Tax treatment of collective investment scheme portfolios in South Africa: Assessing implications and alternative solutions

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Abstract

The Collective Investment Scheme (CIS) industry plays a significant role in South Africa's savings and economic landscape, with substantial growth and assets under management in recent years. However, the tax treatment of CIS portfolios has become a subject of concern, as incorrect approaches could lead to substantial revenue losses for the fiscus. This study examines the proposed amendment to section 25BA put forward in the 2018 Draft Taxation Laws Amendment Bill, which aims to introduce a new tax treatment for the proceeds of sales of financial instruments held by CIS portfolios for less than 12 months.

Through a comprehensive analysis of the proposed amendment, this study explores the potential implications and challenges that may arise if the amendment is implemented. It also investigates the common law principles in South African case law regarding capital and revenue determination and assesses their applicability to CIS managers and portfolios. By doing so, the study highlights the need for clarity and consistency in tax methodology to ensure fair treatment within the CIS industry.

In response to the identified issues, the study proposes alternative solutions that align with existing legislative frameworks and uphold precedents set by case law. These alternative solutions aim to promote tax compliance, transparency, and efficiency within the CIS industry, while avoiding the potential drawbacks associated with the proposed amendment.

The findings of this study contribute to the ongoing discourse surrounding tax and provide valuable insights for policymakers, regulators, and stakeholders within the CIS industry. By critically examining the Proposed Amendment, analysing its implications, and offering alternative solutions, this research contributes to a better understanding of the complexities surrounding tax treatment in the CIS industry and facilitates informed decision-making.

1. Introduction

The Collective Investment Scheme ("CIS") industry plays a prominent role in South Africa's savings and economic landscape, boasting remarkable growth over the years. Starting with a single fund in June 1965, the industry now encompasses over 2 000 CIS portfolios (Financial Sector Conduct Authority (FSCA), 2023b) with a staggering total asset value exceeding R2.6 trillion as of December 2022 (Association for Savings and Investment South Africa (ASISA), 2022). This growth trajectory shows no signs of slowing down, with the addition of approximately 700 portfolios and R600 billion in asset value over the past four years alone.

Given the sheer size and scale of the CIS industry, any incorrect tax approach adopted could lead to substantial revenue loss for the fiscus. Consequently, it is of utmost importance to provide clarity regarding the tax methodology to be used within this industry. However, while ensuring tax compliance and revenue generation, it is equally imperative that any new tax treatment imposed by the South African National Treasury does not significantly alter the operations of CIS managers or the portfolios they administer. Such alterations could have adverse implications not only for the CIS industry but also for a significant portion of the South African population and the broader economy.

Against this backdrop, this study aims to examine the proposed amendment to section 25BA put forward in the Draft Taxation Laws Amendment Bill (“TLAB”) in July 2018 (the "Proposed Amendment") (Taxation Laws Amendment Bill (Draft), 2018). By analysing the impact of this Proposed Amendment on the CIS industry, the study seeks to identify potential issues that may arise and propose alternative solutions that mitigate these concerns.

To achieve this objective, this study will proceed as follows: First, a brief overview of the legislative landscape and structure of the CIS industry will be provided, examining key regulations, documents, and parties involved in the formation and management of CIS and its portfolios. Then the relevant regulations will be delved into, and the roles of crucial stakeholders, including trustees, independent auditors, investors in CIS portfolios (referred to as “Unitholders”), the Financial Services Conduct Authority (“FSCA”), and the Association for Savings and Investment South Africa (“ASISA”) will be discussed.

Subsequently, the study will scrutinize the Proposed Amendment, which aims to introduce a new tax treatment for the proceeds of sales of financial instruments held by CIS portfolios for less than 12 months. This analysis will provide insights into the potential implications and challenges that may arise if the Proposed Amendment is implemented. Furthermore, an exploration of the common law principles in South African case law concerning capital and revenue determination will be conducted, along with an analysis of how these principles can be applied to CIS managers and portfolios.

As the study progresses, alternative solutions will be presented that aim to avoid the identified pitfalls while maintaining consistency with existing legislative frameworks and the precedents set by case law. These proposed alternatives will be carefully developed to promote tax compliance, transparency, and efficiency within the CIS industry.

Finally, the research findings and their implications will be summarized. Through a critical assessment of the Proposed Amendment, an examination of its potential ramifications, and the proposal of alternative solutions, this study aims to contribute to the ongoing discourse surrounding tax in the CIS industry.

