Discussion Document on

THE TAX TREATMENT OF COLLECTIVE INVESTMENT SCHEMES

national treasury
Department:
National Treasury
REPUBLIC OF SOUTH AFRICA

PREFACE

This discussion document stems from a statement in the 2020 *Budget Review* that National Treasury will undertake a review on the income tax treatment of amounts received by portfolios of collective investment schemes in line with the announcement in the 2019 *Budget Review*[1]. In 2018 amendments were proposed in the Taxation Laws Amendment Bill to clarify and provide certainty on the income tax treatment of trading profits earned by collective investment schemes. The amendments proposed in 2018 were due to the realisation that some collective investment schemes were generating profits arising from frequent trading. According to the legislation, and depending on the circumstances, these amounts could be seen as revenue in nature and would be taxable.

The proposals in 2018 aimed to provide certainty on when these amounts should be treated as income (taxable) instead of a capital nature (exempt from tax). After reviewing the public comments on the Taxation Laws Amendment Bill, 2018, government decided to withdraw the proposed amendments to allow more time to work with industry to find solutions that will not negatively affect the relevant stakeholders[2].

This document addresses policy considerations on the taxation of collective investment schemes under section 25BA of the Income Tax Act, 1962, and puts forward different policy options. National Treasury issues this discussion document to improve understanding of section 25BA and facilitate engagements on the policy proposals. The two main policy proposals for the tax treatment of collective investments schemes are to move to a full flow-through system, where all returns are attributed to each unit holder, or the creation of a safe harbour rule based on turnover. A separate treatment for hedge funds is also proposed.

The discussion document also includes technical issues surrounding collective investment schemes, as provided for in the revisions to section 25BA by the Taxation Laws Amendment Act, 2009, the Taxation Laws Amendment Act, 2011, the Taxation Laws Amendment Act, 2012, and the Taxation Laws Amendment Act, 2013.

The explanations and examples in this document reflect the understanding by the National Treasury of tax legislation, the South African Revenue Service's Binding Rulings BCR 056, BCR 059, BPR 186, BPR 339 and BPR 344, and court decisions.

National Treasury requests stakeholders to submit detailed written comments on the proposed options in this discussion document. Written comments can be emailed to CIS-Tax@treasury.gov.za by close of business on **13 December 2024**.

1 See 2020 *Budget Review* page 46 and 2019 *Budget Review* page 132

2 See Final Response Document on Taxation Laws Amendment Bill, 2018 and Tax Administration Laws Amendment Bill, 2018 page 23

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INTRODUCTION

1 BACKGROUND

A portfolio of a Collective Investment Scheme (CIS) is a pool of assets created through the contributions of different investors and operates as an investment vehicle on behalf of those investors (holders of participatory interests or portfolio unit holders). The CIS is managed by a professional manager who, depending on the mandate of that CIS, will use the contributions of the investors to invest in listed shares, bonds, other financial instruments and properties. The portfolios of collective investment schemes are separate persons and taxpayers for income tax purposes and are in essence vesting trusts with specific timing rules for the accrual of amounts.

The concept of a unit trust was becoming increasingly outdated and subsequently changes were made to the Income Tax Act, Act No. 58 of 1962 (the Act) in 2009 such that the conduit principle is applied to receipts and accruals (other than amounts of a capital nature) of specified portfolios of CISs, as defined in the Collective Investment Schemes Control Act, Act No. 45 of 2002 (CISCA Act)[3].

In general, under section 25BA of the Act, CISs are subject to a special tax dispensation in terms of which capital gains are not taxed within a portfolio of a CIS. However, the taxation of the underlying capital gains is, in essence, deferred until the holder of a participatory interest in that portfolio disposes of that interest. Amounts that are not of a capital nature are taxed within a portfolio unless they are distributed to the holders of participatory interests in that portfolio within 12 months after their accrual or receipt. The amounts so distributed, retain their nature as income (e.g. interest or dividends) for the holders of participatory interests and are taxable[4].

The special tax dispensation applying to CISs does not regulate whether an amount is of a capital nature or not. The Act does not provide a definition or guidance of what constitutes an amount of a capital nature. CIS's are subject to normal tax principles regarding the characterisation, for tax purposes, of the nature of receipts or accruals from the disposal of assets by a portfolio, i.e. whether an asset disposed of results in a capital gain, in which case the capital gain will not be taxed in the portfolio, or income, in which case the amount will be taxable in that portfolio or for holders of participatory interests in that portfolio.

South African courts consider various objective and subjective factors to assess the intention with which an asset was acquired, held and disposed of. These factors, which include the nature of an asset, the holding period and the frequency of transactions, are important indicators of whether an asset was disposed of as part of a profit-making scheme, in which case the gains are viewed as 'revenue' gains that were not fortuitous but were specially sought after as part of that activity.

3 Taxation Laws Amendment Act, 2009
4 Explanatory Memorandum on the Taxation Laws Amendment Bill, 2009

The frequency and scale on which a portfolio of a CIS in securities acquires and disposes of financial instruments would, in terms of case law, be strongly indicative of whether the resulting gains and losses are of a revenue nature. The question, to paraphrase the words of the court in *Natal Estates v CIR* [5], would be whether in the light of all the facts it can be said that the Rubicon had been crossed by embarking on a business or profit-making scheme.

This distinction was also addressed in the judgment of the *Californian Copper Syndicate v Inland Revenue*[6] court case that clarified the distinction that must be made in determining whether gains on the disposal of assets are of a capital or revenue nature as follows:

> *"What is the line which separates the two classes of cases may be difficult to define, and each case must be considered according to its facts, the question to be determined being, is the sum of gain that has been made a mere enhancement of value by realising a security, or is it, a gain, made by an operation of business in carrying out a scheme for profit-making".*

Therefore, in summary one must consider the intention of the taxpayer to affirm the conclusions made in *Californian Copper Syndicate v Inland Revenue* and *Natal Estates v CIR* that where the gain is made in the operation of business in carrying out a scheme of profit-making, the profit was revenue in nature. It should be noted that there are various court cases that deal with the nature of gains, the ones mentioned above are for illustrative purposes.

1.1 Overview of the collective investment fund industry

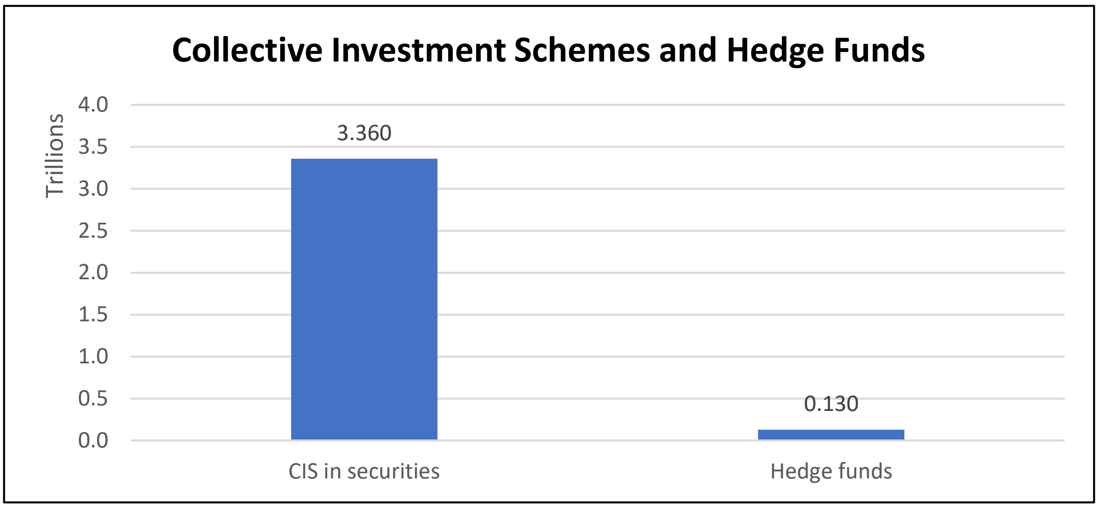
CIS's are well-established in the South African market and have grown rapidly. The domestic CIS industry reported assets under management of R3.36 trillion at the end of the second quarter 2023. This represents an increase of 3 per cent from the end of the first quarter of 2023, when assets stood at R3.27 trillion, or just less than 50 per cent of GDP. Over the 12 months to 30 June 2023, assets grew by 13 per cent, primarily due to strong stock market performance, and the CIS industry experienced outflows of R10.4 billion. However, R26.4 billion in reinvestments in the industry resulted in an effective net inflow of R16 billion.

