THE PRIVATE EQUITY REVIEW

SEVENTH EDITION

Editor
Stephen L Ritchie

THE LAWREVIEWS

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Seventh Edition

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Stephen L Ritchie

THE LAWREVIEWS

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PREFACE

The seventh edition of *The Private Equity Review* follows a turbulent and at times nerve-wracking 2017. It was also a year in which private equity demonstrated its strength as an asset class in spite – perhaps because – of that turbulence. Deal activity and fundraising were strong in almost every major market despite fierce competition from public strategic buyers and strong returns in other asset classes, demonstrating private equity's ability to adapt quickly to changing conditions to find profitable investment opportunities. As a result, we expect private equity will continue to play an important role in global financial markets, not only in North America and Western Europe, but also in developing and emerging markets in Asia, South America, the Middle East and Africa. In addition, we expect the trend of incumbent private equity firms and new players expanding into new and less-established geographical markets to continue, although recent protectionist trends remain a risk factor.

While no one can predict how 2018 will unfold, one can confidently say that private equity will continue to play an important role in the global economy, and will likely seek to expand its reach and influence. It remains to be seen how local markets and policymakers respond.

Private equity professionals need – now more than ever – guidance from local practitioners about how to raise money and close deals in multiple jurisdictions. This review has been prepared with this need in mind. It contains contributions from leading private equity practitioners in 27 different countries, with observations and advice on private equity deal-making and fundraising in their respective jurisdictions.

As private equity has grown, it has also faced increasing regulatory scrutiny throughout the world. Adding to this complexity, regulation of private equity is not uniform from country to country. As a result, the following chapters also include a brief discussion of these various regulatory regimes.

I want to thank everyone who contributed their time and labour to making this seventh edition of *The Private Equity Review* possible. Each of them is a leader in his or her respective market, so I appreciate that they have used their valuable and scarce time to share their expertise.

Stephen L Ritchie
Kirkland & Ellis LLP
Chicago, Illinois
March 2018

Part I

FUNDRAISING

Chapter 18

SOUTH AFRICA

Johan Loubser, Magda Snyckers and Lorica Elferink[1]

I GENERAL OVERVIEW

The private equity industry in South Africa is among the most established in emerging markets and has fund types that vary by fund vehicle, investment stage, size and sector specialisation.

With respect to the size of the industry, at the end of 2016 (the most recent year for which data is available) the industry employed around 780 investment professionals and had funds under management of approximately 171.8 billion rand (including both government and private funds), located both locally and abroad.[2] The membership of the local industry association, the South African Venture Capital Association (SAVCA), includes more than 100 fund manager firms.[3] These numbers include fund managers who raise funds from third parties and fund managers who manage on-balance sheet investments for banks, insurance companies, investment holding companies and government development agencies. At the end of 2016, fund managers managing third-party funds had approximately 108 billion rand of assets under management and undrawn commitments of approximately 54.9 billion rand.[4] The amount raised from third parties during the 2016 calendar year was estimated to be 10.2 billion rand, earmarked mostly for early-stage South African developments.[5] Pension and endowment funds were the source of 40.2 per cent of all third-party funds raised during 2016. Government, aid agencies and DFIs accounted for 20.6 per cent and insurance companies and institutions made up 19.6 per cent of funds raised in 2016.[6] The South African private equity industry is dominated by a small number of independent fund managers who can point to their successful historical track records, although there are also a fair number of promising new players and fund managers affiliated with local banks and insurers.

While private equity fundraising activity and the success rate thereof has not returned to 2006–2007 levels, the relatively expensive level of equities on the Johannesburg Stock Exchange (JSE), regulatory acceptance of investment by South African pension funds in private equity funds, the South African government's renewable energy programme, the need

1 Johan Loubser, Magda Snyckers and Lorica Elferink are directors at ENSafrica.
2 SAVCA, 2017 Private Equity Industry Survey covering the 2016 calendar year, published in June 2017 (see http://www.savca.co.za/wp-content/uploads/2017/06/SAVCA-2017-Private-Equity-Industry-Survey-electronic.pdf), pp. 2, 5 and 9 (the SAVCA Survey, 2017).
3 See http://savca.co.za/member-category/full-member/.
4 SAVCA Survey, 2017, pp. 5 and 9.
5 SAVCA Survey, 2017, p. 19.
6 SAVCA Survey, 2017, p. 19.

for banks to reduce their loan books, infrastructure requirements and the economic growth enjoyed by some sub-Saharan African countries are fuelling renewed interest in private equity investment.

There is also an increase in funds raised outside South Africa and that will invest in other sub-Saharan African countries, but which will be managed by managers with strong links to South Africa. Investors in such funds typically include international development finance institutions and, increasingly, South African institutional investors.

