

## Association for Savings and Investment SA

### Headline Concerns

#### Tax Treatment of Amounts Received by or Accrued to Portfolios of Collective Investment Schemes in the 2018 Draft Taxation Laws Amendment Bill ("TLAB")

##### Current Tax Treatment of Collective Investment Schemes (CIS)

Portfolios of CIS are separate persons for income tax purposes and are in essence vesting trusts. If income such as rent and interest is distributed by a CIS within 12 months after that income has accrued, it is not taxed in the CIS, but in the hands of the investor. Capital gains and losses are also taxed in the hands of the investor, but when an investment is redeemed. For CIS, investors therefore pay tax at their normal marginal tax rate and all capital gains and losses are included in taxable income when they withdraw their savings.

However, the Act does not provide a definition of what constitutes an amount of a capital nature. The concept of what constitutes an amount of a capital nature depends on facts and circumstances as well as the tests enunciated in case law.

##### 2018 TLAB Proposal

The Explanatory Memorandum to the TLAB provides the following rationale for the proposed change in tax policy for Collective Investment Schemes:

It has come to Government's attention that some CIS are in effect generating profits from the active frequent trading of shares and other financial instruments. These CIS 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 CIS.

The TLAB proposes 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. Distributed net gains will therefore be taxed as ordinary income at a unitholder's marginal rates.

##### Outline of headline concerns for ASISA members:

1. Incongruent tax policy consequences
2. Tax equity for the investor
3. Conflicted duties of the manager
4. Treating customers fairly
5. Impact on the financial markets
6. Equal penalty for dissimilar transactions

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## Savings policy

The proposed amendment to Section 25BA in the 2018 TLAB will have a significant impact on saving in South Africa. It will undermine policy consistency, negatively differentiate South Africa from CIS taxation in other jurisdictions, encourage withdrawals in favour of less regulated saving and promote externalisation to foreign CIS.

### National saving

For decades South Africa's gross saving has been steadily declining. Since the 1980s gross saving has fallen from about 25% to 13.8% of GDP. National saving is essential for any economy wishing to have capital for investment in the public and private sectors. This includes the financing of government debt, state owned companies (SOCs), municipalities, existing businesses and new ventures. For example, the long-term savings industry (excl. the PIC) holds R1.3 trillion in government, SOC and municipal debt.

The aggregated asset allocation for CIS as at end March 2018 (SARB) is as follows:

	<u>Rbn</u>
Cash and deposits	594
Government and public sector debt	243
Other fixed income debt	70
Ordinary shares	<u>1 198</u>
<b>Total</b>	<b>2 105</b>

There are three domestic sources for this funding: saving by government, saving by corporates or saving by households. Our inability to fund our needs from either of these sources means a direct dependency on foreigners to fund our debt and investment. For example, the infrastructure that the economy depends on for its efficient functioning has to be financed from either accumulated stocks of saving or debt via government, public entities or private companies. Government debt is at 53% of GDP (almost doubled in 10 years) and SOCs are in severe financial difficulty. Gross capital formation to be financed by foreigners now stands at 25.8%.

### Household saving

Household saving is essential to not only national savings, but also the health of household balance sheets. Household saving has been declining since 1980 as ordinary citizens weigh immediate priorities against competing longer-term necessities. Household debt to disposable income reached an all time high of 86% in 2008. Since then, households have been dissaving, a trend which has only very recently reversed with 0.2% of disposable income being saved.

### The savings system

Collective Investment Schemes were conceived as a means for investors to pool their savings and gain affordable access to the financial markets.

While CIS took many years to gain acceptance with the general public following their launch in South Africa, they have become increasingly popular as investors have grown to accept them as a safe, well

regulated vehicle. Twenty years ago there were 165 funds registered with the Financial Services Board, with assets totalling R78.8 billion. As at end June 2018, registered funds have grown to 1551 and assets under management total R2.26 trillion. This is in strong contrast with household saving which has been in steady decline for decades. The formalisation of saving in South Africa via well regulated CIS is desirable from a policy perspective.

ASISA has been actively advocating for improved certainty across the tax system for all long term saving portfolios. This has included representation to the Davis Tax Committee. However, the proposed amendment did not include consultation on how this might be achieved, any impact assessment and is highly selective in its application. These points are explained below:

## 1. Incongruent tax policy consequences

### 1.1 Context

South Africa, like most foreign jurisdictions, did not always tax capital gains. Prior to the introduction of Capital Gains Tax (CGT) in 2001, capital gains were exempt from tax. The differential between what constitutes capital and ordinary revenue was therefore often litigated. Since 2001, that differential has been mitigated by the introduction of CGT. Although capital gains are still taxed more lightly than ordinary income, this is in line with international practice, especially for a country like South Africa that suffers from capital scarcity. However, the uncertainty in law remains and the onus on the taxpayer to prove that an amount is capital is onerous.