The South African hedge fund industry is significantly smaller. Association for Savings and Investments South Africa (ASISA) statistics show that the industry ended the second quarter of 2023 with assets under management of R120 billion. This represents an increase in assets of R7 billion over the six months from the end of December 2022, when assets stood at R113.01 billion.

The hedge fund industry attracted net inflows of R4.27 billion in the first six months of 2023. The number of hedge funds increased from 216 at the end of 2022 to 219 at the end of June 2023.

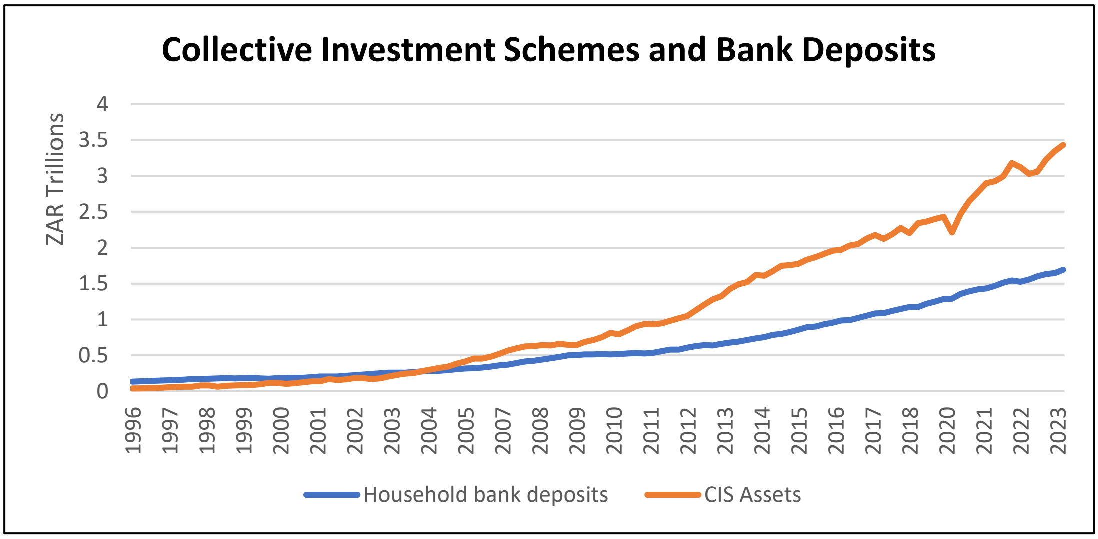
5 See *Natal Estates v CIR* 1975 (4) SA 177 (A)
6 See *Californian Copper Syndicate v Inland Revenue* 1904. 41 ScLR 691

Figure 1 Collective investment schemes in securities dwarf hedge funds, June 2023



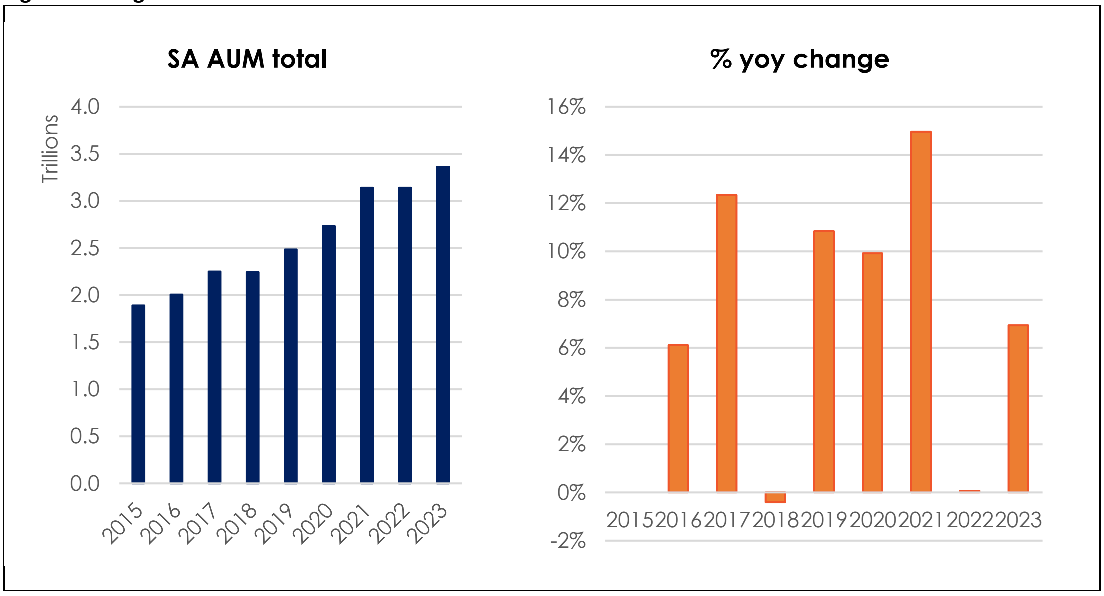
Source: ASISA

Figure 2 Assets in CIS have grown faster than bank deposits and have become an important source of savings