II LEGAL FRAMEWORK FOR FUNDRAISING

As mentioned in Section I, *supra*, the South African private equity industry includes significant on-balance sheet investment by special purpose acquisition companies, insurance companies, banks, investment holding companies and government agencies and institutions. For example:

a Special purpose acquisition companies are permitted to list on the JSE. Such a company may not carry on any commercial or business operations at the time of its application for a listing,[7] but must within 24 months from the date of its listing[8] acquire assets meeting the qualifying criteria of the main board or the alternative exchange (AltX) of the JSE.[9] In order to list on the main board of the JSE an applicant must raise at least 500 million rand through the issue of shares. A minimum of 50 million rand must be raised for a listing on the AltX.[10] All capital raised must be held in escrow with an escrow agent until acquisitions of qualifying assets are made.[11] We anticipate that this type of vehicle, together with investment entities (discussed below) may in future be used as an alternative to the more traditional private equity funds structures.

b In addition, entities whose principal business is investment in securities are permitted to list on the JSE. Such an investment entity could, for example, purchase existing private equity fund portfolios and serve as a vehicle through which investors could gain long-term exposure to portfolio companies while enjoying the benefit of increased liquidity.[12] For example, Ethos Capital Partners raised 1.8 billion rand by listing on the JSE in a private placement in August 2016.[13]

c Long-term insurance companies hold large unlisted investments on their balance sheets, often on account of linked policies issued to policy holders on the basis that the policy proceeds will be equal to the realisation achieved with respect to the 'linked' unlisted investments, less costs and taxes. It is common for such insurers to group such unlisted assets together in a portfolio managed by a specialised asset manager, and for policies linked to such portfolio to be managed as if the portfolio was held in a separate pooled fund vehicle.

7 JSE Listings Requirements 4.34(a).

8 JSE LR 4.35(a).

9 JSE LR 4.33 – see definition of 'Viable Assets'.

10 JSE LR 4.34(g).

11 JSE LR 4.34(h).

12 JSE LR 15.

13 www.savca.co.za/press-release-ethos-capital-debuts-on-jse-following-r1-8-billion-oversubscribed-private-placement/ (last accessed on 27 January 2017).

d There has been a marked increase in the creation of venture capital companies (VCCs) benefiting from the favourable tax incentives introduced by Section 12J of the Income Tax Act.[14] The investors in such funds typically include high net worth individuals who make use of the tax deductibility of their subscription for shares in VCCs. As at the time of writing, more than 60 VCCs have been approved by the South African Revenue Service.[15]

e Private equity funds housed in unlisted investment holding companies – so-called permanent capital vehicles – are becoming a feature of the South African market. A permanent capital vehicle is appropriate where it is thought that the lifespan of a traditional private equity fund is too short to build and realise the underlying investments.The intended exit mechanism for investors investing in such a company is a listing of the company's shares. The company is usually managed by a separate fund manager.

It falls outside the scope of this chapter to discuss comprehensively the legal, tax and regulatory framework within which all of the above-mentioned industry participants raise and invest funds. The focus of this chapter is on fundraising by fund managers from third parties who invest in more traditional closed-ended funds domiciled in South Africa and that are governed by South African law and also on certain tax and exchange control issues arising for investors into South Africa and certain foreign domiciled funds.

i South African private equity structures

The principal vehicle housing South African private equity funds investing in South Africa is the limited liability partnership (called *en commandite* partnerships). A trust structure (called a bewind trust) is also sometimes used. The main reasons for the use of these entities to house funds are the following:

a they permit the income and capital gains of the fund to be taxed in the hands of investors according to the tax profile of each investor;

b they provide investors with limited liability, so that an investor will not have liability exceeding its contractual commitment to the fund;

c they are not subject to cumbersome regulatory oversight and can be established with relative ease;

d they allow the day-to-day affairs of the fund and all operational matters to be outsourced, which permits the fund manager a high degree of autonomy; and

e they permit the use of the types of contractual terms and organisational practices that are commonly used internationally.

Limited liability partnership

An *en commandite* partnership is established by contract. The contract between the parties should expressly reflect the intention of establishing an *en commandite* partnership and should expressly identify the general or disclosed partner.[16] There are no registration requirements

14 The Income Tax Act No. 58 of 1962 (the Income Tax Act).

15 http://www.sars.gov.za/AllDocs/Documents/Venture%20Capital%20Companies/20180123%20LIST%20OF%20APPROVED%20VENTURE%20CAPITAL%20COMPANIES%20(website).pdf (last accessed on 6 February 2018).

16 The Law of South Africa (Lawsa) Vol. 19, JJ Henning Partnership, Paragraph 260.

for establishing, and no legislation regulating, *en commandite* partnerships. An *en commandite* partnership is carried on by one or more partners, called the general or managing partner or partners, to which every partner whose name is not disclosed, called a commanditarian partner or partner *en commandite*, contributes a fixed sum of money on condition that he or she receives a certain share of the profit, if there is any, but that in the event of loss he or she is liable to his or her co-partners to the extent of the fixed amount of his or her agreed capital contribution only. Commanditarian partners:

a are not presented as partners (and accordingly, persons dealing with the partnership do not form the mistaken impression that they are entitled to rely on the credit of the commanditarian partner);

b are not liable for partnership debts to creditors of the partnership, and are only liable to their co-partners to the extent of their agreed capital contribution (and therefore enjoy the benefit of limited liability);

c may not participate actively in the business of the partnership (although the commanditarian partner may be entitled to advise the managing partner and may also enjoy limited consent rights); and

d cannot claim repayment of their contributions or payment of their share of the partnership profits in competition with the creditors of the partnership.[17]

The general partner of the *en commandite* partnership has unlimited liability toward creditors of the partnership in circumstances where the partnership's assets are insufficient to settle relevant debts. The *en commandite* partnership usually terminates by agreement between all the partners or in accordance with the terms of the partnership agreement, which may, for example, provide that the general partner may terminate the partnership on notice to the other partners. All commercial aspects of the partnership, such as profit share arrangements, permitted expenses, investment restrictions and so forth, are usually contained in the partnership agreement. The partners have wide discretion to arrange their affairs in the partnership agreement in accordance with their commercial intentions, provided that the partnership adheres to the requirements for an *en commandite* partnership (and subject to general requirements for enforceable contracts, such as the requirement that the terms of the agreement should be sufficiently certain). The terms of the partnership agreement are not publicly available. *En commandite* partnership agreements usually provide for the removal and replacement of the general partner.