2. Methodology

This qualitative study uses doctrinal research methodology and document analysis to interpret the results. Document analysis is the evaluation of all forms of documents (Bowen, 2009). Textual analysis is also used, focusing on the meaning that can be extracted from documents (De Vos et al., 2011).

This study seeks to examine the Proposed Amendment, the impact thereof on the CIS industry, and provide alternative solutions which avoid any potential drawbacks. The research was conducted by studying and analysing the following material:

(a) The legislative framework governing CIS managers and portfolios,
(b) Submissions made before National Treasury by ASISA on behalf of the CIS industry regarding the Proposed Amendment,
(c) The evolution of, and establishment of precedent in South Africa’s tax legislation regarding capital gains tax and income tax, and
(d) Publicly available documents and figures from registered South African CIS managers, ASISA, National Treasury, the FSCA, the South African Revenue Service (“SARS”) and the Johannesburg Stock Exchange (“JSE”).

3. The CIS Industry

The South African CIS industry has a number of key stakeholders, and applicable regulations that give it its structure. CIS portfolios and managers are governed by the Collective Investment Schemes Control Act, Act 45 of 2002 ("CISCA") and fall under the authority of the Registrar of Collective Investment Schemes (the "Registrar"). As per sections 1 and 1A of CISCA, the Registrar falls within the ambit of the FSCA. Before being authorised to offer CIS portfolios to the public, section 5(1)(a) of CISCA indicates a manager of these portfolios must first be approved by the Registrar to administer such portfolios.

The foundation of a CIS is the trust deed, defined in section 1 of CISCA as the agreement between a manager and a trustee, or the document of incorporation. In terms of section 69 of CISCA, only certain types of institutions may be registered as trustees for CIS portfolios. These institutions must satisfy the Registrar that the overall financial and commercial status and self-reliance of the institution are of a suitable nature, as well as it possessing ample expertise and resources necessary to operate effectively. The trustee's mandate under section 70 of CISCA includes monitoring and reporting on a CIS manager's administration of its portfolios, specifically with regards to compliance with investment limits, provisions of CISCA and the trust deed. Assets held in CIS portfolios are held in the name of the trustee, who will also hold voting rights on relevant instruments e.g., ordinary shares. Trustees, in safeguarding assets, are required by section 71 of CISCA to deal with monies invested and assets held in the portfolios within the best interests of the unitholders.

Unitholders are not restricted to any types of investors and include individuals, retirement funds and trusts, amongst others. Unitholders purchase a participatory interest in these portfolios, commonly referred to as "units" (National Treasury, 2018). Unitholders will participate in the returns and losses of the portfolio in proportion to their interest i.e. investment in these portfolios. The unitholders have no rights to the underlying holdings of portfolios, nor appoint portfolio managers of CIS portfolios.

Supplemental deeds are used in the CIS industry to establish new or amend existing CIS portfolios, which in terms of section 1(a) of Schedule 1 of CISCA must contain the investment policy to be followed by each portfolio. Should CIS managers wish to deviate from or change this investment policy, by virtue of section 98 of CISCA, they may not amend this provision of a supplemental deed without first obtaining the approval of the Registrar and the majority (in value) of unitholders. As party to the deed, the trustee will be aware of this variation of the supplemental deed and will need to approve any changes to an investment policy of a CIS portfolio.

Section 73 of CISCA requires CIS managers to appoint an auditor who will be responsible for conducting an independent audit.

CIS managers are required to disclose full holdings of each of their portfolios to the Registrar on a quarterly basis in a format determined by the Registrar (FSCA, 2017), while Board Notice 92 of 2014 ("BN92") governs advertising, marketing and information disclosure requirements for CIS portfolios. Section 16 of BN92 requires each portfolio to provide a Minimum Disclosure Document ("MDD"). Each MDD must include the investment objective, policy summary, and essential characteristics for informed investment decisions. They must also provide the distribution dates and values over the past 12 months (section 16 of BN92).

CIS Hedge Funds are a relatively new entrant to the South African CIS industry with the enactment of Board Notice 52 of 2015, which governs the limits of investment for CIS in Hedge Funds. As at 31 December 2021, the Hedge Fund industry had combined assets under management ("AUM") of R75.8 billion (Novare Holdings, 2021). While this figure is not insignificant, it only represented just under 3% of the CIS industry AUM as at 31 December 2021 (ASISA, 2022).