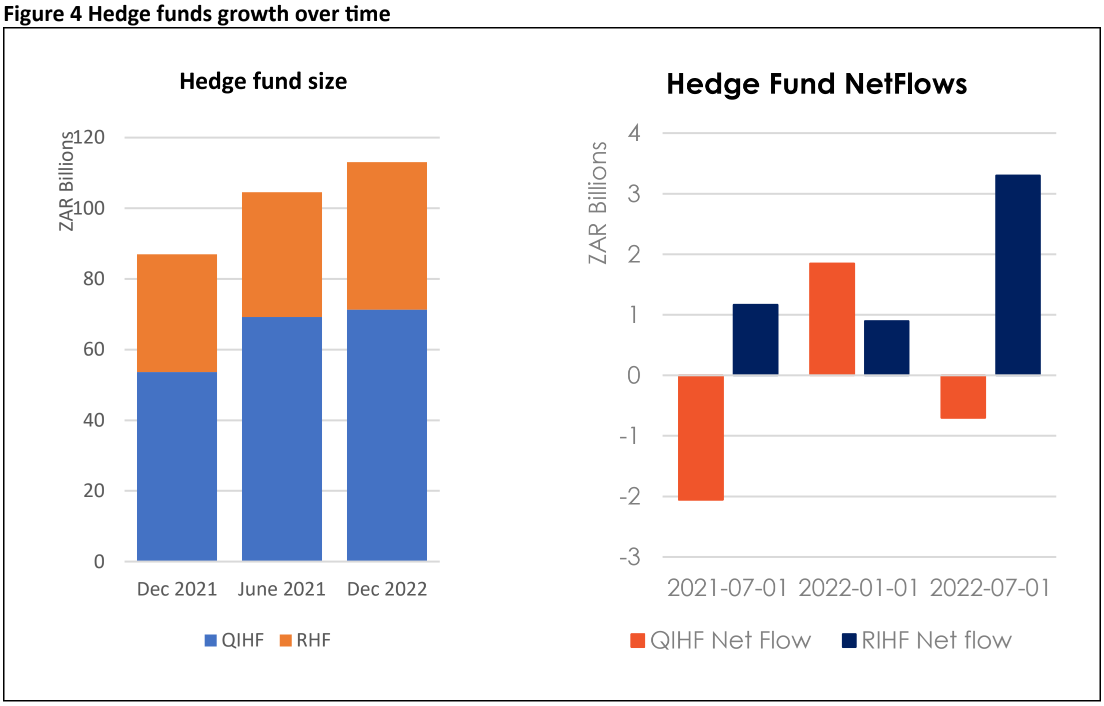
Source: SARB Quarterly Bulletin

Figure 3 CISs growth over time



Source: ASISA

Figure 4 Hedge funds growth over time



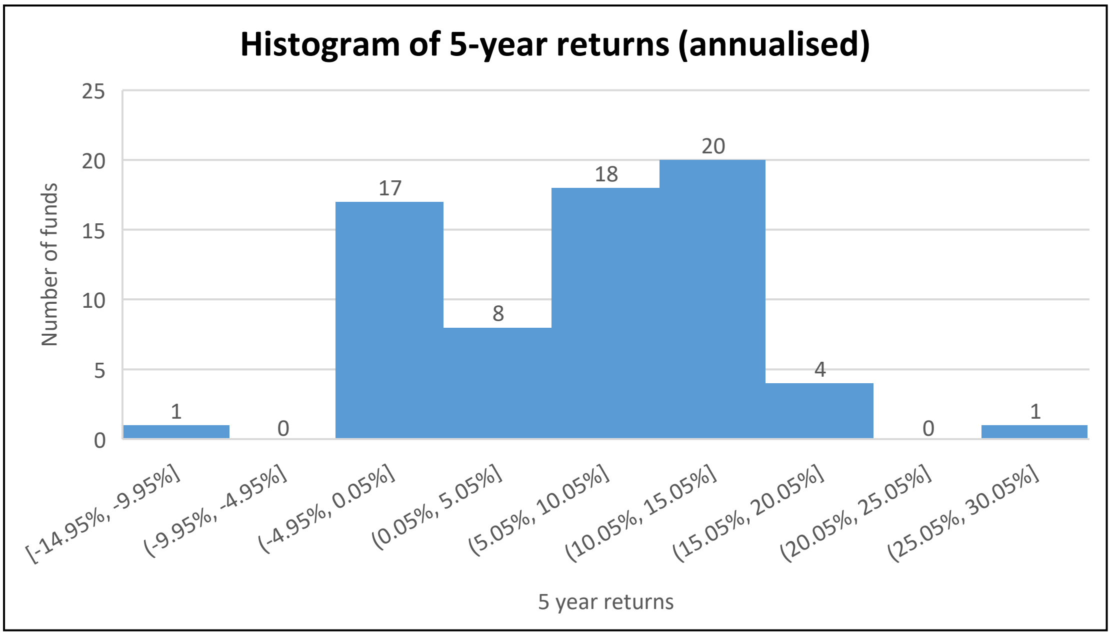
QIHF = Qualified investor hedge funds are targeted for institutional investors (or experienced investors) who have R1 million or more to invest with the funds being priced on a monthly basis, RIHF = retail hedge funds are available to the ordinary public.

1.2 Returns offered by CIS's in securities versus hedge funds

There is a common assumption that hedge funds provide outsize returns, however the data does not support this. Of the 69 hedge funds that have been in operation for five years, only

5 have delivered annualized returns of greater than 15 per cent per annum, while 20 have delivered returns of between 10 and 15 per cent, and 18 have provided returns of between 5 and 10 per cent. There were 18 hedge funds that delivered negative returns, highlighting that these investment vehicles are inherently risky.

Figure 5 Hedge funds returns



Source: Hedge News Africa

2 REGULATORY ISSUES

This section provides a brief outline of the regulatory issues affecting CIS's (both non hedge fund and hedge fund CIS's).

The regulatory framework for CIS in securities is set out and comparisons are drawn between that framework and the regulatory framework for hedge funds. The section highlights that the hedge fund framework does not fit neatly within the overall collective investment scheme framework and indicates that the future policy direction will move toward improving the regulatory framework.

It is important to note at the outset that hedge funds remain relatively small as an industry compared to "vanilla" CISs in securities, which are currently at R3.3 trillion (48 per cent of GDP). The size of the hedge funds industry is estimated at R120 billion (less than 2 per cent of GDP). While relatively small, hedge funds are an important part of the set of legal investment vehicles that support savings and investments, and their activity in derivatives assist in creating market liquidity. They are well suited to mobilising the savings of high-net-worth individuals who typically take on more risk – they thus suit the objectives of growing new small and medium-sized enterprises and unlisted companies. Their role in, for instance, pension funds to enhance returns, should also not be underestimated. An appropriate regulatory and tax framework can support innovation and growth, whilst an appropriate regulatory framework can mitigate the risks posed by hedge funds, which include risks from high levels of leverage.

Summary of the regulatory framework

ASPECT	COLLECTIVE INVESTMENT SCHEMES	RETAIL HEDGE FUNDS
Regulatory Framework	Regulated under CISCA	Regulated under CISCA via a Declaration by the Minister of Finance
Investment Strategies	Conventional, limited strategies	Diverse, including hedging
Risk and Return Profile	Lower risk, steady returns	Higher risk, potential for higher returns
Accessibility	Accessible to a broad retail audience	May require higher minimum investments
Fees	Transparent fees (management and possibly performance fees)	May charge higher fees, including performance fees
Liquidity	Daily buying and selling options	Longer lock-up periods and less frequent redemptions

3 THE REGULATION OF CIS'S

3.1 The nature of a CIS

A collective investment scheme is a legal structure that pools funds from multiple investors ranging from the retail investor to large corporates and financial institutions, such as pension funds. The primary purpose of a collective investment scheme is to provide individual investors with access to a professionally managed and diversified investment portfolio that they might not be able to achieve on their own, or which simply provides for an investment need.

The current regulatory framework is contained in the Collective Investment Schemes Control Act (CISCA), read together with the Financial Sector Regulation Act (FSRA), the Financial Markets Act (FMA) and the Financial Advisory and Intermediary Services Act (FAIS).

Each of these Acts provides for a different part of the regulatory framework. CISCA creates and defines a collective investment scheme. FSRA defines the powers of the regulators, which in the case of a CIS is mainly the Financial Sector Conduct Authority (FSCA), and FAIS provides the framework for how CIS's are sold to customers. Importantly, the FSCA is empowered to make regulatory instruments to regulate the operations of CIS's.

From a self-regulatory standpoint, the industry body, ASISA, has published various standards that are influential, such as a standard on the calculation of total expense ratio and transaction costs, a standard on the classification of funds and a standard on performance fees.

3.2 Retail CIS's

"Vanilla" or CIS in securities are the standard, well developed schemes. The legal requirements are that collective investment schemes must be held by an approved custodian which is also the trustee in the case of trust based schemes (all CIS's in securities are currently trust based).

CIS's operate as "managed conduit vehicles", insofar as they provide for a highly regulated environment for an individual to pool assets and have these managed by a third-party manager.

The assets of the CISs are protected in the following way:

- **Segregation and identification**. Section 2 of CISCA provides that the assets of a portfolio must at all times be properly protected by application of the principle of segregation and identification (e.g., section 105 of CISCA requires that the manager must, within one business day of receiving cash from investors, deposit such amounts in a trust account controlled by the trustee). Subsection 70(1)(i) also requires of the trustee to ensure that there is legal separation of assets held under custody and that the legal entitlement of investors to such assets are assured;
- **Trust property**. Section 71 of CISCA requires that any money or other assets received from an investor and assets of a portfolio are regarded as trust property for the purposes of the Financial Institutions (Protection of Funds) Act (with the effect, for example, that the manager may not derive improper advantage from the investment activities of the portfolio and must declare relevant conflicts of interest) and a manager, its authorised agent, a trustee or custodian must deal with such money or other assets in terms of CISCA and the applicable deed and in the best interests of investors;
- **Permissible deductions**. Section 93 of CISCA provides for a closed list of permissible deductions against the portfolio for fees, charges and so forth; and
- **Third party claims are excluded**. Section 104 of CISCA protects investors from the manager or trustee and provides that the assets of a portfolio are not available to satisfy third-party claims against the manager or trustee.

The trustee or custodian of the collective investment scheme is required to:

- ensure that the selling or repurchase price of participatory interests is calculated in accordance with CISCA and the applicable deed;
- enquire into and prepare a report on the administration of the collective investment scheme by the manager during each annual accounting period and send the report for submission by the manager to the FSCA together with the manager's annual compliance report;
- ensure that appropriate internal control systems are maintained and that records clearly identify the nature and value of all assets under custody, the ownership of each asset and the place where documents of title pertaining to each asset are kept; and

- report any irregularity or undesirable practice concerning the collective investment scheme of which it becomes aware to the FSCA.

3.3 Restrictions on CIS's in securities

CIS's in securities are subject to detailed investment regulatory restrictions contained in Board Notice 90 of 2014 to manage various risks and protect investors. The restrictions distinguish between standard portfolios, money market portfolios, fund of funds portfolios and feeder fund portfolios. Notable restrictions relating to standard portfolios include the following:

- Standard portfolio limitations on the maximum exposure of a portfolio to equity securities issued by any one entity, calculated with reference to the value of the portfolio and the weighting of the applicable security in applicable indices. In addition, there are limits on the maximum exposure to listed or unlisted non-equity or debt securities, based on who the issuer or guarantor is (unlisted issuers, for example, can receive a maximum of 5 per cent of the portfolio)
- A requirement that at least 90 per cent of the market value of a portfolio must consist of the following:
  - securities listed on an exchange that is a full member of the World Federation of Exchanges;
  - securities acquired by the manager pursuant to the exercise of rights attaching to securities listed on an exchange; and
  - permissible unlisted non-equity securities and derivatives; and
  - derivatives, such as listed futures, option contracts, warrants or index tracking certificates and unlisted swaps (relating to exchange rates, interest rates of indices) may not be used to leverage or gear the portfolio and exposures must be covered at all times (Chapter V of Board Notice 90 of 2014).