Bewind trust

A bewind trust differs from other forms of trusts under South African law in that the trustees do not own, but merely hold and administer, the assets of the trust that are owned in undivided shares by the beneficiaries of the trust.[18] The trust property does not form part of the estate of the trustee[19] except insofar as the trustee is also a beneficiary. The trust is established by way of a trust deed. Copies thereof may be requested from the Master of the High Court by any person who has, in the opinion of the Master, sufficient interest therein.[20]

17 Id., Paragraph 258.

18 Lawsa Vol. 31, MJ De Waal and others, Trusts, Paragraph 531.

19 Section 12 of the Trust Property Control Act 1988 (the Trust Property Control Act).

20 Section 18 of the Trust Property Control Act.

The trustees may not act as such until they have been authorised to do so by the Master[21] after following a simple registration process. The Master has limited regulatory powers in relation to the trust in terms of the Trust Property Control Act 1988 and may, for example, in certain instances remove the trustee or apply to court for his or her removal.[22]

Fund organisation

In the South African context, the vehicle housing the private equity fund (whether a partnership or a trust) would typically appoint a separate fund manager or adviser in terms of a written mandate to manage the day-to-day affairs of the fund and to identify and execute investments and disinvestments. Increasing use is also made of independent valuators.

Although practice varies, the fund manager or adviser would not always have direct contractual obligations to specific investors (save if created by way of a side letter) and would in many cases only owe contractual obligations to the trust or partnership housing the fund.

Although it is standard practice for the attorneys advising on the establishment of the fund to issue an opinion confirming that the applicable agreements have been duly authorised and are lawful, valid and enforceable, such opinion is often given to the fund rather than applicable investors.

The matters typically addressed in the applicable trust deed or partnership agreement have, over time, to a large extent become standardised. Investors in a South African private equity fund could expect contractual provisions dealing with the following matters, among others:

a minimum investment requirement for the fund manager, adviser or associate;
b the admission of further investors following the first closing;
c time periods for the making of investments and disinvestments by the fund;
d investor default;
e guidelines, requirements and prohibitions relating to investments;
f the composition and functions of the investor advisory board;
g reporting requirements;
h key personnel assurances during and after the commitment period;
i conflicts of interest;
j co-investments;
k allocation of expenses;
l distributions (including whether distributions must be in cash and clawback provisions);
m carried interest (in this regard, investors increasingly insist that the carried interest be calculated over the life of the fund and that distributions of carried interest be kept in escrow);
n fees of the adviser or fund manager;
o replacement of the fund manager;
p limitations of liability for managers;
q termination of the fund;
r side letters; and
s requirements in respect of valuations.

21 Section 6(1) of the Trust Property Control Act.
22 Section 20 of the Trust Property Control Act.

ii Marketing of South African private equity funds

Investors commit to the fund by signing deeds of adherences to the partnership agreement or trust deed, as the case may be. Fundraising is typically organised by the fund manager, and in some cases investors are introduced to the fund by way of the distribution of a short-form private placement memorandum, which functions as a summary of the applicable terms. The key matters disclosed in such a memorandum would include the historic success of the fund manager, the fees payable to the fund manager, any carried interest arrangements, and whether any investor commitments have already been received and the amount thereof.

Partnerships and trusts could in theory satisfy all of the requirements of a collective investment scheme and fall to be regulated as such in terms of the Collective Investment Schemes Control Act 2002 (CISCA) if 'members of the public' are invited and then permitted to invest. Since there is currently no licensing scheme in place to regulate private equity funds under the CISCA, triggering the application of the legislation by inviting or permitting members of the public to invest in the fund could result in the fund being unlawful and persons involved in the administration of the fund being criminally liable.[23] For this reason, it is not advisable for any person to advertise investment opportunities in a private equity fund in the press or for private placement memoranda to be made available indiscriminately. Moreover, although the statutory limit on the number of partners in a partnership was abolished in 2011,[24] it remains prudent to limit the number of investors in the fund in order to counteract any suggestion that 'members of the public' are permitted to invest, but there is no bright line as to how many partners or investors would be too many. One possible way of permitting a larger number of investors to invest is for an insurance company to invest in the private equity fund and then to permit policy holders to share in the performance of the investment through 'linked policies'.

Uncertainty and debate as to whether the investor's partnership interest or interest in a bewind trust housing a private equity fund would constitute a 'financial product' under the Financial Advisory and Intermediary Services Act 2002 (FAIS) has recently been removed by the amendment of the FAIS to include an 'alternative investment fund' as a 'financial product'.[25] Accordingly, it is necessary to limit marketing of the applicable interest within South Africa to financial services providers authorised under the FAIS. As will be seen below, the fund manager is usually so licensed.

