December 2024

Draft proposals on the taxation of Collective Investment Schemes

Background

During November 2024, National Treasury released the long-awaited discussion document on the tax treatment of collective investment schemes, as part of a broader effort to ensure that the tax framework for collective investment schemes (CIS) is comprehensive and equitable. The aforementioned discussion document has been in the making for a while, following consultation and representations made by various industry bodies. It is, arguably, as a result of commentary released by National Treasury in the Explanatory Memorandum to the 2018 Draft Taxation Laws Amendment Bill: "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… 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."

Introduction

CIS' are subject to a special tax dispensation under the provisions of section 25BA of the Income Tax Act. Section 25BA of the Income Tax Act provides that a person who is entitled to a distribution from the CIS and who receives a distribution from the CIS will be subject to tax on the distribution provided the amount is distributed within 12 months of its accrual or receipt (in the case of interest.) To the extent the CIS receives or accrues an amount and does not distribute that amount to the holder of the participatory interest within 12 months, then the CIS is deemed to have received that amount and will be subject to tax on the amount received or accrued.

In addition, paragraph 61(3) of the Eighth Schedule to the Income Tax Act provides that a CIS (other than portfolios of collective investment schemes in property) may disregard any capital gain or loss on the disposal by the CIS. In addition, paragraph 61(1) provides that the holder of the participatory interest in a CIS must determine a capital gain or loss in respect of the participatory interest only upon the disposal of that participatory interest.

Hedge Fund CIS' are subject to the same tax dispensation as "conventional" CIS' even though hedge funds may have a different investment strategy. The investment strategy of a hedge fund is to both leverage and short securities to achieve an absolute return. Hedge funds have generally been regarded as complex and exotic investment vehicles that are only available to high-net-worth individuals and institutional

investors. Furthermore, hedge funds may employ strategies to earn the highest possible return for investors. Their business model is characterised by active trading of underlying assets to ensure the highest possible returns.

Draft conceptual proposals set out by National Treasury

As a result of the concern highlighted above, a number of policy decisions regarding the principles governing the characterisation of receipts and accruals of a CIS had to be considered. In addition to the above, National Treasury will look to implement a targeted and separate regulatory framework for hedge funds, which will fall outside the framework of the traditional CIS'.

Two options being considered by National Treasury, with a view to addressing the concerns identified, are:

1. A fully transparent tax regime
2. Using turnover to create a safe harbour.

Fully transparent tax regime

This is anticipated to provide the outcome(s) that arise if the holder of the participatory interest had invested directly in the underlying financial assets. Investors would earn amounts and incur expenditure directly and would be taxed accordingly, regardless of whether the amounts are distributed. It is also proposed that the first-in-first out (FIFO) approach be used to determine whether the section 9C relief would be applicable. Some of the concerns under this regime include, amongst others, the fact that investors would lose the benefit of the capital gains tax deferral provided for in terms of paragraph 61(1) of the Eighth Schedule to the Act. Investors may also face cash flow issues if returns are retained in the CIS and not distributed. In addition, this option does not eliminate the need to determine the capital or revenue nature of the amounts arising from a sale, or disposal. If taxes are triggered on unrealised gains, adjustments to the base cost of the participatory interest may be required.

Turnover used to create safe harbour

Turnover would be used to create a safe harbour whereby gains would be treated as capital receipts, provided that the safe harbour is met. This option would require the comparison of total trade volumes over the tax year relative to the overall portfolio size. Trades in excess of the prescribed ratio would need to be assessed on the facts and circumstances to determine if they are capital or revenue in nature. The discussion document released by National Treasury does not specifically state whether paragraph 61 would be retained under the turnover based method.

This alternative also raises some concerns; where gains are treated as revenue in nature, holders may be taxed on unrealised gains arising prior to acquiring the participatory interest. In addition, CIS managers may engage in excessive trading towards the end of the year if they anticipate that they will be below the ratio. The appropriate turnover ratio may be further complicated by the inclusion of derivatives and other instruments. This may result in the turnover ratio having to be adjusted if there are significant withdrawals by investors.

If the proposal to set the ratio at 33% is accepted, this will align (to some extent) with the three-year safe harbour provided for in terms of section 9C of the Income Tax Act.

Conclusion

The proposals included in the discussion document will require input from various stakeholders and is likely to undergo a number of revisions before draft tax legislation is introduced to address National Treasury's concerns. Careful consideration should also be given to the impact that either of the alternatives may have on the CIS industry given its size and importance as a savings and investment vehicle used by many investors.

[1] Discussion Document on the tax treatment of collective investment schemes issued by National Treasury 2024.
2 Section 9C in summary provides that the sale of an equity share held for three years will be deemed to be held on capital account.

KPMG Tax and Legal

For more information and assistance, please contact:

Yacoob Jaffar
Director
yacoob.jaffar@kpmg.co.za
M: +27 78 786 2277

Shaficque Narker
Associate Director
shaficque.narker@kpmg.co.za
M: +27 66 101 6774

kpmg.com/socialmedia

Privacy | Legal

© 2024 KPMG Services Proprietary Limited, a South African company with registration number 1999/012876/07 and a member firm of the KPMG global organisation of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved.

The KPMG name and logo are registered trademarks or trademarks of KPMG International.