3.4 The nature of CISs -The regulatory framework for hedge funds[7]

A hedge fund is a pooled investment vehicle administered by a professional investment management firm, and can be structured as a regulated limited *en commandite* partnership or trust.

The first hedge fund was established in 1949. At the time, the investment strategy was to both leverage and short securities to achieve an absolute return, these two strategies still largely define a hedge fund.

Both at manager and product level hedge funds have generally been regarded as complex and exotic investment vehicles that are only available to high-net-worth individuals and

[7] This section draws heavily on the Explanatory memorandum on the draft regulations for hedge funds in South Africa issued by National Treasury in 2014.

institutional investors. The principle was "buyer beware" due to the market conduct regulation of such funds being lighter on the basis that the investors understand the risk.

Hedge funds were first introduced in South Africa as a separate investment vehicle, distinct from traditional CISs. These hedge funds operated under their own regulatory framework.

In 2015, the South African government took steps to incorporate hedge funds into the broader regulatory framework for collective investment schemes. The implementation of these changes was gradual, and the industry saw the introduction of new regulations aimed at creating a regulated space for retail hedge funds.

A special set of rules that applied to hedge funds were created. That said, these were incorporated under CISCA, given the relatively flexible nature of CISCA. These regulations provided a set of rules and requirements specific to hedge funds, ensuring that they adhere to the same regulatory standards as traditional collective investment schemes while accommodating their distinct investment strategies.

The FSCA took on the role of supervising and regulating hedge funds under the CISCA framework. This allowed for standardized regulation and oversight of the hedge fund industry.

The process of transitioning hedge funds into CISCA was expected to take several years, and the regulatory framework was continually adjusted to accommodate the evolving industry needs while ensuring investor protection.

The South African regulatory authorities continue to work on refining and enhancing the regulatory framework for hedge funds within collective investment schemes, aligning it more closely with international best practices.

3.5 Types of hedge funds

The framework provides for two types of hedge funds: retail investor hedge funds (RIHF) and qualified investor hedge funds (QIHF).

The intention is to provide a way to distinguish between sophisticated and relatively less sophisticated hedge fund investors.

A qualified investor hedge fund may only permit investment by investors who have 'demonstrable knowledge and experience' in financial and business matters that would enable them to 'assess the merits and risks of a hedge fund investment' (or are advised by a financial services provider having such knowledge) and who initially invest at least R1 million.

3.6 Investment and borrowing restrictions

In contrast with CIS in securities, hedge funds can create leverage by borrowing funds or by engaging in derivative transactions with counterparties. The details of this are provided in Board Notice 52 of 2015, which:

- Limits the fund's total exposure to derivative instruments to the total net value of the portfolio. In essence, a fund that does not follow the value at risk approach can gear the portfolio to a maximum of 100 per cent, i.e., gross assets are double that of net assets.
- The rules for measuring total exposure and leverage differ depending on whether the fund uses simple or complex (termed "sophisticated") investment strategies. A fund that uses non-complex investment strategies will generally measure total exposure and leverage according to the commitment approach. A fund that uses more complex or "sophisticated" strategies will employ an advanced risk measurement methodology. The use of the Absolute Value at Risk (VaR) method is required. VaR is an estimate of the worst possible loss an investment could realise over a specified period under normal market conditions.
- Value at risk may not exceed 20 per cent of the fund's net asset value; calculated daily using daily data to determine with a 99 per cent confidence level that the potential loss over the following month will not exceed 20 per cent.

3.7 Future direction of regulation

The draft Conduct of Financial Institutions (COFI) Bill sets out a framework that revises the framework to regulate any investment arrangement that brings together contributions from the public for purposes of investing such contributions in order to generate a return.

Accordingly, traditional products such as collective investment schemes will move to be licensed under the framework of the Bill. The category of pooled investments currently contemplated under CISCA is retained under COFI, whilst provision has been made for another pooled investment product to be known as "alternative investment portfolios". This will ensure that there is sufficient regulatory oversight, considering the risks that different portfolios pose to different customers. The licensing requirements will, in turn, distinguish between the licensing for a pooled investment product contemplated under a CIS and pooled products classified as alternative investments. COFI and its relevant conduct standards will replace CISCA in its entirety.

This will provide an opportunity to reconsider the framework for licensing of hedge funds.

However, given how relatively small these funds are, the regulatory framework can evolve in a way to encourage growth of the industry.

Hedge funds are a small component of the savings industry, accounting for only R120 billion of assets. This is in comparison to collective investment schemes in securities where there is R3.3 trillion under management.

Hedge funds provide investors with the ability to get exposure to instruments they may not usually purchase. In this way they can stimulate new unlisted companies, innovation and growth. The ability to take on leverage can support riskier investments and the ability to short shares can bring liquidity. They thus play an important role in the financial investment ecosystem. There is an incorrect perception that they provide outsize returns to a small group of investors. Their performance has not been stellar, with most funds delivering returns of less than 15 per cent per year annualized. A small but notable proportion of hedge funds have delivered negative returns. The regulatory framework recognizes that these risks are for the investor – hedge funds have substantially more investment latitude on the presumption that the ultimate investor is relatively sophisticated.

DISTINGUISHING TRANSACTIONS AS CAPITAL OR INCOME IN NATURE

4 BACKGROUND

As mentioned in section 1, South African case law considers various factors to assess the intention with which an asset was acquired, held and disposed of. In the main, these factors, such as the nature of an asset, the holding period and the frequency of transactions, are important indicators of whether an asset was disposed of as part of a profit-making scheme, in which case the gains are viewed as revenue gains.

4.1 Introduction of Capital Gains Tax (CGT)

CGT was introduced into SA through the insertion of section 26A and the Eighth Schedule into the Income Tax Act, 1962, in 2001. This section stipulates that a taxable capital gain will be included in the taxable income of a person as determined by the Eighth Schedule to the Income Tax Act (ITA). The Eighth Schedule governs the determination of taxable capital gains and assessed capital losses.

With the introduction of CGT, the question of the treatment of CISs' disposals of the underlying investments had to be addressed. The following three options were available:

1. Tax the capital gains in the CIS unless it was distributed to the CIS investors. Industry opposed this approach on the grounds that, if a periodic distribution was made, the CIS investors at the time of the distribution would not necessarily be the investors at the time the gains were realised. In addition, distributions of the actual gains would undermine the savings motivation, while distributions of capital gains and losses would require a base cost adjustment to prevent double taxation or under taxation when the investment in the CIS was disposed of. Investors might also experience cash flow difficulties if taxable capital gains were distributed and have to realise investments to fund the tax due on these gains. Performing base cost adjustments on an annual basis would be complex for CIS investors. CISs would not be able to assist since they would not have known the CIS investors' base costs given historical data limitations, the transitional rules to exclude pre-CGT implementation gains and losses, and the election available to taxpayers as to which transitional rules to follow.
2. Follow a pure flow through approach, as used by the United States of America, where taxable gains and losses are allocated to CIS investors on a daily basis and reported to them on an annual basis. This would be aligned with the policy approach to CISs and avoid the timing difference problem of the first option. Industry was opposed to this approach for the reasons set out under the first option above.
3. Exempt capital gains for CIS's. This would be the simplest approach. Capital gains and losses on disposals of the CIS's underlying investments would be reflected as part of the

gain or loss on the disposal of CIS investors' interests in the CISs. CIS investors, would, however, enjoy a significant advantage in respect of the deferral of the taxation of gains.

Prior to 2018, National Treasury received requests from the industry through ASISA where the industry was seeking certainty on the taxation of amounts earned by CISs by proposing that all returns realised by CISs should be of a 'capital' nature. It can be inferred that the frequency of transactions in some portfolios, high asset turnover rates, as well as the brief duration or holding periods of some of the financial instruments involved may have created unease in the industry regarding the tax consequences.

It seems the reason for proposing that all returns by the CIS should be of a 'capital' nature stemmed from some fund managers that argued that persons as a rule hold participatory interests in portfolios for a long period as capital assets. It follows that this intention also governs the nature of the proceeds and accruals on disposal or realisation by the portfolio, as a separate taxpayer.