Where the FAIS applies, it imposes the duty on the relevant financial services provider to render financial services honestly, fairly, with due skill, care and diligence, and in the interests of clients and the integrity of the financial services industry.[26] Apart from the FAIS, the fund manager or other promoters could potentially attract contractual or delictual liability pursuant to, for example, non-performance, negligent misrepresentation or fraud. There is no well-developed body of case law dealing with such liability in the context of private equity funds.

Shares in companies (including VCCs) constitute 'financial products' under the FAIS. Persons rendering, as a regular feature of business, advice or intermediary services to clients

23 See Sections 5 and 115(b) of CISCA.

24 The Companies Act No. 71 of 2008 does not contain a prohibition similar to that contained in Section 30 of the Companies Act No. 61 of 1973.

25 See Section 290 of Act 9 of 2017.

26 Board Notice 80 of 8 August 2003: General Code of Conduct for Authorised Financial Services Providers and Representatives, Paragraph 2.

in respect of investment in shares therefore require a licence under the FAIS. In addition, care should be taken to comply with the prospectus requirements of the Companies Act if shares are offered to the public or sections of the public. Section 96 of the Companies Act contains exceptions to the requirement to register a prospectus with the Companies and Intellectual Property Commission. For example, no prospectus is required where the shares are marketed only to certain financial institutions.

iii Tax and exchange control

To encourage the use of South Africa as a springboard for investment into Africa, the government has over the past few years made significant changes to the country's tax and exchange control regime, which was in the past fairly unfavourable to outward investment and to the management of offshore investments from South Africa. Such changes include various amendments to the tax legislation to prevent the activities of South African investment managers from causing the investments of non-South African investors to be taxed in South Africa and a specific dispensation for the issuance of shares by a VCC.

General principles

Both *en commandite* partnerships and bewind trusts constituted in terms of South African law are fiscally transparent vehicles for South African tax purposes. All of the tax implications in respect of the underlying investments of the fund will accordingly arise directly in the hands of the relevant investors. In addition, a 'foreign partnership', as defined in the Income Tax Act, is a fiscally transparent entity.[27] Conversely, a company (including a VCC) is a taxpayer in its own right for South African tax purposes[28].

South African investors in partnerships, foreign partnerships or bewind trusts will be required to include income generated in respect of the underlying assets in their gross income and will be taxed in accordance with the tax regime applicable to such investors. Dividend income on shares in South African companies will generally be exempt from income tax in South African investors' hands[29] (subject to certain exceptions in respect of, *inter alia*, preference share type investments[30], extraordinary dividends[31] and lending arrangements), while any dividends[32] on shares in non-South African companies or interest income will

27 See Section 1 of the Income Tax Act No. 58 of 1962 (the Income Tax Act).

28 See heading entitled 'Investors investing into a company fund vehicle' below.

29 See Section 10(1)(k)(i) of the Income Tax Act.

30 The Income Tax Act deems the dividends on certain shares containing debt-like characteristics, or a right or interest the value of which is determined directly or indirectly with reference to such shares or an amount derived from such shares. to be income in the hands of the recipient. These rules, found in Sections 8E and 8EA of the Income Tax Act, have been subject to extensive amendments over the past few years. The amended rules impact, among others, on the type of security arrangements that may be utilised in respect of preference share funding as well as the purpose for which the funding may be utilised.

31 See Section 22B of the Income Tax Act and paragraph 43A of the Eighth Schedule to the Income Tax Act which seek to tax 'extraordinary dividends' (as defined in the provision) and which were otherwise exempt from both income tax and dividends tax. The extraordinary dividends are taxed upon the disposal of shares. The provisions only apply where the seller or a connected person held a qualifying interest, as defined in the provision, at any time during a period of 18 months prior to the disposal.

32 South African investors are required to include foreign dividends in their income. Certain exemptions (see Section 10B of the Income Tax Act) are available in respect of foreign dividends. The general exemptions achieve an exemption of foreign dividends to the extent that the foreign dividend is effectively only subject

generally be subject to income tax in South African investors' hands. Dividends on shares in South African companies and cash dividends on shares in non-South African companies listed on the JSE may be subject to dividends tax, subject to certain exemptions that may depend on the nature of the investor (e.g., if the investor is a South African tax resident company, the dividend should be exempt from dividends tax).[33] Certain documentary requirements must be met in order to rely on exemptions from, or reductions in the rate of, the dividends tax. Specific anti-tax-avoidance provisions exist, which may deem interest payments on a debt instrument that qualifies as a 'hybrid debt instrument' or interest that qualifies as 'hybrid interest' to be dividends in specie and taxed accordingly.[34] A South African investor into a 'foreign partnership' may be required to include a proportional amount equal to the net income of any controlled foreign company (CFC) into which the partnership invests its income and be taxed on such inclusion, subject to one of the exemptions or exclusions to the CFC rules not applying.

