BUDGET PROPOSAL TO PROVIDE MUCH NEEDED CLARITY TO MANAGERS AND UNIT HOLDERS OF COLLECTIVE INVESTMENT SCHEMES

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The taxation of collective investment schemes ("**CIS**") and their participatory interest holders is governed by sections 25BA and 10(1)(iB) of the Income Tax Act, No 58 of 1962 ("**Act**") and by paragraph 61 of the Eighth Schedule to the Act. Sections 25BA and 10(1)(iB) deal with the taxation of receipts and accruals of an income nature, whereas the receipts and accruals of a capital nature are dealt with under paragraph 61 of the Eighth Schedule.

In its most basic form, section 25BA determines whether it is the CIS or the participatory interest holder that must be subject to income tax on a receipt of an income nature of the CIS. This determination is based on whether the CIS distributes the particular receipt to the participatory interest holder within 12 months of the date on which it was received by the CIS.

Section 25BA(1)(a) states that such a receipt of a CIS must be taxed in the unit holder's hands if so distributed, and taxed in the hands of the CIS if retained.

If the amount is retained, the CIS will then be subject to income tax thereon. Any after-tax amounts of an income nature that are distributed by the CIS to its participatory interest holders will then be exempt from income tax in their hands in terms of section 10(1)(iB).

The purpose of paragraph 61 of the Eighth Schedule is *inter alia* to provide so-called "wrapper protection" to the participatory interest holders of the CIS if they hold their units as assets of a capital nature (i.e. with a long-term capital appreciation intent or in order to earn passive income). The effect of paragraph 61(1) is that the holder of a participatory interest is only required to calculate a capital gain or loss when such holder disposes of participatory units in the CIS and not on each and every disposal of a capital asset underlying the CIS from which the participatory units derive their value. The capital gain or capital loss will in such case be equal to the difference between the amount paid by the participatory interest holder for its participatory interest and the proceeds from the sale.

Thus paragraph 61(3) provides that a CIS must disregard any capital gain or loss in respect of the disposal of a capital asset held by the CIS. Just as with any other taxpayer, it is feasible that a CIS will hold assets both on capital account and on revenue account (the latter being the case if the assets are acquired by the CIS with the intention of using them as trading stock in a scheme of profit-making). The dispensation in paragraph 61(3) obviously only applies to assets of a capital nature.

To date, the CIS industry has relied on paragraph 61(3) in order to disregard the profits on disposal of all the CIS's underlying assets, irrespective of whether or not the CIS held the assets disposed of as assets of an income or of a capital nature, i.e. the CISs treated everything as capital, regardless of the circumstances. It would seem as if SARS has accepted this treatment as, to this author's knowledge, no CIS has ever been taxed on its share profits.

It follows that the correct legal approach is that any revenue profits on share deals must be subject to income tax in the hands of the CIS if such proceeds are not distributed to the unit holders within 12 months of being derived.

Common law principles are used to determine whether an asset is of an income or of a capital nature. In the leading case of *CIR v Pick 'n Pay Employee Share Purchase Trust*, it was held that *"[t]he appropriate test in a matter such as the present is a well-established one. The receipts accruing to the Trust will be revenue if they constitute 'a gain made by an operation of business in carrying out a scheme for profit-making"*. In commenting on this principle, the court held in the more recent case of *CSARS v Capstone 556 (Pty) Ltd* that *"[t]hat expression refers to the use of the taxpayer's resources and skills to generate profits, usually, but not always, of an on-going nature"*.The Budget Speech 2018 states the following with regards to the status *quo:*

"Amounts (other than capital amounts) are taxable in the portfolio of a collective investment scheme ***unless*** *they are distributed to participatory interest holders within 12 months of accrual.* ***Some collective investment schemes are trading frequently and arguing, contrary to current case law, that the profits are of a capital nature****.It is proposed that the current rules be clarified to provide certainty on the treatment of trading profits in this context."* (Our emphasis)

The above proposal is silent on whether the proceeds derived from the disposal of assets of an income nature by a CIS will be subject to income tax in the CIS's hands if they are not distributed to the participatory interest holders within 12 months of their accrual. One would certainly hope that National Treasury would include a provision similar to paragraph 61(3) in the Act in order to allow CISs to disregard the proceeds resulting from the disposal of assets of an income nature, given that many holders of participatory interests are not taxable, e.g. pension funds.

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