It became clear that some fund managers took a conservative approach regarding the frequency of asset disposals and were of the view that the portfolios they manage were at a disadvantage in relation to other portfolios which were engaging in frequent disposals since the gains on those portfolios were perceived as not being treated as revenue. In 2018, legislative amendments were proposed in the 2018 Draft Taxation Laws Amendment Bill (the 2018 draft TLAB), discussed below, to include a provision that would increase certainty in deciding whether a gain was of a revenue or capital nature. It was clear from some of the comments received on the 2018 draft TLAB, as well as submissions by some fund managers, that the tax treatment of receipts and accruals by CIS's is an issue that should be addressed with urgency.

4.2 Prior to 2018 and industry requests for clarity

In the past, CIS's generally followed relatively conservative investment strategies. The question of the taxation of 'revenue' gains on the disposal of investments did not arise. In certain instances, where the question of 'revenue' versus 'capital' arose it was in cases where a request of interpretation in a contentious area was required, and it was normally settled on the basis of a warning to the relevant fund manager. This recognised that taxation of the CIS some years later would impact on the then CIS investors, rather than the CIS investors at the time of the transactions, who might have "cashed out" in the interim. Unfortunately, in retrospect, this approach was the beginning of the perception by the industry that SARS would not strictly enforce the capital/revenue divide that would have applied had the CIS investors invested in the underlying securities directly.

4.3 Tax treatment of collective investment schemes in securities

The tax treatment of CISs in securities follows from the principle that it is an investment conduit, and in many ways is simply a convenient way for an investor to hold an unleveraged interest in securities for a long period of time. In this way, it intends to encourage savings.

From a tax perspective, the tax law regards portfolios of collective investment schemes in securities and participation bonds and declared collective investment schemes as "conduit vehicles" to the extent that amounts of income are distributed within 12 months of their accrual. Those amounts are taxed in the hands of the investors in accordance with their tax profile.

Distributions retain their nature for tax purposes and any exemptions available in relation to particular income amounts (e.g., the domestic dividend exemption or the individual interest exemption) are accordingly generally available to the investors in respect of such amounts.

Capital gains are exempt in the hands of a collective investment scheme in securities and participation bonds and declared collective investment schemes. A disposal of participatory interests in a collective investment scheme is taxable in the hands of the investor disposing of the participatory interest as either revenue or capital depending on whether the participatory interests are acquired as part of a scheme of profit making or as capital assets. Where participatory interests in a portfolio of a collective investment scheme in securities or a portfolio of a hedge fund collective investment scheme were held for at least three years any amounts in respect of them are deemed to be of a capital nature for tax purposes.

2018 Draft Taxation Laws Amendment Bill

The draft Explanatory Memorandum to the 2018[8] draft TLAB provided the following rationale for the proposed change in tax policy for CISs:

> *It has come to Government's attention that some CISs are in effect generating profits from the active frequent trading of shares and other financial instruments. These CISs argue that the profits are of a 'capital' nature. They base this argument on the intention of long-term investors in the CIS. The fact that the determination of 'capital' or 'revenue' distinction is not explicitly stated in the Act and reliance is based on facts and circumstances as well as the case law has led to different application of the law and this has resulted in an uneven playing field regarding the taxation of CISs.*

The 2018 draft TLAB that was published on 16 July 2018 proposed that all gains and losses derived from the disposal of financial instruments within 12 months of their acquisition in CIS portfolios be deemed income of a 'revenue' nature.

It should be noted that National Treasury acknowledged the issues that were raised by the industry and was prepared to make certain concessions to address the issues in the revised draft TLAB[9]. The issues included unit holders withdrawing large amounts from portfolios, portfolio rebalancing, index tracking, hedging and transactions directed at efficient portfolio management by using a derivative to gain economic exposure to a share *in lieu* of acquiring the share. However, National Treasury took a decision to withdraw the amendment, recognising the industry's request for the amendment to be withdrawn (despite the

8 Draft Explanatory Memorandum on the Draft Taxation Laws Amendment Bill, 2018

9 Final Response Document on the Taxation Laws Amendment Bill, 2018 and Tax Administration Laws Amendment Bill, 2018, page 23

proposed concessions and prevailing uncertainty) and mainly to allow more time to find solutions that will not negatively affect stakeholders.

5 DISCUSSION OF MAIN COMMENTS EMANATING FROM THE 2018 DRAFT TLAB

It became clear that a number of policy decisions regarding the principles governing the characterisation of receipts and accruals of a portfolio of a CIS had to be considered. The various rounds of consultation and the resultant deliberations highlighted the following aspects:

5.1 Options of determining the character of assets held in a portfolio

The case was made for objective rules for determining the character of assets held in a portfolio. Two options have thus far come to the fore, namely a time-based rule targeting the disposal of assets held for less than a fixed period (as was proposed in the 2018 draft Bill), and a turnover-based rule that would target a percentage of gains based on the extent to which the turnover of assets held by a portfolio exceeded a prescribed limit. A turnover-based rule would be more complex to design than a time-based rule especially for derivative financial instruments or assets with a short lifespan.

5.2 Use of derivatives

In essence derivatives are short-term financial assets or liabilities. Derivatives such as options and futures contracts are often used to speculate or hedge assets held in a portfolio against short-term price fluctuations. They must usually be exercised or are realised within a relatively short period, e.g. three or six months, after which they expire. They therefore serve as hedges for a limited period or are used in the scheme of profit-making. Assets or liabilities that must, due to their nature, be disposed of or settled within a short period of time to yield any return tend to be treated as not being of a capital nature. Fund managers argue that a derivative should be treated for tax purposes as being of the same nature as the underlying asset in respect of which it serves as a hedge. The view to treat all derivatives as of capital nature, based on the assumption that the underlying is usually of a capital nature, has to be dismissed because it may be that some underlying assets are traded in the pursuit of profit-making.

Suggestions included that derivatives entered into by a portfolio to take a position without any hedging intention and instead of acquiring or shorting an asset that are realised in a shorter period, should be treated as being ‘revenue’ in nature. While derivatives entered into by a portfolio to take a position without any hedging intention and instead of acquiring the underlying item, held for a period of at least 3 years and not used in a scheme of profit-making, should be treated as ‘capital’ in nature.

5.3 Hedge fund business

Hedge funds employ various strategies to earn the highest possible return for investors. Their business model is characterised by the active trading of underlying assets or positions held for relatively short periods and may well include gearing and the use of derivatives to ensure the highest possible returns. This business model would be indicative, in terms of case law, of a profit-making scheme, the gains of which should be of a 'revenue' nature. It was suggested by some within the industry that hedge fund CIS are in effect unlawfully using the current dispensation regarding the deferral of capital gains as a shield in respect of gains from the trading of assets held for short periods of time. Some commentators suggested that hedge fund business be excluded from the current CISs tax regime.

5.4 Closely-held portfolios

This is not, strictly speaking, a tax issue although the suggestion was made that the tax rules regarding the characterisation of assets held by a portfolio should be strictly applied in the case of closely-held portfolios, but not in the case of widely-held portfolios. The rationale for any differentiation in this regard would go against the horizontal equity tax principle.

In accordance with the definition of "members of the public" in section 1 of the CISCA Act[10], persons confined to a restricted circle of individuals with a common interest who receive an invitation or are permitted to invest in a portfolio in circumstances which can be regarded as a domestic or private business venture between those persons would not qualify as members of the public. An invitation solely to that group to invest in a CIS or in a portfolio would, therefore, not be an invitation to members of the public, as required by the definition of "collective investment scheme" and "portfolio" in section 1 of CISCA. A portfolio in which investors have been confined to a family group with a common interest would therefore not qualify as a portfolio of a collective investment scheme and would therefore not be entitled to utilise the tax dispensation regarding the deferral of capital gains.

The issue regarding a closely-held portfolio revolves, in essence, around the question whether such portfolio meets the statutory requirements set out in CISCA for its recognition as a portfolio of a CIS. The proper application and the interpretation of these requirements is a matter to be considered by the Financial Sector Conduct Authority.