Non-South African investors will only be required to include income generated in respect of the underlying assets in their gross income if the income is from a South African source.[35] This will be the case, *inter alia*, in respect of interest on loans applied in South Africa and dividends on shares in South African tax resident companies or interest that is deemed to constitute dividends.[36] Such dividends will generally be exempt from income tax in the non-South African investors' hands[37] (subject to certain exceptions in respect of preference share-type investments and lending arrangements).[38] Any interest income should be exempt from income tax in the non-South African investors' hands, unless it is a natural person investor who has been physically present in South Africa for more than 183 days in aggregate in the 12-month period preceding the date on which the interest was received or accrued, or if the debt from which the interest arises is effectively connected to a permanent establishment of the non-South African investor in South Africa.[39] This exemption would not apply to

to income tax at a rate of 20 per cent (which equates to the dividends tax rate in respect of dividends distributed by South African companies). In certain instances the full foreign dividend may be exempt, for example where the South African resident holds at least 10 per cent of the equity shares and voting rights in the foreign company and subject to certain provisos and exclusions not applying.

33 The dividends tax regime was introduced on 1 April 2012 and is contained in Part VIII of the Income Tax Act. Dividends tax is levied at a rate of 20 per cent, subject to certain exemptions, and a reduction of such rate in terms of any applicable treaty.

34 See Sections 8F and 8FA of the Income Tax Act. These anti-avoidance provisions only apply in instances where the issuer of the debt instrument is (1) a resident company, or (2) a non-resident company if the interest in respect of that instrument is attributable to a permanent establishment of that company in South Africa, or (3) a company that is a controlled foreign company (CFC) if the interest incurred in respect of that instrument must be taken into account in determining the net income of that CFC as contemplated in Section 9D of the Income Tax Act.

35 See the definition of 'gross income' in Section 1 of the Income Tax Act.

36 Historically, the Income Tax Act did not provide specific source rules, which were determined largely with regard to tests laid down by the courts. With effect from 1 January 2012, certain statutory source rules were introduced in Section 9(2) of the Income Tax Act. These rules provide, *inter alia*, that dividends distributed by South African companies and interest on loans attributable to an amount incurred by a South African resident, or that are received or accrue in respect of the utilisation or application in South Africa by any person of any funds or credit, will be deemed to be from a South African source.

37 See footnote 29.

38 See footnote 30.

39 See Section 10(1)(h) of the Income Tax Act.

interest which is deemed to be a dividend as the provisions relating to dividends would apply. Provided certain requirements are met, the actions of the general partner or trustees should not result in the non-South African resident investor having a permanent establishment in South Africa for purposes of the Income Tax Act.[40] Any dividends declared by a South African company and interest deemed to be a dividend or interest from a South African source that is paid to a non-South African resident investor will be subject to dividends tax and, with effect from 1 March 2015, interest withholding tax,[41] respectively (subject to certain exemptions and any available treaty relief). Certain documentary requirements must be met in order to rely on certain exemptions from, or reductions in the rate of, dividends tax and the interest withholding tax.

Any gains in respect of a disposal of the underlying assets may give rise to income tax or capital gains tax implications in the hands of the South African investors, depending on whether the investor trades in the underlying assets or not, which will be taxed in accordance with the tax profile of the applicable investor. Generally, non-resident investors will only be subject to South African tax in respect of such disposals if they have a permanent establishment in South Africa (see above).[42]

An *en commandite* partnership and a bewind trust can give rise to complexity from a tax perspective in respect of exiting partners or the admission of new partners. This is so since every time a new partner or beneficiary enters the partnership or bewind trust, on a technical basis, each of the partners or beneficiaries will dispose of a portion of the underlying investments to the new partner or beneficiary, which may cause the realisation of unrealised gains for the other partners or beneficiaries and which may be subject to tax in their hands.

40 The definition of 'permanent establishment' in Section 1 of the Income Tax Act has been amended with effect from 1 January 2011 to exclude the activities of certain general managers and trustees from creating a permanent establishment for qualifying investors. A 'qualifying investor' is a defined concept – see Section 1 of the Income Tax Act.

41 With effect from 1 March 2015, interest withholding tax is levied at a rate of 15 per cent on the amount of any interest that is paid by any person to or for the benefit of any foreign person to the extent that such amount of interest is from a South African source. Exempt from the interest withholding tax is any amount of interest that is, *inter alia*, paid in respect of any listed debt; paid by the South African government, any bank, the South African Reserve Bank, the Development Bank of Southern Africa or the Industrial Development Corporation; or paid to *inter alia* the African Development Bank, the World Bank, the International Monetary Fund and the African Import and Export Bank. An additional exemption from the interest withholding tax was introduced with effect from 1 March 2015 in terms of which South African sourced interest paid to a non-resident in respect of a debt owed by another non-resident is exempt from this withholding tax provided that the exclusions to the exemption do not apply.

42 The statutory source rules (see footnote 30), simplistically speaking, provide that gains made in respect of the disposal of an asset (other than immovable property or an interest in immovable property) by a non-resident is only deemed to be from a source in South Africa if it is attributable to a permanent establishment of the non-resident in South Africa. Furthermore, the capital gains tax provisions contained in the Eighth Schedule to the Income Tax Act only apply to non-residents in respect of immovable property or interests in immovable property (which is a defined concept – see Paragraph 2(2) of the Eighth Schedule to the Income Tax Act) situated in South Africa or assets effectively connected with a permanent establishment of the non-resident in South Africa.

Carried interest

Where a fund manager or an affiliate of the fund manager obtains an additional distribution from the applicable fund, there has been an ongoing international debate as to whether such carried interest is subject to capital gains tax or income tax. The debate is currently unresolved.