ASISA was formed in 2008 and represents most of South Africa's asset managers, CIS management companies, linked investment service providers, multi-managers and life insurance companies (Association for Savings and Investment South Africa (ASISA), 2021b). While membership of ASISA is not compulsory, it can be inferred that membership is held in high regard. The majority of active CIS managers are associated with ASISA (ASISA, 2021; FSCA, 2023b).

The aforementioned structures and regulations encompass only a portion of the legal requirements applicable to CIS managers and portfolios. More than 35 Board Notices and General Notices (FSCA, 2023c) are applicable to CIS portfolios in addition to more than 25 Circulars (FSCA, 2023a). The industry is highly regulated, with independent oversight from the trustee and auditor, as well as the possibility of a fine and/or imprisonment for most parties if CISCA requirements are not followed.

4. The taxation of proceeds of disposals in CIS portfolios

The CIS industry may encounter problems through the introduction of the Proposed Amendment. The Eighth Schedule of the Income Tax Act, Act No 58 of 1962, ("the Act") requires under paragraph 61 that any capital gain or loss in respect a disposal of a holding by a CIS portfolio (other than a portfolio of a collective investment scheme in property) must be disregarded. Where the proceeds of the disposal of assets held by a CIS portfolio are deemed to be revenue in nature, these are be dealt with under Section 25BA of the Act.

4.1. Section 25BA

As Section 25BA currently stands, CIS portfolios will need determine whether the disposal of a financial instrument by a CIS portfolio is capital or revenue in nature. Those proceeds of disposals of assets determined to be capital will be taxed in the hands of the Unitholders when they redeem Units of the portfolio they are invested in, in terms of paragraph 61 of the Eighth Schedule of the Act. Those proceeds that are deemed to be revenue in nature, will be assumed to have accrued to the Unitholder when the amount in question is distributed to the Unitholder, and hence form part of their taxable income for the tax year. Note that it is standard practice for CIS portfolios to distribute at least annually.

However, the Act does not define what would render an amount revenue or capital in nature. Whether an amount constitutes capital or revenue will depend on facts and circumstances as well as tests laid down in case law.

4.2. The Proposed Amendment

The Explanatory Memorandum accompanying the Draft TLAB suggests that SARS and National Treasury express concerns over potential misuse of registered CIS portfolios as undisclosed trading accounts for shares and other financial instruments (National Treasury, 2018). This risk is particularly heightened in Hedge Fund CIS portfolios, which often utilize derivative instruments. Retail Investor Funds, according to Section 14(5) of Board Notice 52 of 2015, are allowed leverage up to 200% of the portfolio value. This leverage can be achieved through borrowing or the use of derivatives, which typically have a maturity of less than 12 months when traded on the JSE (Johannesburg Stock Exchange (JSE), 2023). Conversely, the FSCA, which also falls under the oversight of National Treasury, has not raised any public concerns hereto.

The Draft TLAB sought to introduce a new subsection to section 25BA of the Act (Taxation Laws Amendment Bill (Draft), 2018), resulting in proceeds from the disposal of a financial instrument to be income in nature if that financial instrument was disposed of within 12 months of the date of acquisition. The definition of "financial instrument" in section 1 of the Act encompasses a wide variety of investment assets, including short and long-term interest-bearing instruments, shares, commodities and participatory instruments in a CIS portfolio. This definition encapsulates the permissible investment universe of South African CIS portfolios.

The result of this new subsection is that any proceeds distributed by CIS portfolios to Unitholders within 12 months of its accrual will be taxed in the hands of these Unitholders at their marginal tax rates. The Proposed Amendment therefore carries significant implications for Unitholders, as well the investment management and administration of CIS portfolios.

4.3. Potential Consequences of the Proposed Amendment

The Proposed Amendment, while providing some clarity in terms of how proceeds from sales of instruments within CIS portfolios should be treated, does raise a number of potential negative consequences for the CIS industry. These may include:

Incongruency with Investment Policy

As previously discussed, managers of CIS portfolios are required to abide by the investment policy stipulated in the supplemental deeds of the respective portfolios. However, portfolio managers may be influenced to hold a particular financial instrument, trading at what they believe to be par value, longer than what may be deemed appropriate, in order to have the proceeds of the sales of these financial instruments be capital rather than income in nature.

Alternatively, portfolio managers may elect to dispose of assets trading below their purchased base cost that have been held for less than 12 months in order to realise a loss on the disposal, instead of holding these assets to ultimately realise gains originally envisioned in the investment objective of the portfolio.