6 SUMMARY OF INTERNATIONAL COMPARISON

6.1 Australia

Under Division 276 of the Income Tax Assessment Act 1997 (ITAA 1997), as effective from 1 July 2017, Australian Managed Investment Trusts (AMITs) can make an irrevocable election to apply the Capital Gains Tax (CGT) regime to the disposal of eligible assets such as shares, units, and real property[11]. To qualify for this election, the trust must meet specific eligibility

[10] Collective Investment Schemes Control Act, No. 45 of 2002

[11] See Division 276 of the *Income Tax Assessment Act 1997* (ITAA 1997)

criteria, including being an Australian resident trust with clearly defined beneficial interests. Once an AMIT makes this election, it is treated as a fixed trust for income tax purposes, meaning that unitholders have vested rights to a proportional share of both the income and capital of the trust throughout the year. This fixed trust status provides certainty to unitholders, ensuring they are entitled to a defined and irrevocable share of the trust's assets and income. Although this regime brings clarity for domestic investors, foreign managed funds still face difficulties in distinguishing between revenue and capital gains for tax purposes, particularly where cross-border income is involved or local tax rules conflict with Australia's tax laws.

The attribution method under Division 276 allows AMITs to pass income, capital gains, and tax offsets directly to unitholders, with each item retaining its tax character (e.g., capital gains, tax-exempt income, dividends). This flow-through treatment ensures that unitholders are taxed in a manner consistent with the nature of the underlying income or gains. A key feature of this method is the ability for unitholders to make upward or downward adjustments to the cost base of their units, which prevents double taxation. For instance, if a unitholder receives an attributed income that differs from the actual distribution received, the cost base of their units can be adjusted accordingly. This mechanism is particularly important during CGT events (as outlined in Sections 104-107 of the ITAA 1997), which cover not just asset disposals, but a range of taxable transactions such as trust restructures, unit redemptions, and mergers. The attribution method also enhances tax transparency by aligning the commercial outcomes of the trust with its tax treatment, ensuring that unitholders are aware of the tax consequences of the trust's activities. This system provides certainty and flexibility for both trustees and unitholders, ensuring tax obligations are appropriately met[12].

6.2 United States

The Internal Revenue Code provide for special favourable rules relating to the taxation of Regulated Investment Companies (RIC)[13]. In summary, a domestic company that would otherwise be taxed as a company registered with the Securities and Exchange Commission as an investment company, under the provisions of the Investment Company Act of 1940, may elect to be a RIC for any taxable year in which it satisfies certain requirements relating to the source of its income, including earning at least 90 per cent of its income from investments, and the diversification of its assets[14].

A RIC that satisfies certain additional distribution requirements, such as distributing at least 90 per cent of its taxable income to shareholders, is generally taxed as a flow-through entity that acts as a conduit of income to its shareholders. This flow-through treatment is achieved by allowing a qualifying RIC to deduct the amount of dividends paid to its shareholders in

[12] See 104-107 Income Tax Assessment Act 1997
[13] See 851- 860G of the Internal Revenue Code
[14] See 851(a) Internal Revenue Code

computing the RIC's taxable income and capital gains with the result that the RIC is tax neutral.

RICs can pass through the tax character of different types of income to shareholders. For example, long-term capital gains are passed through as capital gain dividends, which benefit from preferential tax rates. Short-term capital gains, however, are treated as ordinary income and taxed at the standard rates. In certain circumstances, tax-exempt interest income can also be passed through to shareholders as exempt-interest dividends, allowing shareholders to receive the tax-exempt benefits at the individual level.

The shareholders, in turn, are taxed on the distributions they receive. Section 854 distinguishes between ordinary income dividends—derived from interest, short-term capital gains, and other taxable income—and capital gain distributions from long-term capital gains. Ordinary income dividends are generally taxed at standard income tax rates, while capital gain distributions benefit from the lower long-term capital gains tax rates. Additionally, Section 854 allows a RIC to pass through foreign tax credits to its shareholders if the RIC has paid foreign taxes on income earned abroad, enabling shareholders to claim either a foreign tax credit or a deduction.

6.3 United Kingdom

Authorised investment funds are generally treated for tax purposes as if it was a company resident in the UK and as if the rights of the unitholders were shares in that company. No flow through principle applies to these funds, The investor will not be deemed to have earned interest income or dividend income, and chargeable gains are exempt from UK tax. The authorised investment fund's income is subject to UK corporation tax at 20 per cent with the exemption of income from derivative contracts, options and creditor loan relationships, provided the authorised investment fund accounts for such income in the appropriate way.

The authorised investment fund is able to deduct all amounts of yearly interest distributed or deemed to be distributed, when calculating its tax liability on income provided such amounts relate to income that was taxable for the authorised investment fund. With a full deduction, the authorised investment fund will avoid the 20 per cent tax charge. Dividends distributed or deemed to be distributed by the authorised investment fund are not, however, deductible[15].

The annual interest received or deemed to be received by the unitholder, is subject to income tax, dividends received or deemed to be received are subject to income tax at the dividend rate. A gain realised on a disposal of the interest in the authorised investment fund where it is not a fund investing in non-reporting offshore funds (FINROF) or where the fund is considered to be 'trading' rather than investing are subject to capital gains tax in the hands of the investor.

[15] Simmons & Simmons – UK Investment Funds Overview – November 2013

6.3.1 Certainty Instruments

The Badges of Trade

These are indicators used by Her Majesty's Revenue and Customs (HMRC) to determine whether profits arising from a transaction are classified as a trade, seeking to catch the swings in the daily market movements, and should be subject to income tax. If an activity is deemed to be a trade, profits are generally taxable. Conversely, if it's considered an investment, capital gains tax might apply (depending on the circumstances).

These badges include Profit-seeking motive for the transaction; Systematic and repeated transactions; Nature of the asset- whether the asset is only realised by way of trade; Existence of similar trading transactions or interests; Modification of the asset; Whether the asset was sold in a way that was typical of trading organisation or whether the sale was to raise cash for an emergency; Method of finance – Whether the money borrowed to buy the asset and whether the funds can only be repaid by selling the asset; Interval of time between purchase and sale; and Supervening trade - An asset that is acquired by inheritance, or as a gift, is less likely to be the subject of trade. No single badge is conclusive, and the overall picture must be considered. HMRC will assess all relevant factors to determine if a trade exists[16].

The White List

The white list was introduced in order to ensure that certain investment funds are taxed in the same way as private investors in the underlying assets. For collective investment schemes the list provides assurance to fund managers and investors that returns from the investment transactions within the list will not be treated as trading income. The primary goal of these regulations is to clarify the tax treatment of these transactions.

A comprehensive list of specified investment transactions that are generally considered to be investment activities not seeking to catch the swings in the daily market movements[17]. The white list is not exhaustive, and transactions outside the list will still be assessed based on the traditional badges of trade. Even if a transaction is on the white list, other conditions may need to be met for the exemption to apply. The white list is subject to review and updates to reflect changes in the financial markets.

6.4 Hong Kong

Collective investment funds in Hong Kong are another example of transparent Collective Investment Vehicles. Funds authorised by the SFC are specifically exempted from Hong Kong profits tax under the Hong Kong Inland Revenue Ordinance Part IVA. Hong Kong profits tax is charged on every person, profession or fund carrying on a trade in Hong Kong in respect of profits arising in or derived from Hong Kong from such trade, profession or fund (excluding profits arising from the sale of capital assets)[18]. Certain exemptions are available, however,

[16] See HMRC BIM20205
[17] The Investment Transactions (Tax) Regulations 2014
[18] Section 14 of the Inland Revenue Ordinance (Cap. 112)

dependent on factors such as (1) non-resident vs resident funds; (2) whether the fund manager is a SFC licensed manager and (3) whether the fund is only engaged in qualifying transactions. A mutual fund, unit trust or similar investment scheme is also exempted from Hong Kong profits tax if it is authorised as a collective investment scheme by the SFC and is a bona fide widely held investment scheme.

Unitholders are tax-exempt respect of income distributions from the fund or capital gains arising from the sale or redemption of units/shares in the fund on qualifying transactions. Qualifying transactions include those that are carried out or arranged in Hong Kong by or through a qualifying fund licensed or registered with the SFC. To be a qualifying fund the fund must meet the following conditions: the number of independent investors exceeds four at all times; the capital commitments made by investors exceed 90 per cent of the aggregated capital commitments at all times; the originator and associates of the fund are entitled to no more than 30 per cent of the net proceeds of the fund's transactions, after deducting the portion attributable to their capital contributions (which is proportionate to that attributable to the investors' capital contributions)[19]. With the exception of investors carrying on profit making trade in Hong Kong who are subject to tax on distributions and gains (which are not capital profits) arising from the sale of units/shares that arise from that trade and that have a Hong Kong source.