Investors investing into a company fund vehicle

A company that is incorporated or effectively managed in South Africa constitutes a resident for South African tax purposes and is taxed at the rate of 28 per cent on taxable income. Capital gains are taxed at an effective rate of 22.4 per cent.

The income tax implications arising for shareholders of a South African resident company are as set out above under the general principles.

To the extent that the company has been approved as a VCC by the South African Revenue Service and the specific requirements in the Income Tax Act have been complied with, a taxpayer to whom a venture capital share is issued by a VCC may be entitled to a deduction of its expenditure for income tax purposes.[43] It should be noted that the investor would suffer a recoupment in the event that the shares are not held for longer than five years. Investors into a VCC should carefully consider the exit mechanism and the tax implications thereof as upon exit the investor may either be exposed to capital gains tax on the proceeds or dividends tax (to the extent that the taxpayer does not qualify for an exemption).

If the specific provisions of the Income Tax Act are not complied with by the VCC, the VCC approval may be withdrawn which would result in the VCC being required to include in its income for tax purposes 125 per cent of the amount the investors were entitled to deduct.

Non-South African private equity funds directly investing into South African companies

In respect of non-residents, South Africa imposes income tax on amounts from a South African source. As discussed above, interest on loans applied in South Africa and dividends on shares in South African companies (including VCCs) are deemed to be from a South African source.[44] A non-resident fund will accordingly be required to include such interest or dividends in its gross income, but should be entitled to an exemption in respect of the dividends[45] (subject to certain exceptions in respect of preference share-type investments and lending arrangements)[46] and any interest income should be exempt from income tax in the non-resident fund's hands, unless the debt from which the interest arises is effectively connected

43 See Section 12J of the Income Tax Act. The provision contains specific requirements relating to the rights attaching to the shares issued, the investment to be made by the VCC, the period during which the investor should hold the shares and the documentation required from the VCC in order to qualify for the tax deduction. The deduction is only allowed in respect of shares acquired prior to 30 June 2021. Specific limitations may apply to the deduction by the taxpayer in instances where the expenditure is funded with a loan or credit or the investor is connected to the VCC.

44 See footnote 36.

45 See footnote 29.

46 See footnotes 29 and 30.

to a permanent establishment of the non-resident fund in South Africa.[47] Furthermore, any capital gains will be subject to tax in South Africa if the fund has a permanent establishment in South Africa to which the asset in question is effectively connected.[48]

Furthermore, the activities of a South African fund manager may result in the gains on the underlying investments being from a South African source. This issue has largely (but not completely) been resolved in terms of the statutory source rules.[49]

In addition, as discussed above, non-resident investors will be subject to dividends tax and interest withholding tax[50] in respect of dividends on South African shares and interest deemed to be dividends or interest regarded as having been received or accrued from a South African source that is paid to them (subject to certain exemptions and any available treaty relief).

Furthermore, should the fund be managed in South Africa, this may result in the fund being effectively managed in South Africa, in which case the fund may become a South African tax resident with the result that its income and capital gains will be subject to tax in South Africa and distributions may be subject to dividends tax. However, statutory provisions have been introduced in terms of which a foreign investment entity (which is a defined concept) will not be effectively managed in South Africa by reason of having a South African fund manager, meaning that having a South Africa fund manager will not result in a non-resident fund becoming a South African resident provided the requirements of the relevant provisions are met.[51] These provisions do not apply to foreign funds where South African investors directly or indirectly hold an interest of 10 per cent or more.

Multilateral instrument

Among the recommendations in the final Base Erosion and Profit Shifting Reports released by the Organisation for Economic Co-operation and Development (OECD) in 2015, were a number of measures which require the participating jurisdictions to amend their double taxation agreements. In order to avoid the need to renegotiate double taxation agreements on a bilateral basis it was proposed that a 'multilateral instrument' would be developed to implement tax treaty related base erosion and profit shifting measures. On 24 November 2016, the OECD released the Multilateral Convention to Implement Tax Treaty Related Measures and Prevent Base Erosion and Profit Shifting (the Multilateral Instrument). On 7 June 2017, South Africa become a signatory to the Multilateral Instrument.

Once the Multilateral Instrument enters into force it will modify all covered tax agreements as defined in Article 2(1) thereof. In order for a double tax agreement to constitute a covered tax agreement each party to the agreement has to be a party to the Multilateral Instrument and each party has to list the agreement in its notification to the depositary.

Although South Africa is a signatory to the Multilateral Instrument, the Multilateral Instrument has not (as at the time of writing) been ratified by the South African parliament.

47 See footnote 40.

48 See footnote 40.

49 See footnotes 40 and 42.

50 See footnote 41.

51 This has been effected in terms of an amendment to the definition of 'resident' in the Income Tax Act, which was introduced by the Taxation Laws Amendment Act 22 of 2012 with effect from 1 January 2013.

Accordingly, the Multilateral Instrument does not yet have the force of law in South Africa. Furthermore, the impact of the Multilateral Instrument on double taxation agreements to which South Africa is a party is unclear at this stage.

Investors and fund managers should carefully consider the potential implications of the Multilateral Instrument on double taxation relief under a double taxation agreement to which South Africa is a party.