Differing Tax Treatments of Unitholders

Unitholders within CIS portfolios may be subject to different tax treatments. Managers, who are considering disposing of an asset within the portfolio held for less than a year, may face the near-impossible task of weighing up the interests of untaxed entities (e.g., retirement funds) and those persons or entities that are taxed at differing marginal rates. Additionally, this may place an enormous burden on trustees who are required to discharge their duties of acting for the benefit of Unitholders.

Withdrawals by Unitholders

Portfolio managers may also be forced to sell instruments against their intentions. Unitholders may not only be subject to different tax treatments but may also have vastly different amounts invested. A Unitholder who seeks to redeem a sufficiently large investment may trigger portfolios having to sell instruments, some of which may have been held for less than 12 months, in order to redeem the Units (CIS portfolios are permitted to go into overdraft under Section 96 of CISCA in order to fund withdrawals, but the costs of overdraft are borne by the CIS portfolio). The instruments disposed of, which have been held for less than a year, would result in proceeds rendered as income under the Proposed Amendment. These forced sales not only affect the CIS portfolio, but every other invested Unitholder within the CIS portfolio.

Index Funds

Index funds, as their names suggest, seek to mimic the behaviour of a specified index. In order to do this, these portfolios need to be rebalanced by buying or selling instruments in line with the weightings of the index, normally performed when the replicated index is rebalanced. Forced disposals to mimic an index would realise proceeds that are revenue in nature, while actively managed portfolios may continue to hold the same financial instruments until the proceeds on disposal would be regarded as capital in nature.

Treating Customers Fairly and Recharacterization of Proceeds

The Financial Advisory and Intermediary Services Act, no 37 of 2002 ("FAIS") requires under section 7(1)(xi) of the General Code of Conduct that financial services providers must disclose all material tax matters that investors should consider. This extends to financial products that utilise CIS portfolios as investment vehicles. In addition, CIS managers are required in terms of section 3 of CISCA to disclose all information necessary for Unitholders to "make an informed decision" in a timely and comprehensible manner.

However, the Proposed Amendment does not invalidate SARS' ability to retrospectively raise an additional assessment against a CIS portfolio (in terms of section 99(2) of the Tax Administration Act) and recharacterize proceeds received by the portfolio as revenue, even if the proceeds were received from a disposal of an asset held for more than 12 months, as envisioned by the Proposed Amendment.

The Proposed Amendment therefore does not provide absolute certainty with regards to tax treatment and makes it difficult for investment managers to discharge their duties under FAIS and CISCA.

Derivative instruments

Derivatives are a crucial part of hedge fund CIS portfolios and in terms of Section 3(8)(b) of Chapter I of Board Notice 90 may also be used in non-hedge fund CIS portfolios for efficient portfolio management seeking to minimize risk, costs, and achieve the investment objectives by generating capital or income within an acceptable risk threshold. South Africa has a large derivative market (Hong Vo et al., 2020). The instruments traded on the JSE include index futures, options and single stock futures. The vast majority of these contracts have a term of less than 12 months. Any profits on these contracts held by a CIS portfolio would be revenue in nature under the Proposed Amendment. Managers of CIS portfolios would therefore be disincentivised from using derivative instruments and so remove a potentially valuable investment tool that may be used for efficient portfolio management.

It is clear that the Proposed Amendment provides a less than ideal solution regarding taxation of CIS portfolios. The Proposed Amendment will likely add additional layers of intricacy to an already complex industry, without providing complete certainty on tax treatment for CIS portfolios.

5. Case Law and CIS portfolio application

This study examined specific principles found in South African jurisprudence with regards to capital and revenue determination, and how these principles may be applied to the disposal of assets held by CIS portfolios.

It is worth noting that in terms of Section 102 of the Tax Administration Act, the taxpayer always bears the onus of proving that an amount in question is capital in nature. In order to discharge this onus, the taxpayer would need to show that the amount in question is capital on a balance of probabilities (*CIR v Middleman (1991 SA 200)(52 SATC 323)*).

5.1. Intention

South African tax case law has extensively addressed the distinction between revenue and capital nature of proceeds from asset sales. One of the dominant tests is intention. More specifically, what was the taxpayer's intention when the asset was acquired and did that intention change prior to sale?

Intention was originally referred to in *CIR v Stott (1928 AD 252)(3 SATC 253)*, where it was stated that in the absence of a scheme of profit-making, intention was conclusive in determining capital or revenue. A change in intention has also been examined by the courts (*Natal Estates Ltd v SIR (1975 SA 177)(37 SATC 193)*).

