by agreement or implication between two but no more than twenty persons (except for certain professional partnerships). A partnership does not have a separate legal personality from the partners who do not generally have the protection of limited liability (undisclosed partners are not liable to third parties). A partnership terminates each time there is a change in partnership.

Generally, a trust is created by entering into a trust deed which is lodged with the Master of the High Court. A trust enables trustees to carry on a business for the benefit of nominated beneficiaries. Although a trust does not have a separate legal personality, it affords limited liability in that the trustees and beneficiaries are not liable for the obligations of the trust. A trust does not have to submit financial statements or appoint an auditor.

A sole proprietorship exists where an individual conducts business in their personal capacity under a trading name or otherwise. There are no formal requirements for establishing and running a sole proprietorship. The sole proprietor is taxed as a natural person. There is no perpetual succession or limited liability. This is obviously not an appropriate investment vehicle.

2. Are there attributes of the form that you consider unique to your jurisdiction?

The external company creates a unique investment vehicle in that it allows any foreign company, with the exception of banking and insurance companies, to establish a place of business and carry on its activities in South Africa without forming a separate locally incorporated company.

The external company is a company incorporated outside South Africa that establishes a place of business in South Africa. A foreign company is deemed to have established a place of business in South Africa where it acquires immovable property in the country. A foreign company that wishes to conduct business in South Africa through a branch in its own name must register with the Registrar of Companies as an external company within twenty one days of establishing a place of business.

The external company does not have a separate existence from the foreign head office. The external company must comply with the provisions of the Companies Act, including the submission of statutory returns and the filing of annual financial statements for its entire operations (not only its South African operations) with the Registrar of Companies. An exemption may be granted in respect of these filing requirements. The external company must appoint a South African resident authorised to accept notices served on the company. Once registered with the Registrar of Companies, an external company will effectively be treated like a South African incorporated company. An external company may be converted to a local private company, subject to certain requirements.

3. Describe the management and governance structure for each organizational form.

Generally speaking, the shareholders retain ultimate responsibility for the company and have the power to appoint and remove directors, they in effect delegate the day to day running of the company to the directors who in turn appoint and supervise management. The board of directors must manage the company within the limits of legislation and the memorandum and articles. The board may delegate certain powers to managers and at the same time impose appropriate restrictions and conditions which can be varied or revoked at any time. The directors have a duty to monitor management's performance and ensure that management work within their delegated powers. In the absence of specific cause for suspicion, directors are generally entitled to trust management to perform their duties honestly and to accept and rely on the judgment, information and advice of management when reaching their own decisions. Directors remain ultimately liable, both jointly as a board and individually, for the well being of the company. The directors of a company are natural persons and cannot be corporations. The directors of an external company are the same individuals as the directors of the foreign parent company.

Every member of a close corporation may participate in management unless disqualified by law or the association agreement determines otherwise.

All partners may take part in the management of a partnership unless the parties create a more sophisticated management structure by agreement.

The assets of a trust are managed by the trustee in accordance with the trust deed.

A sole proprietor may manage the business as he or she sees fit.

4. Is there a residency requirement for management or owners? In particular, are there restrictions or prohibitions on foreign investors to perform, or have interests in, specific activities?

There is no such requirement. However, certain ownership and control restrictions and specific authorizations may be required in regulated sectors such as broadcasting, telecommunications, banking, insurance, defence and mining. Furthermore, the non-resident status of individuals, shareholders or directors has a number of consequences. For example, certain investments are required to be marked as "non resident" in terms of the exchange control regulations; thin capitalization rules may apply where financial assistance, such as a loan, is granted by non-residents to connected or related companies; and the nationality of non-South African directors must be disclosed on all documents where directors' names are required to be listed.