Exchange control

South African residents are generally prevented from transferring capital to any country outside the common monetary area (CMA) (consisting of South Africa, Namibia, Lesotho and Swaziland), subject to a number of exceptions. In relation to South African private equity funds wishing to invest outside of South Africa, such investment will generally be made through an institutional investor, utilising its institutional investor allowance. An institutional investor allowance is available to certain institutional investors and fund managers in South Africa, subject to limitations (institutional investors' foreign exposure of retail assets may not exceed 30 per cent in the case of retirement funds and the underwritten (non-linked) policy business of long-term insurers, and investment managers registered as institutional investors, collective investment scheme management companies and the investment-linked business of long-term insurers are restricted to 40 per cent of the total retail assets under management). Institutional investors may, directly or indirectly, invest in African countries outside the CMA an additional 10 per cent of total retail assets in terms of the African allowance.

However, in terms of a recent relaxation, private equity funds that are members of SAVCA, mandated to invest outside the CMA,[52] may apply to the Financial Surveillance Department of the South African Reserve Bank for approval to invest offshore (information that must accompany the application includes a copy of the local *en commandite* partnership's mandate to invest outside the CMA or, in the case of a local fund running parallel with an offshore fund, a copy of the co-investment agreement between the local and foreign partnership, cash flow projections for a 36-month period indicating the amount of capital to be exited from South Africa for investment purposes, and the percentage equity and voting rights acquired in the foreign entity). Applications will also be considered where an unintended loop structure is created as a result of private equity funds investing in companies outside the CMA with a portion of their business in South Africa. In terms of the 'look through' principle, any offshore acquisitions by an institutional investor held indirectly via a local private equity fund must be marked off against its respective foreign portfolio investment allowances. The Financial Services Board Regulations governing the permissibility of these investments for institutional investors as part of their portfolios must also be complied with.

iv Offshore structures

For reasons relating to South African tax legislation, South African private equity managers in the past often created parallel offshore structures within which to house investments from non-resident investors, and which offshore funds co-invested with South African-domiciled funds. Mauritius, the Cayman Islands and the British Virgin Islands have in the past often

52 This dispensation previously applied only to South African private equity funds that were mandated to 'invest into Africa'. However, in terms of Section B.2(G) of the Currency and Exchanges Manual for Authorised Dealers, this dispensation now allows for global investments outside the CMA.

been used as the domicile for these parallel structures. Although recent tax changes to the Income Tax Act have removed some of the previous obstacles, the introduction of new taxes, such as the interest withholding tax, may neutralise or remove the benefits that resulted from the changes. Fund managers and their advisers should carefully consider the potential South African tax implications and applicable double taxation relief and the potential impact of the Multilateral Instrument prior to taking decisions as to whether a parallel offshore structure is required.

Because of its wide network of double taxation treaties and low tax rates, Mauritius is a popular jurisdiction for the establishment of private equity funds, including funds with South African investors, and funds that will invest in sub-Saharan African countries other than South Africa or countries within the CMA. A new double taxation agreement between South Africa and Mauritius has entered into force on 28 May 2015, which replaced the previous agreement.

It should be noted that certain sovereign fund investors may not invest in funds domiciled in certain jurisdictions.

III REGULATORY DEVELOPMENTS

Private equity funds are not subject to specific regulations, and there is no government agency that exercises regulatory oversight specifically over such funds. There is no requirement that a fund be registered with a government agency. Fund managers are, broadly speaking, required to register as financial services providers under the FAIS. As mentioned below, fund managers are, from a practical perspective, also required to register as members of SAVCA, the voluntary industry body.

We have discussed the regulatory requirements that apply to the marketing of funds above. Regulatory developments over the past few years that deserve mention are the position with respect to black economic empowerment (BEE), the position with respect to pension fund investors and the government's intention to harmonise the regulation of financial institutions.

i BEE

By way of background, since the election of South Africa's first democratic government in 1994, the government implemented a comprehensive programme aimed at the transformation of South Africa's economy in order to address racial and other discrimination of the past. The Broad-Based Black Economic Empowerment Act 2003 provides the general legislative framework for the promotion of BEE, empowering the Minister of Trade and Industry to issue Codes of Good Practice. The approach under these Codes is to measure the contribution of each South African firm to broad-based BEE in accordance with a detailed prescribed scorecard. An important element of this scorecard involves the percentage of the equity shares of a firm held directly or indirectly by black persons. On a practical level, a firm's BEE score affects whether it qualifies to participate in regulated industries (such as mining or gaming) and its chances of winning business (including government tenders).

Accordingly, an important consideration in respect of any investment in a portfolio company by a private equity fund is how the investment (together with co-investments) will affect the BEE score of the portfolio company.