In the case of *Elandsheuwel Farming (Edms) Bpk v SBI (1978 SA 101)(39 SATC 163)*, the court held that when new shareholders took ownership of the company, the intentions of the company changed, inferring that the intentions of the shareholders be taken as those of the company. However, Unitholders do not enjoy comparable rights to shareholders. Unitholders do not own the assets underlying their Units and have no say with regards to the investment policy, apart from voting for or against a proposed change to the investment policy, in terms of Section 98(2)(a) of CISCA. Therefore, the intentions of Unitholders are inconsequential when it comes to determining the intentions of a CIS portfolio.

One can also look to the intention of the investment policy of a CIS portfolio. The policy may be comparable to the memorandum of incorporation ("MOI") of a company in that it is the reason for the formation of the respective entities and describes activities each will undertake. The courts have made numerous references to the MOI in seeking to determine whether profits on sales of shares were capital or income in nature (*African Life Investment Corporation (Pty) Ltd v SIR (1969 SA 259)(31 SATC 163); Commissioner of Taxes v Booysens Estates Ltd (1918 AD 576)(32 SATC 10)*).

The investment policy includes a portfolio's objective, which if sufficiently clear, is useful in portfolios that invest in asset classes that are generally associated with capital growth (e.g., equities) and income-generation (e.g., interest-bearing instruments). Where this is the case, it is the 'dominant purpose' which is decisive (i.e., capital growth or income generation) (*Bloch v SIR (1980 SA 401)(42 SATC 7)*).

Conversely, it has been stated the underlying motives of purchases and sales, as well as the manner in which they were conducted is more important than the MOI (*African Life Investment Corporation (Pty) Ltd v SIR (1969 SA 259)(31 SATC 163)*).

The conclusion that may be drawn in this instance is that while the MOI or investment policy may provide useful information on intention, the motives of the company or CIS portfolio weigh heavier.

The last intention principle to consider is the intention of the portfolio manager. If companies' directors are akin to portfolio managers of CIS portfolios, and courts have said the only way of ascertaining a company's intention is to consider the directors' actions (*CIR v Richmond Estates (Pty) Ltd (1956 SA 602)(20 SATC 355)*), then portfolio managers' intentions should be considered. However, portfolio managers, overseen by the trustee and auditor, are required to operate strictly within the investment policy of the trust or supplemental deed. Consequently, the manager's intention holds limited significance.

5.2. Length of Time held and Fortuitous Sales

When seeking to determine the nature of proceeds, another factor that has been considered is the length of time assets are held. The longer the time, the more likely the proceeds are capital in nature (*CSARS v Capstone 556 (Pty) Ltd 2016 (4) SA 341 (SCA)*). Additionally, section 9C(2) of the Act states that the proceeds of a disposal of shares held for at least 3 years will be deemed to be capital in nature. However, this principle is not set in stone and shorter time periods have not necessarily resulted in proceeds being revenue in nature (*Bloch v SIR (1980 SA 401)(42 SATC 7)*). Even SARS has agreed the manner in which the asset is dealt with is more important that the length of time held (South African Revenue Service (SARS), 2020).

For portfolio managers that trade in listed shares there may be other investors bidding on the relevant exchanges for shares at levels these managers deem high. Accepting these offers to dispose of shares at profit may therefore be deemed to be fortuitous and a sale of their shares be regarded as "a realization of their investment" (*Bloch v SIR (1980 SA 401)(42 SATC 7)*).

5.3. Proceeds of Sales from a CIS Scheme Perspective

CIS managers may argue that irrespective of a CIS portfolio's investment policy, or how long an asset was held for before disposal, that proceeds are by default capital in nature. The merits for this argument begin with an understanding of the CIS managers' fees, the income earning structure versus operations, the "tree vs fruit" principle and the contribution of proceeds to the manager's fees.

Fees

CIS managers earn either performance fees or fixed fees. The quantum of both will depend on the AUM of their CIS portfolios. AUM increases as a combination of the net Unitholder inflows into portfolios and the CIS managers growing assets in these portfolios. Growing portfolio assets are a combination of capital appreciation (producing positive returns) and capital protection (limiting negative returns).

Income Earning Structure vs Income Earning Operations

It was made clear in *New State Areas Ltd v CIR (1946 AD 610)(14 SATC 155)*, that the income earning structure is capital in nature while the income-earning operations are revenue in nature.