5. Describe the extent to which management and owners are exposed to liability.

In general, the shareholders of a company are not liable for the obligations of the company because the company has a separate legal personality from its members. In very limited circumstances, the corporate veil will be pierced. There are very few statutory obligations which apply to owners and managers under our current legislation. At common law, the directors of a company are personally liable for the company's actions if they cannot show

that they acted honestly and with the knowledge, skill and experience which can reasonably be expected of them. Statutory personal liability can arise for fraud or trading when the director knows, or ought to know, that the company cannot avoid insolvent liquidation. Criminal liability may apply to the breach of environmental and health and safety legislation.

In general, the members of a close corporation are not personally liable for the obligations of the close corporation because the corporation has a separate legal personality from its members.

Although a trust does not have separate legal personality, the debts of a trust are normally paid out of the trust estate. As such, trusts offer a form of limited liability in that neither the trustees nor the beneficiaries can be held liable for the obligations of the trust in the absence of fraud.

Partnerships do not generally offer limited liability and the partners are each jointly and severally liable for the obligations of the partnership. Undisclosed partners are not liable for the obligations of a partnership owed to third parties.

A sole proprietor is liable for the obligations of a sole proprietorship.

6. Ownership interest: (i) how is it represented? (ii) is it transferable?; and (iii) is there a minimum number of owners?

Ownership interest in a company is represented in the form of shares. The members of a company may freely transfer their shares, except where the right to transfer is restricted, as is the case with private companies. Furthermore, shares in a private company may not be offered to the public. The number of shareholders in a private company must be between one and fifty. A public company may have at least seven or more shareholders.

Ownership interest in a close corporation is represented by a member's interests expressed as a percentage of all the members' interests. A member's interest in a close corporation can only be transferred with the consent of all the members. A close corporation may have up to ten members who must all be natural persons.

Ownership interest in a partnership is represented by the partners' contribution to the partnership. A member of a partnership cannot transfer their interest in a partnership without the express agreement of all the partners. When a new partner joins or an existing partner leaves a partnership, a new partnership is created. A partnership must be made up of between two and twenty persons (except in the case of certain professional partnerships, where there is no limitation on the number of partners).

Ownership interest in a trust is as set out in the trust deed. The ability to transfer the interests in a trust depends on the trust deed. There is no limitation on the number of trustees or beneficiaries to a trust.

The sole proprietor and the business are one and the same. As such, only the business can be transferred. As the name suggests, a sole proprietorship has one member.

7. Is there a minimum capitalization?



There are no minimum capitalization requirements in South Africa.

8. Is there a security that can be issued to the public?

Generally shares in companies can be issued to the public, subject to certain restrictions and formalities.

[Note: It is not clear to us what this question relates to or if the answer satisfies the question]

9. Can the form incur debt, or grant security for debt?

In general, any one of the entities discussed above can incur debt or grant security.

10. What is the duration of the form? Can it be renewed?

Companies and close corporations have perpetual succession and can therefore continue unless dissolved. Partnerships, trusts and sole proprietorships do not have perpetual succession.

11. Describe the process, customary time period and approximate cost of establishing the form.

A company must register its name and constitutional documents with the Registrar of Companies at the Companies Office. Registration of a new company takes between seven and fourteen days from submission of the relevant documents. It is also possible to buy a shelf company. To operate through a branch, a foreign company must submit certain information and its memorandum and articles of association (constitutional documents) to the Companies Office within 21 days of establishing a place of business in South Africa. The total fee for lodging documents is R400 / US\$53 (an amount will also have to be paid on the authorised share capital of the company). Once all the formalities of the Companies Act have been met, the Registrar must register the company. On Registration, the registrar will issue an incorporation certificate and a certificate to commence business. Only when the latter certificate has been issued may the company commence business. The Companies Act 1973 is in the process of being replaced by a new Act. It is intended that the new Act will streamline the registration requirements. The new Act has been promulgated but will only take effect some time in 2010.

Close corporations must be registered in accordance with the requirements of the Close Corporations Act. A close corporation is formed by complying with the requirements for registering a founding statement. A prescribed fee of R150 / US\$20 is payable. The registration process is much simpler and quicker for close corporations than it is for companies.

