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A REVIEW OF THE GOVERNMENT GAZETTE AND NEW DEVELOPMENTS IN LAW

Local schemes see change in rules

Collective investment scheme distribution to follow flow-through principle

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A PORTFOLIO in a collective investment scheme in securities is currently treated as a company for income tax purposes, even though its legal form is that of a trust.

As a result of this, any distribution of the income earned by a collective investment scheme constitutes a dividend. Such dividends are exempt in the hands of the holders of partici-

pation rights in the scheme (the "unit holders") except to the extent that they are distributed from income which was exempt in the hands of the scheme under section 10(1)(iA) of the Income Tax Act.

Income generated by a collective investment scheme from its investments, such as interest income, is typically exempt in terms of section 10(1)(iA). Foreign dividends are treated differently in that they are deemed to accrue directly to the unit holders in terms of paragraph (k) of the gross



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income definition.

In this year's budget review it was proposed that distributions by a local collective investment scheme should follow a flow-through principle. The Taxation Laws Amendment Act of 2009 contains these changes.

The explanatory memorandum to the act says the reason for the changes is the difficulty experienced with the current dispensation. Although special provisions exist to ensure the collective investment scheme effectively functions as a flow-through entity, these provisions are not consistent. To illustrate the inconsistency, the example of a long-term insurance company is given. A long-term insurance company calculates a percentage in terms of section 29A(1) of the act (the "expense relief ratio") to determine what percentage of its indirect expenses relating to the sale of policies it may claim as a tax deduction. If the long-term insurance company receives interest income

it has a more beneficial effect on the expense relief ratio than the receipt of taxable dividends. Currently, the act does not contain special provisions to treat the taxable dividends as interest for purposes of calculating the expense relief ratio, even though the underlying amounts represent collective investment scheme distributions derived from interest.

To give effect to the intended flow-through treatment of a collective investment scheme, the following principle changes are proposed by the act (these changes are proposed to come into operation from the commencement of the years of assessment commencing on or after January 1 2010):

■ In future the scheme, which is set up under the Collective Investment Schemes Act, will not be treated as a company for income tax purposes, except in certain limited instances. A foreign collective investment scheme will still be treated as a company and the

changes discussed in this article are not applicable to a foreign scheme.

■ The definition of "person" in the new legislation will be amended to include a portfolio of a collective investment scheme. The instances where a portfolio of a scheme will still be treated as a company relate to the connected person definition and the group relief provisions. If a scheme were treated as a trust, for purposes of the connected person definition, then all the unit holders would be deemed connected persons in relation to each other which would lead to absurd results.

■ The act proposes introducing a new section 25BA to legislate the conduit principle in respect of the income received by a scheme. Section 25BA provides that any amount, other than an amount of a capital nature, received by, or accrued to, a portfolio of such a scheme must, to the extent that the amount is distributed by that portfolio to a unit holder within 12 months of its receipt by that portfolio, be deemed to have directly accrued to the unit holder on the date of the distribution.

To the extent that the amount is not distributed by the scheme within 12 months of its receipt, such amount will be deemed to have accrued to the collective investment scheme and will be taxed in its hands. Section 25BA replaces the existing exemption for income accrued to a collective investment scheme which is contained in section 10(1)(iA) and the special rules which deemed foreign dividends to directly accrue to the unit holders.

The existing capital gains tax exemption for the scheme, which is contained in paragraph 61 of the eighth schedule, is retained.

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