"Fruit vs Tree" Principle

The definition of capital excludes income, and vice versa (*CIR v Visser (1937 TPD 77)(8 SATC 271)*). The case goes on to to conclude that income is what capital produces and is similar to the nature of interest or fruit as opposed to principal or tree. However, due to differing viewpoints, this application is often difficult to adhere to. Law books in the hands of a lawyer are a capital asset; in the hands of a book seller they are a trade asset (*CIR v Visser (1937 TPD 77)(8 SATC 271)*).

In terms of section 93 of CISCA, the majority of net proceeds of sales of instruments will accrue to the Unitholders of the portfolio, after the deduction of the CIS manager's fee and other expenses. The net proceeds of the sales are thus not the fruit of the CIS manager's labour – the fee is. If the net proceeds of sales are not the fruit, they are not income (revenue).

Contribution of Proceeds to Managers' Fee

It may be argued that the profits on sales of instruments do, however, contribute to the manager's fee or are sufficiently closely associated with this fee. However, this is only true in certain cases. It is not true in the case of fixed fee arrangements, as fees are based on AUM, and not returns of the portfolio. It is also not always true of performance fee arrangements, as fees are based on a manager meeting a certain benchmark. It is possible for managers to earn a management fee where a CIS portfolio reports a negative return, but one that is better than the portfolio's benchmark. The occasions where positive proceeds may yield fees is where a portfolio charges a performance fee and shows a positive return in excess of its benchmark.

This study has discussed certain principles laid down in South Africa tax case law in determining the nature of proceeds. Ultimately, the intentions of the portfolio managers of the CIS portfolio, like directors of a company, may be taken as the intentions of the CIS portfolio itself. However, unlike directors of a company, portfolio managers may only act strictly within the constraints of the investment policy of the specific CIS portfolio they manage. The length of time an asset was held for before disposal is of less importance than the intention with which it was acquired and disposed of. The intention of CIS managers is to build an income-producing structure through protecting and growing AUM, as well as attracting and retaining investors, so as to earn fees, and therefore proceeds cannot be the income (revenue). The intentions of Unitholders are of no consequence to portfolios managers with regards to how a portfolio is run. As the effects of Proposed Amendment will be borne by Unitholders, there is a distinct disconnect in precedent established by tax case law and the effects of the proposal.

6. Development and discussion of possible alternative solutions

6.1. SARS' Tax Principles and the Proposed Amendment

National Treasury, faced with the potential loss of taxes from some CIS portfolios allegedly claiming proceeds as capital rather than revenue in nature, sought to introduce the Proposed Amendment that unfortunately carries a number of unintended consequences potentially harming the CIS industry.

SARS aims to ensure compliance in an efficient and cost-effective manner, avoiding excessive administrative burdens that could hinder trade, economic growth, and development. To this end, SARS states three principles that it seeks to adhere to in this approach (SARS, 2023a): (i) Making taxpayers aware of their obligations; (ii) Making it easy for taxpayers to meet these obligations; and (iii) Acting against those who breach the law.

This study will seek to develop and evaluate potential alternative solutions in line with SARS' stated goal of tax compliance and the aforementioned principles.

6.2. Alternative Solution: Classification of Portfolios by SARS

Normal Operations of CIS Portfolios

CIS portfolios are required to invest as per the investment mandate and objective of the respective portfolio; buying and selling is not driven by how long instruments have been held. The selling of an instrument that has been held for only a number of months is not inconsistent with a portfolio that seeks to grow capital over the long-term.

Hans Hoogervorst, Chairman of the International Accounting Standards Board, has emphasized the importance of considering short-term fluctuations even for long-term investors. There is a need for continuous evaluation and adjustment in business to avoid larger corrections in the future. One must be cautioned against disregarding market values and solely focusing on the long term (Hoogervorst, 2013). Managing portfolios requires that a number of long- and short-term variables need to be considered with day-to-day decisions made in with light of the portfolio objective.

Leveraging and adding to existing measures of oversight

CIS portfolios are established through supplemental deeds, which outline the investment mandate and objectives approved by the FSCA. While the intentions of the portfolio manager are considered, they must operate within the constraints of the mandate and relevant legislation, under the oversight of the trustee and independent auditor. If a portfolio adheres to its mandate, regardless of the holding period of specific instruments, all proceeds may be argued to be of a capital nature, especially for portfolios focused on long-term capital growth. Categorising portfolios based on their dominant intention, such as capital appreciation or revenue generation for Unitholders, could simplify the application of capital or income tax on distributions. ASISA's Standard on Fund Classification offers a useful framework for grouping portfolios with similar objectives (ASISA, 2021a), which can be extended by assigning trustees and auditors the duty to report on portfolio adherence to its objective when capital appreciation is the goal.