6.5 Switzerland

Collective Investment Schemes are regarded another example of a transparent Collective Investment Scheme and (with the exception of collective investment schemes with direct property holdings) do not constitute entities taxable in their own right, i.e. no income tax at a fund level on dividends, capital gains or other income. Taxation of net wealth and income is applied exclusively and directly to investors pursuant to the tax provisions in force at their tax residency. In Switzerland, investments in units of collective investment schemes are governed largely by the same rules as direct investments in the markets covered by a collective investment scheme.

[19] Section 26A (1A) of the Inland Revenue Ordinance.

International Comparison Matrix

Jurisdiction	Investment Vehicle	Capital-Income Designation	Distribution and Transparency
South Africa	Collective Investment Schemes	Based on facts and circumstances - case law*	Flow through with CGT deferral
Australia	CCIVs	Qualifying investments and case law* Pre-selection	Flow through
United States	Regulated Investment Companies (RIC)	Timing Rule: -Long-term Capital: assets held for more than 12 months, preferential long-term capital gains rate. -Short-term Capital: held for less than a year, taxed as ordinary income for that tax year.	Flow through
United Kingdom	Authorised investment funds (non-equity funds)	Badges of Trade, White List and Case Law*	Deduction for distributions
Hong Kong	Authorised retail investment funds	Based on case law*	Tax transparent
Switzerland	Collective investment schemes	Specific qualifying investment/fund types	Tax transparent

**Common case law considerations internationally: (i) the taxpayer's intention at the time of acquiring and holding the investment securities; (ii) the length of ownership of the investment securities; (iii) the frequency and regularity of conducting similar transactions; (iv) how the acquisition of the investment securities has been financed; (v) the reasons of the disposal; (vi) the principal activity of the company; and (vii) the classification of the investment securities in the company's balance sheet.*

7 CONCEPTUAL RECOMMENDATIONS

The previous topics considered whether there should be any change to the current taxation regime of CISs with respect to the characterisation of the receipts and accruals of a portfolio and any recommendations should seek to enhance tax certainty in the South African CIS industry while maintaining the integrity of the tax system.

As noted previously, CIS investments totalled R 3.27 trillion from the end of the first quarter of 2023. This is a significant source of savings for a wide variety of savings vehicles, notably pension funds and unit trusts. CISs offer a liquid, regulated and diversified savings option to ordinary retail investors. This is important given that South Africa has a low savings rate for both retirement and non-retirement savings. According to the 2023 World Bank Development Indicators, South Africa's savings rate is 13.6 percent of GDP. This low savings ratio continues to be a concern for policymakers, and National Treasury has attempted to encourage savings through policy adjustments on both the regulatory and tax side. Besides tax deductions available for retirement savings, the Minister of Finance also introduced tax free savings accounts to encourage non-retirement savings. Any changes to the CIS taxation regime should be in line with efforts to encourage more savings while retaining the principles of a fair tax system.

7.1 Treating all income within a CIS as revenue in nature

Any recommendation with respect to the characterisation of the receipts or accruals of a portfolio should seek to improve certainty and simplicity and enable better harmonisation, consistency, and coherence across the various CISs.

From the onset, the argument has been made by some fund managers that persons usually hold a participatory interest in a portfolio with the intention of holding it long-term as a capital asset, and therefore this intention should also govern the nature of receipts and accruals of the portfolio. This approach is not accepted, as it would mean that all returns within the CIS would be treated as capital in nature and would not be taxable within the CIS, regardless of the trading activity within the CIS.

As a general matter, fund managers act for the benefit of the investors. However, activities of fund managers conducted for a portfolio (as a separate taxpayer) should, in terms of current law, be evaluated in terms of the normal characterisation rules. The outcome should be similar to that which would follow should individuals have performed and concluded those transactions in their own names. The emphasis of the importance of a taxpayer's intention was displayed in the case of *Secretary for Inland Revenue v The Trust Bank of Africa* and the precedence established over time cannot be deviated from only in the case of CISs.

CIS investors already receive a favourable tax treatment through the deferral of capital gains until their participatory interest is sold, but it is not proposed that a further tax concession be provided for returns that would be of a revenue nature.

7.2 Design of a new tax regime for CIS's under section 25BA of the Act which will make them fully transparent

Given the international precedence that most countries aim at ensuring that the outcome from investing in CISs should replicate, as far as possible, the outcomes that would arise as if the investor had directly acquired the underlying financial instrument, and after factoring in the concerns raised by the CIS industry, one option is to adopt a tax model for the taxation of CIS's whereby CIS's will be treated as fully transparent. It will allocate all the different items of receipts, accruals and expenditure to investors on a daily basis. Investors will be treated as if they earned the amounts and incurred the expenditure directly and are taxed accordingly, even if the CIS's do not distribute the income. The CIS will not be a taxable entity in its own right, but merely a conduit. The revenue or capital nature of amounts will be determined from the perspective of the portfolio and activities of a CIS. Each holder of a participatory interest in a CIS and SARS will receive a return from the CIS indicating the amounts to be taken into account in the determination of the participatory interest holder's taxable income for its year of assessment. As noted already in the discussion on international examples, Switzerland and Hong Kong treat CIS type entities as tax transparent in a similar fashion.

This would require CISs to determine daily amounts for each holder of a participatory interest holder that could be aggregated for that holder based on the relevant year of assessment. Conversely, if tax has not been deducted by a CIS, the payment will constitute income or a capital gain of the unitholders.

This option aligns with the tax treatment of investment funds in many other jurisdictions and would eliminate the problem that the current investors of a CIS may be liable for potential tax payments from trading activities when they did not hold a participatory interest in that CIS. The uncertainty about the characterisation of income would remain, but in theory any income that is seen as revenue could then be attributed to the CIS investor at the time as it is calculated. This option would eliminate tax concerns for the CIS manager, however investors would lose the benefit of the deferral of capital gains tax and may face cash flow issues if a tax liability is due on the returns within the CIS, even if they have not sold any of their participatory interests in the CIS. Further considerations are described below.

7.2.1 Treatment of unrealised gains and losses when participatory interest holders join or withdraw from the portfolio and identification of shares sold

The CISs will be disregarded for tax purposes, that is, tax effects occur at the level of the holders of participatory interests and the CIS is merely a conduit by which those persons derive amounts, as would be the case for beneficiaries of a vesting trust without the deferral rules under the current section 25BA of the Act. Adjustments may be required to the cost or base cost of the participatory interests held by taxpayers to take into account taxes paid on unrealised gains.

7.2.2 Selling shares by a portfolio of a CIS that were purchased or acquired at different dates

When a portfolio of a CIS acquired shares on different dates it is proposed that the first-in first-out method be used to determine the application of section 9C to shares disposed of by the portfolio of the CIS.

7.2.3 Treatment of unrealised gains and losses on assets of the portfolio

When a participatory interest holder disposes of the interest in the portfolio of a CIS the proceeds would reflect the value of the underlying assets in the portfolio including unrealised gains and losses. As the flow through of amounts only occurs on disposal or realisation of financial assets or liabilities by the portfolio, the participatory interest holder disposing of the interest does not share in the flow through of subsequent realised amounts.

When a person acquires a participatory interest the cost or base cost would reflect the value of the underlying assets in the portfolio including unrealised gains and losses. On subsequent realisation of the unrealised gains and losses that participatory interest holder will share in the flow through of realised amounts. It will be difficult to identify the portion of the cost or base cost that relates to the subsequent realised gains and losses, and it is recommended that no adjustment is made to the cost or base cost of the participatory interest.

7.3 Using a turnover ratio to create a safe harbour

This proposal would look at total trade volumes over a tax year relative to the overall portfolio size to get a better sense of how actively its traded. If the trades are within a specified turnover ratio, it will be taxed as capital, otherwise the current rules would apply. This would effectively act as a safe-harbour, where CIS's which have a turnover ratio that is below a particular level in a tax year would have certainty that all gains would be treated as capital in nature, and not taxed. However, if the level of turnover is above a particular level, the current rules would apply and whether the gains are capital or revenue in nature would be based on facts and circumstances.

During discussions with the industry, it was shown that the vast majority of CIS portfolios have a turnover ratio of below 1, so it may be possible to set a realistic limit which will only target those CIS's that are overly aggressive, while also making it more flexible for CIS's to manage their portfolio flows and risk within reasonable limits.