### 1.2 Distinguishing between capital and ordinary income

What constitutes capital or ordinary income has no definition in SA tax legislation. The courts have therefore followed a 'facts and circumstances' approach to determine an outcome, which has mostly relied on the intention of the taxpayer. One of the indicators of 'intention' has been the frequency of buying and selling an asset (land, property, shares etc.) However, frequency of its own is not a singular or infallible test. We do accept that instances might arise where the actions of a portfolio manager might be questionable for a transaction or series of transactions. This could be better addressed through financial markets legislation, rather than a tax rule.

### 1.3 Incongruent consequences

The TLAB policy amendment mimics an approach by the US, which differentiates between short and long-term capital gains using a 12 month rule. However, the US has a vastly different tax system to our own. Dual-rate capital treatment applies across the tax system, where short-term capital gains are distinguished by a 12 month time-based rule. Importing this approach selectively for CIS creates incongruent outcomes for the SA tax system as a whole: between licensed products within the financial system, between CIS and unregulated portfolios and between portfolio assets and the instruments often used to hedge or insure against market loss (these instruments are generally not available in the market for periods greater than 12 months). This tax proposal also seems to be at odds with the Foreign Member Fund framework published by National Treasury in March 2018, where the policy objective is stated as:

The policy objective of the FMF framework is to enable and encourage foreign investors to use South Africa and its investment management industry as a hub and gateway for

investments into Africa and the rest of the world. Secondly, the objective is to also provide a domestically regulated channel for local investors to obtain foreign exposure, subject to the applicable macro-prudential limits. The intention is also to attract foreign capital.

## 2. Tax equity for the investor

### 2.1 Private investors and CIS unitholders

The general policy underlying the taxation of investors in CISs' is that it should be similar to that applying to investors with direct interests in the underlying assets. Section 9C achieves this for investors in private portfolios and CIS.

CISs' tend to enjoy an easement of this concern within the portfolio, precisely because the portfolios and managers are regulated and licensed and their investment powers limited. They are also subject to audit. For example, UK funds (and offshore funds reporting income to UK residents) benefit from an approved 'list' sanctioned by the tax authority, which deems transactions not to be trading transactions when executed by licensed CISs.

### 2.2 Inequity between CIS unitholders

The introduction of a tax rule based on time will disturb fairness between unitholders within a portfolio. For example, a large unitholder's decision to redeem units in less than a year could result in the sale of portfolio assets that have been held for less than a year – thus generating a tax liability that has to be distributed to all unitholders. To make matters worse, the exiting unitholder may escape the tax event entirely, leaving patient investors in the fund with a liability. This is clearly inequitable.

## 3. Conflicted duties of the manager

Portfolio managers are employed to manage money in a prudential manner. We believe that fiduciary duty should be the manager's primary focus, rather than tax optimisation. A tax hurdle will now impede those decisions whether related to asset allocation, liquidity provision or the use of financial instruments as insurance against loss. For example, untaxed investors such as retirement funds will have unitholdings in the same portfolio as taxed unitholders. When weighing an investment outcome, how does the manager balance the interests of the two types of taxpayers? Investment professionals should focus on generating the best investment ideas for their investors. We believe that the proposed changes will negatively affect risk-adjusted returns and conflict managers.

## 4. Treating customers fairly

As mentioned above, we are concerned that, currently, SARS has the discretion at any time to retrospectively raise a tax liability against an investment portfolio and recharacterise what was considered capital gains as ordinary revenue. This places the Financial Services Provider in a precarious predicament. In terms of Section 7(1)(xi) of the General Code of Conduct for Services Providers and their Representatives under the Financial Advisory and Intermediary Services Act no 37 of 2002, such providers and their representatives need to disclose all material tax considerations to a prospective client. It is difficult for this duty to be discharged, given the absence of symmetrical certainty for the portfolio manager in legislation or regulation.

#### 5. Impact on the financial markets

We have not had the required time within the submission deadline to attempt to model the impact on financial markets. Managers have made submissions suggesting that liquidity will be adversely affected. We have no doubt that assets of R2.3 trillion in CISs are systemically significant. The artificiality of the 12 month period could introduce a 'lock-in' effect within the market and potential price distortions in the asset pricing model (prices have a time bias). We have employed the services of an independent actuarial consulting firm to model transactions for the CIS industry to attempt a quantitative impact assessment. This unfortunately cannot be completed within the submission deadline.

#### 6. Equal penalty for dissimilar transactions

The proposed time based rule affects all manner of transactions, including unitholder withdrawals, portfolio rebalancing, index tracking, hedging and transactions directed at efficient portfolio management (for example purchasing a derivative to gain economic exposure to a share in lieu of holding the physical). It does not solve selectively for a concern about trading. We have compiled a technical submission for National Treasury and SARS, which provides details and examples of these transactions.

#### 7. Conclusion

We are concerned about the lack of consultation on such a significant tax amendment. As always, we make ourselves available to work with the authorities to investigate various options to improve certainty for clients, members and the broader economy.

We request that the amendment to Section 25BA of the Income Tax Act, 1962, per paragraph 47 of the TLAB be withdrawn.