Supporting Records

CIS portfolios are required to provide detailed reports to external stakeholders, including the FSCA, following a prescribed format. SARS has the authority under section 46 of the Tax Administration Act to request relevant information for tax administration purposes. To ensure compliance with the investment policy, SARS can request records from CIS portfolios on a regular basis, such as quarterly, specifying the list of financial instruments sold, duration of holdings, and reasons for the sales. Suspicious transactions may trigger further investigation to verify if the portfolio has conducted the sales in alignment with its objective of capital growth.

Common Oversight of SARS and the FSCA

SARS and the FSCA, both reporting entities under National Treasury, have a common reporting line that facilitates collaboration and efficiency. The FSCA conducts onsite visits at CIS managers to ensure compliance with financial sector regulations, as mandated by section 132(2) of the Financial Sector Regulation Act. In the event of potential non-compliance uncovered during FSCA inspections, SARS may be prompted to investigate whether portfolios administered by the CIS manager are still adhering to their investment objectives. Similarly, if SARS identifies a CIS portfolio operating more like a share dealing account rather than an investment vehicle, this could indicate to the FSCA that the portfolio is deviating from its investment mandate, potentially leading to appropriate action against the relevant CIS manager, trustee, and/or auditor.

Assessment of the Approach of Classifying Portfolios

The classification of CIS portfolios into categories eligible for capital gains tax treatment presents challenges and potential costs for SARS, as it may require significant time and resources. Some portfolios may not fit neatly into either the capital or revenue category due to wide investment mandates or unclear objectives. CIS managers with ambiguous investment objectives may dispute the classifications assigned by SARS, arguing that their portfolios actually focus solely on capital appreciation despite broad mandates. Redrafting the investment mandate is an alternative, but it involves time, cost, investor balloting, independent auditing, and authorisation from the Registrar, potentially leading to capacity constraints and delays if many portfolios seek such changes.

This approach discourages artificial arrangements aimed at minimising tax liabilities and promotes transparency in reporting. It simplifies the application of tax laws, making it easier for taxpayers to understand their tax obligations and reduces administrative burdens. Requiring detailed records from CIS portfolios on a regular basis ensures transparency and accountability and enhances the detection of potential non-compliance. The common oversight between SARS and the FSCA facilitates collaboration and efficiency, deterring non-compliant behaviour and ensures appropriate actions are taken. Therefore, the approach aligns with the principles of awareness, ease of compliance, and enforcement, while avoiding excessive administrative burdens that could hinder trade, economic growth, and development.

6.3. Alternative Solution: Introducing Holding Periods on Unitholders

Argument for Imposing a Holding Period on Unitholders

The focus of the study thus far has primarily been on the operations of CIS portfolios, with limited consideration given to Unitholders. However, it is important to acknowledge that Unitholders would be responsible for the tax payable at their marginal tax rates if the Proposed Amendment is enacted, as CIS portfolios typically distribute profits at least annually.

SARS aims to treat taxpayers fairly and equally (SARS, 2023b). However, under the Proposed Amendment, some Unitholders may benefit from fortuitous timing of redeeming their Units, while others, through no fault of their own, may face higher taxes due to remaining invested when instruments held for less than 12 months are sold for a profit.

To address this unequal treatment, SARS could impose a holding period on Units held by Unitholders, rather than focusing solely on the instruments held by CIS portfolios, as a basis for determining tax treatment.

While Units in CIS portfolios are generally perceived as medium to long-term investments (Section 6(1) of Board Notice 92), allowing for the assumption that proceeds are capital in nature, it is also recognised that Unitholders may engage in portfolio switching to chase performance. Such practice should be cautioned; Unitholders should consider whether their objectives have changed significantly enough to justify a switch.

Unitholders who engage in market timing to pursue performance suggests a scheme of profit-making rather than a focus on capital growth. In South African case law, the dominant test for tax treatment when disposing of an asset relates to the taxpayer's intention. Consequently, the profits from the redemption of Units should be treated as revenue rather than capital.

Implementing a holding period for Units, similar to the provisions outlined in section 9C of the Act, would offer guidance on how profits from the redemption of Units should be treated. Unitholders who dispose of Units before the prescribed holding period could still claim the proceeds as capital, but they would bear the burden of proving the capital nature of the amount.