In general, a trust is formed by means of a trust deed that is lodged with the Master of the High Court. A prescribed fee of R100 / US\$ 13 is payable on lodging the trust deed.

There are no specific formalities for establishing a partnership which is governed by common law. A partnership is based on an agreement between the parties and requires nothing more.

A sole proprietorship comes into being when a person starts a business. There are no specific formalities for establishing a sole proprietorship.

12. Are there requirements for the government (central or local) to be part of a project or investment vehicle or receive part of the profits arising therefrom (apart from taxes)?

There is no such requirement.

13. For what taxes is the form liable?

Companies incorporated, established or formed in South Africa, or "effectively managed" in South Africa are subject to South African income tax on their worldwide income and capital gains tax (CGT) on their worldwide capital gains.

For tax purposes, a company includes private companies, public companies and close corporations. Companies are taxed at a flat rate of 28% on any income received or accruing to them. Companies are also subject to CGT at a rate of 14% on the disposal of a capital asset.

In addition, South African companies are also subject to secondary tax on companies ("STC") at a rate of 10% on declared dividends. As a result of the income tax rate of 28% and STC rate of 10%, South African companies have an effective tax rate of 34.55%. STC is a tax on the profits of the company and is paid when a company distributes its profits to shareholders.

The beneficiaries of trusts, partners in a partnership and the sole proprietor pay individual tax based on a sliding scale with a maximum marginal rate of 40%. A beneficiary of a trust will be subject to income tax if he or she has vested rights to the income and assets of the trust. If the beneficiary has no vested rights, the trust will be subject to income tax at a rate of 40%.

The beneficiaries of trusts with vested rights, the partners in a partnership and the sole proprietor are subject to CGT on the disposal of a capital asset at a rate of 10%. A trust with no vested beneficiaries is subject to CGT at the rate of 20%.

14. What is the tax treatment of payments to foreign owners?

Non-resident companies, such as external companies (branches), are taxed on income derived from South African sources and on capital gains made on the disposal of immovable assets situated in South Africa, interests in immovable property or assets of their permanent establishments in South Africa at a rate of 33%, unless a double tax treaty provides otherwise.

There is generally no tax on interest paid to foreign corporate shareholders exceptions include interests attributable to a South African permanent establishment or paid in the form of an annuity.

The proposed amendments to the Income Tax Act ("ITA") seek to tax interest paid to non-residents in certain circumstances. The interest exemption will apply to savings that flow into the general economy i.e. interest received from products listed on the JSE, interest paid to any one of the three spheres of governments, interest from dealer or brokerage accounts etc. If the proposed amendments become law, they will come into operation on 1 March 2011. A

double tax treaty may reduce the rate of tax payable by the non-resident or provide that the interest is taxable in the non-resident's home country.

Royalties paid to non-residents from a South African source are subject to a withholding tax imposed at the rate of 12%. This rate may be reduced by a double tax treaty, if any.

15. Is there a tax treatment which would impact foreign owners differently than owners resident in the jurisdiction?

Foreign shareholders need to comply with transfer pricing and thin capitalisation rules contained in the ITA. The transfer pricing provisions require transactions between related/connected parties to be effected at an arm's length price and empower SARS to adjust prices that do not reflect an arm's length price, in other words, prices that are artificially high or low.

Thin capitalisation rules apply where a foreign shareholder gives financial assistance (includes the making of a loan, advance or debt and the provision of any security or guarantee) to a resident, and the non-resident and resident are connected persons in relation to each other. If the financial assistance is considered to be excessive in relation to the fixed capital, any interest, finance charge or other consideration payable in respect of the loan which relates to the excessive amount will not be allowed as a deduction in the hands of the resident borrower. An excessive debt to equity ratio is one that exceeds the ratio of 3:1.

The resident borrower cannot deduct interest of the excessive amount from its taxable income and in addition, the excessive amount will be deemed to be a dividend and be subject to STC.