This proposal could eliminate the uncertainty of the tax treatment of gains within the CIS, providing assurance to both portfolio managers and investors in the CIS, as long as turnover remains within the prescribed limit. However, for CIS's with a higher turnover ratio the uncertainty will persist, and if any gains are subsequently treated as revenue and taxed accordingly, the new holders of the participatory interests would still face the tax burden even if they were not the holders at the time of the transactions in question.

One disadvantage of this approach is that the setting of the turnover ratio limit would be somewhat arbitrary. To link the proposed turnover ratio limit with current legislation, it is proposed that it could be set at 33 per cent. This would in some way align with the existing provision that if a share is held for three years or longer than any gains from the sale would be treated as capital. Another disadvantage is that CIS managers may engage in excessive trading close to the end of the year if they know the turnover over the whole period will be below the set level, creating another level of distortions. Additionally, the calculation of the appropriate turnover ratio may well be complicated by the inclusion of derivatives or other instruments and would need to be adjusted to cater for withdrawals by investors.

Comments are invited on whether the certainty provided by a safe-harbour as proposed would outweigh the disadvantages that are described.

7.4 Take hedge funds out of the CIS tax definition

Given the systemic and significant size of the "vanilla" collective investment schemes in the securities industry (R3.3. trillion), the options above try to provide certainty on the tax treatment to reduce systemic risk and encourage continued savings, which is important for economic growth and household resilience.

The role of hedge funds is somewhat different. They play an important role in funding innovation and providing liquidity to the market. However, they can leverage and short. They are designed for more sophisticated investors which use hedge funds as an active part of a high risk, high return investment strategy. That said, the industry is still very small. Returns are low. The National Treasury and FSCA can use the regulatory framework to encourage the development of the industry while ensuring stability and the protection of consumers. It is sensible to also treat hedge funds differently from a tax perspective as they are not collective investment schemes in essence. This option would remove hedge funds from the CIS regulatory regime, which would automatically remove the tax treatment and take out many of the funds where the revenue versus capital distinction is most at question. Comments would be welcome as to whether this amendment alone would be sufficient to address the concerns from the industry, both in terms of fair treatment between CISs and in terms of tax certainty for these funds.

Going forward, National Treasury will look to implement a targeted and separate regulatory framework for hedge funds brought about through COFI to operate alongside and outside of the framework for traditional CIS in securities. This recognises the unique characteristics of hedge funds and more correctly distinguishes them from collective investment schemes, allowing for greater alignment between the tax and regulatory treatment.

8 TECHNICAL TAX ISSUES INVOLVING COLLECTIVE INVESTMENT SCHEMES

8.1 Background

In the 2015 Budget Review, the Minister of Finance made an announcement and with effect from 1 April 2015 declared the business of hedge funds in terms of section 63 of CISCA to be a CIS. In terms of Government Gazette No 38503 of 25 February 2015, the managers of all hedge funds had to within six months from 1 April 2015, lodge with the Registrar of CIS (who was the Executive Officer of the Financial Services Board (FSB) at the time) an application to register as a manager to operate a hedge fund in accordance with the CISCA.

For tax purposes, the regulation of these declared CISs created some unintended transitional tax consequences that arose on the disposal by a holder of an interest in an unregulated hedge fund to a vehicle that was acceptable to and approved by the FSB. Amendments were then proposed in the 2015 Draft TLAB that was issued for comments on 22 July 2015.

The 2015 Draft TLAB contained proposed tax amendments to corporate re-organisation rules to allow holders of interests in unregulated hedge funds to dispose of their interests (assets) to a portfolio of a hedge fund CIS on a tax neutral basis by amending the definitions of a “company” and “equity share” to include any “portfolio of a hedge fund CIS” in section 41(1) of the Act for the purposes of section 42 of the Act.

After the publication of the 2015 Draft TLAB, a request was received to amend paragraph (b) of the definition of a “qualifying interest” in section 42(1) of the Act to also include an “equity share” held by a person in a portfolio of a hedge fund collective investment scheme. At the time, section 42(1) already defined a “qualifying interest’ as including an equity share held by that person in a portfolio of a collective investment scheme in securities. This request was accepted on the basis that the "asset-for-share transaction" definition in section 42 of the Act applies to a person disposing an asset to a company in exchange of an equity share in the company subject to certain other requirements being met. In particular, it requires the person at the close of the day on which the asset is disposed of to hold a "qualifying interest" in the company.

8.2 Tax avoidance transactions

The tax neutral transfer of shares to a CIS has created the opportunity for the avoidance of large amounts of tax for corporate restructuring of listed companies as the unrealised gains in the shares are not taxed on transfer to the CIS. For an example, as part of a tax planning strategy:

- a person transfers shares in accordance with the requirements in section 42 of the Act to a CIS in exchange for participatory interests in the portfolio and no CGT is triggered when the shares are transferred to the portfolio. CGT will only arise if and when there is a disposal of the participatory interests in the portfolio while the CIS is still owning the shares transferred from the person; and
- as the CIS is exempt from CGT under paragraph 61(1) and (3) of the Eighth Schedule to the Act, the CIS will subsequently sell the shares free of CGT and utilise the proceeds to acquire other financial instruments.

These avoidance transactions resulted in SARS releasing a press statement on 30 September 2016 warning against this abuse[20].

8.3 Conceptual proposal

It is proposed that this revenue leakage to the fiscus be addressed by withdrawing the ability of CISs to be part of asset-for-share transactions. In order to achieve that result amendments are proposed to the definitions of "company" and "equity share" in section 41 and to the definitions of "asset-for-share transaction" and "qualifying interest" in section 42.

During the 2022 Annexure C process, ASISA requested that section 42(1)(b) of the Act be amended to allow for the deferral of any gains that would otherwise arise on the "swapping" out of units from one foreign CIS to another foreign CIS. It stated that its request stemmed from given several binding rulings that have been issued stating that a South African resident investor either an individual, company or trust can dispose of assets in the context of listed equity shares to a 'local' CIS without triggering any immediate South African tax consequences by utilising the roll-over relief provisions set out in section 42(1)(a) of the Act. Based on fact that foreign CISs may not be regulated by the Financial Sector Conduct Authority (FSCA), are not subject to section 25BA and the proposed withdrawal of "asset-for-share transactions" for domestic CISs the request was not accepted.

[20] 30 September 2016 – SARS on collective investment schemes and takeovers

9 ANOMALY IN THE ACT RELATING TO CAPITAL DISTRIBUTIONS

9.1 Background

9.1.1 Prior to the introduction of CGT

South African CIS's are set up as trusts and are often for this reason referred to as unit trusts. Income flowing to unit holders was deemed to be taxable dividends from the unit trust that was deemed to be a company until 2009. From 1 January 2010 the trust model provided a mechanism to flow income through to unit holders without being subject to tax in the CIS. This is based on the so-called conduit principle associated with trusts, where income that vests in beneficiaries is not taxed in the trust but in the hands of the beneficiaries. If any revenue gains on the disposal of investments were realised by the portfolio of a CIS, the portfolio is taxed unless the gains are distributed to the investors.

Under paragraph 61 of the Eighth Schedule of the ITA, a holder of a participatory interest in a CIS must determine a capital gain or loss in respect of the participatory interest when it is disposed of. Under paragraph 61(3), any capital gain or loss on a disposal by a portfolio of a CIS, other than a portfolio of a CIS in property, must be disregarded.

9.1.2 Distributions of capital by CIS's

Since the taxation of CISs in securities were changed to be similar to an adjusted trust system in 2009 there has been no clear rule in the law relating to "capital distributions" made to holders of participation interests. Paragraph 61 does not deal with this issue and CISCA does not prevent it.

If a portfolio of a CIS in securities were to be liquidated any payments at that stage could be regarded as proceeds on disposal of the participatory interests but there is no distinct rule for going concern payments out of the capital of the portfolio.

9.1.3 Conceptual proposal

It is proposed that a new paragraph be inserted in the Eighth Schedule to the Act so that a capital distribution (distribution from a portfolio of a CIS that is not income, prior to the disposal of a participatory interest in the CIS, the holder of that participatory interest must reduce the expenditure in respect of the participatory interest in a CIS by the amount of that distribution.

In instances where a capital distribution is received or accrued to the holder of the participatory interest in a portfolio of a CIS exceeds the expenditure in respect of the participatory interest in the portfolio of a CIS, the amount of the excess must be treated as a capital gain in determining the aggregate capital gain or aggregate capital loss of that holder for the year of assessment in which that capital distribution is received or accrues.

Discussion Document on

THE TAX TREATMENT OF COLLECTIVE INVESTMENT SCHEMES

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