Assessment of the Approach of Introducing Holding Periods on Unitholders

The potential alternative solution of imposing a holding period on Unitholders, instead of CIS portfolios, aligns with SARS' goals of tax compliance and the three principles informing this compliance. This approach ensures that Unitholders are informed of their obligations through CIS managers (section 3 of CISCA and section 7(1)(xi) of the General Code of Conduct for Services Providers and Representatives of the Financial Advisory and Intermediary Services Act), while allowing uninterrupted operations of CIS portfolios. Imposing a holding period on Unitholders does not burden CIS managers excessively, as they already provide information disclosures (and already track when certain financial instruments were bought and sold for a particular CIS portfolio).

Furthermore, this approach avoids the drawbacks discussed earlier, such as pressure on portfolio managers to operate outside of the investment mandate (or consider the needs of one unitholder over another), penalties for Index Funds when rebalancing, and limitations on derivative instrument usage. By placing the responsibility on Unitholders, they have control over the tax treatment of sales proceeds and are unaffected by others. Additionally, this strategy may promote savings and discourage switching, contributing to National Treasury's goal of improving savings rates (National Treasury, 2022). It may also enhance compliance within CIS portfolios by reducing incentives for short-term performance chasing (and potentially share-dealing).

7. Conclusion

This study aimed to assess the potential impact of the Proposed Amendment on the CIS industry and explore alternative solutions that could address the identified issues. By examining the regulatory environment, potential challenges of the Proposed Amendment, and relevant South African case law on capital and revenue determination, the study has provided valuable insights into the subject matter.

The findings reveal that the CIS industry is subject to rigorous regulation, with multiple layers of oversight and reporting requirements for CIS managers and portfolios. This level of scrutiny makes it difficult for CIS portfolios to deviate significantly from their investment mandates unnoticed. Moreover, the study argues that short-term sales of instruments within CIS portfolios should not be automatically considered as indicative of profit-making schemes, as they can align with the long-term capital growth objectives.

Based on the analysis, it is concluded that the Proposed Amendment could potentially create significant difficulties for the CIS industry and have adverse consequences for Unitholders. In response, the study proposes two alternative solutions. The preferred solution suggests imposing a holding period on Units held by Unitholders to determine whether proceeds should be classified as income or capital. This approach aligns with the goal of tax compliance and principles set by SARS.

Furthermore, the study suggests that CIS managers can provide guidance to Unitholders regarding the tax treatment of Unit disposals based on the holding period. Given the comprehensive records already maintained by CIS managers, this recommendation can be implemented relatively easily, benefiting both the National Treasury and the CIS industry.

Overall, this study contributes to the ongoing discourse surrounding tax regulation in the CIS industry. By critically assessing the Proposed Amendment, examining its potential ramifications, and proposing alternative solutions, the study offers valuable insights for policymakers, industry stakeholders, and researchers interested in tax compliance, transparency, and efficiency within the CIS industry.

7.1. Limitations and Areas of Future Research

Firstly, this study focuses specifically on CIS in Securities portfolios and not on any other unitised savings vehicles which are not approved in terms of CISCA. Therefore, the findings and conclusions of this study may not be directly applicable to other types of investment vehicles. Secondly, this study relies on the existing regulatory framework, case law, and proposed amendment to analyse the implications and propose alternative solutions. Changes in regulations or new legal developments subsequent to the completion of this study may impact the applicability of the findings in future scenarios. Additionally, this study does not consider broader macroeconomic factors or external influences that may affect the CIS industry and its tax treatment. Factors such as market conditions, economic trends, or changes in investor behaviour could have implications beyond the scope of this study. Despite these limitations, the findings and insights presented in this study contribute to the understanding of the tax implications for CIS portfolios and provide a foundation for further research and exploration in this area.

Based on the findings and analysis presented, several areas for future research can be suggested. Firstly, investigation into the value of Units disposed of before three years (when proceeds from disposals are automatically deemed to be capital), and the gains or losses on such Units should also be considered in order to determine the current potential losses to the fiscus and inform the necessity for amendments to tax law. A comparison could be performed of the tax treatment of CIS portfolios in South Africa with other jurisdictions that have similar investment schemes. This comparative analysis would shed light on best practices and alternative approaches to tax regulation in the CIS industry. Lastly, an exploration of the behaviour and decision-making processes of Unitholders in response to the Proposed Amendment would provide insights into how investors might adjust their investment strategies and portfolios based on the tax treatment changes, contributing to a better understanding of market dynamics. By exploring these areas of future research, scholars and policymakers can further advance the understanding of tax regulation in the CIS industry, enhance the effectiveness of tax policies, and promote the sustainable growth of the industry.

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