In this regard, the Codes of Good Practice[53] published in 2013 (Revised Codes) are designed to give an advantage to private equity fund managers who meet certain BEE requirements, since portfolio companies will be entitled to deem all of the shares held by funds managed by qualifying managers to be held by black persons. Broadly speaking, the qualifying requirements include the following:

a at least 51 per cent of the fund manager's voting rights associated with the equity investments in the underlying portfolio companies must be held by black persons;[54]

b black persons must own 51 per cent of the shares of the fund manager and receive at least 51 per cent of the profits (including carried interest earned by the fund manager or its associate) of the fund manager;[55]

c 51 per cent of the executive management and senior management of the fund manager must consist of black persons;[56] and

d the fund manager must invest a prescribed percentage of the value of its funds under management in firms that are at least 25 per cent black-owned. This prescribed percentage is 5 per cent in 2014 and gradually rises to 51 per cent over a period of nine years.[57]

These provisions in the Revised Codes have arguably served as an impetus for the development of more black-owned and controlled private equity fund managers. Note, though, that it should be established, with respect to each portfolio company, whether there are sector-specific BEE charters or licensing conditions that may preclude the application of the provisions in a specific case.

ii South African pension funds

The prudential investment limits for pension funds registered under the Pension Funds Act 1956 were amended in 2011 to expressly permit pension funds to invest up to 10 per cent of their assets in private equity funds (with sub-limits of 2.5 per cent per private equity fund and 5 per cent per fund of funds). In terms of the regulatory framework, the Registrar of Pension Funds published conditions for investment in private equity funds (the Conditions) in March 2012[58] that stipulate requirements in order for a private equity fund to qualify for investment by a pension fund. The Conditions came into effect in 2012. Although the applicable requirements do not bind private equity funds, pension funds are significant investors and private equity funds therefore have a strong incentive to comply.

The most significant requirements contained in the Conditions are the following:

a permissible local private equity structures are limited to *en commandite* partnerships, bewind trusts and companies;[59]

53 General Notice 1019 of 2013, Gazette No. 36928 of 11 October 2013.

54 P. 22 of the Revised Codes. Paragraph 3.10.1.1. There is debate as to the application of this requirement.

55 Pp. 22–23 of the Revised Codes, Paragraphs 3.10.1.3 and 3.10.3.

56 Id., p. 23, Paragraph 3.10.1.2.

57 Id., pp. 23-24, Paragraphs 3.10.8 – 3.10.13.

58 Conditions for investment in private equity funds; approval in terms of Section 5(2)(e) of the Pension Funds Act 15 March 2012.

59 Condition 2(1).

b fund managers must be members of SAVCA[60] and are required to be authorised as discretionary financial services providers under the FAIS – a category of licence that many fund managers did not hold before the Conditions were published;[61]

c the auditors of the private equity fund must verify the assets of the fund on a biannual basis,[62] and the fund must produce audited financial statements complying with international financial reporting standards within 120 days of the end of its financial year;[63]

d the private equity fund must have clear policies and procedures for determining the fair value of the assets of the fund in compliance with the International Private Equity Valuation Guidelines, and any valuations must be verified at least annually by a third party;[64] and

e the pension fund must consider a list of prescribed due diligence matters before investing in a private equity fund, including the fee structure of the private equity fund, and the risk and compliance policies and procedures of the private equity fund.[65]

In our experience, the Conditions have affected the contractual terms of new private equity funds in that pension funds seek warranties from the private equity fund and the fund manager that they will adhere to the requirements set out in the Conditions and wish to see that the contractual terms expressly address the checklist of due diligence matters prescribed by the Registrar. Generally speaking, the regulatory framework has in our view encouraged interest by pension funds in private equity investment. We have also found that pension funds are in their negotiations requiring fund managers to lower fees and carried interest percentages and to accept governance checks and balances to a greater extent than was perhaps the case before the 2008 financial crisis.

iii Financial Market Conduct Legislation

The government is moving toward a 'twin peaks' model of regulation, in terms of which supervision and monitoring of the health and soundness of financial institutions will be exercised by a newly established Prudential Authority and financial market conduct will be regulated by a newly established Financial Sector Conduct Authority. To this end, the Financial Sector Regulation Act[66] was adopted in 2017. In addition, it is contemplated that the FAIS and the CISCA will be repealed and replaced with an omnibus bill addressing the structure, licensing and market conduct of all financial institutions. A draft of the new legislation, to be named the Conduct of Financial Institutions Bill, has at the time of writing not yet been published. It is possible that the Bill may affect private equity funds.

60 Condition 2(2).
61 Condition 3(1).
62 Condition 6.
63 Condition 9(1).
64 Condition 8.
65 Condition 7.
66 Act No. 9 of 2017.

iv Anti-money laundering legislation

Recent amendments to the Financial Intelligence Centre Act (FICA)[67] broaden mandatory checks required to establish and verify the identity of investors and their ultimate beneficial owners and to assess transactions with domestic prominent influential persons. The FICA places the responsibility to do so on the fund manager of the private equity fund.

IV OUTLOOK

Since many funds were established some years ago, increased exits from existing private equity investments as well as increased fundraising activity can be expected. Although South African private equity funds are likely to have increased exposure to sub-Saharan African countries other than South Africa, the current trend is for most South African private equity funds to maintain a primary focus on investment in South Africa. A trend that is likely to continue is the creation of credit opportunity funds with terms very similar to those of private equity funds, but whose investments are primarily in credit assets and whose investment objective is to earn interest and other income. In addition, we expect to see continued growth in funds focused on investment in infrastructure projects and funds dedicated to investment in particular economic sectors, such as healthcare. On the regulatory front the main development in the next 12 months will be the publication of the Conduct of Financial Institutions Bill.

67 Act No. 38 0f 2001.

Appendix 1

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Magda also assists local and foreign investors with the drafting and submission of exchange control applications, and assists taxpayers with the resolution of their disputes with the South African Revenue Service.

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