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**THE TAXATION OF INVESTMENT
RETURNS ARISING IN
COLLECTIVE INVESTMENT
SCHEMES AS COMPARED TO
HEDGE FUNDS**

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requirements for the Degree of Master of
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Thesis abstract

The thesis compares the taxation of the investment returns from a hedge fund to those derived from a collective investment scheme. Taxation within the investment entity and in the hands of the investor were considered, this yielding the overall effective tax rate on the return. The scope of the comparison was limited to the consideration of two types of investors only: a retirement fund and an individual.

The methodology entailed an initial analysis of the nature of investment returns generated in a hedge fund (chapter 1). An examination of the regulation and types of collective investment schemes considered within the Income Tax Act was performed in order to explain why hedge funds could not also be classified as collective investment schemes (chapter 2). The taxation of retirement funds was reviewed (chapter 3). The taxation of returns from a hedge fund housed in a company was compared to that of returns from a collective investment scheme in securities, as defined in the Collective Investment Schemes Control Act, No. 45 of 2002 (CISCA). The taxation of returns from a hedge fund housed in a trust was compared to that of returns from a collective investment scheme in property, as defined in the CISCA. The taxation of a hedge fund housed in a partnership was considered separately (chapter 4). A tax-efficient structure, comprising a combination of the types of entities in which hedge funds may be housed was proposed (chapter 5). It was concluded that, in some instances, investors enjoyed a lower overall effective tax rate on the returns from a hedge fund than the equivalent returns from a collective investment scheme. In other instances, the overall effective tax rate was found to be greater or identical (chapter 6).

Declaration of independent work performed

I, the undersigned hereby declare that the work contained in this thesis is my original work and has not previously been submitted, in part or entirely, to any university for a degree.

Susan Amelia McCready

Date

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The CISCA refers to the Collective Investment Schemes Control Act, No. 45 of 2002

The Companies Act refers to the Companies Act, No. 61 of 1973

The Eighth Schedule refers to the Eighth Schedule of the Income Tax Act, No. 58 of 1962, as amended

The Income Tax Act refers to the Income Tax Act, No. 58 of 1962, as amended

The Pension Funds Act refers to the Pension Funds Act, No. 24 of 1956

The Stamp Duties Act refers to the Stamp Duties Act, No. 77 of 1968

The TORFA refers to the Tax on Retirement Funds Act, No. 38 of 1996

The Trust Property Control Act refers to the Trust Property Control Act, No. 57 of 1988

The Uncertificated Securities Tax Act refers to the Uncertificated Securities Tax Act, No. 31 of 1998

The VAT Act refers to the Value-Added Tax Act, No. 89 of 1991

Abbreviations used

CGT Capital gains tax

STC Secondary Tax on Companies

FSB Financial Services Board

ACI Association of Collective Investments

AIMA Alternative Investment Management Association

SARS South African Revenue Service

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1 Introduction

Traditional investment strategy entails investment in assets such as cash, bonds and equity with the expectation that their market values will increase over time. If such a strategy is enacted in a fund for the benefit of members of the public, it is called a Collective Investment Scheme.¹ However, an investment portfolio which is over-subscribed in equities, during a period in which stock market corrections are ensuing, may be considerably detrimental to the investor's overall net worth. Hedge funds arose as a means of increasing the portfolio value of an investment despite a concomitant *decrease* in the equity market value. This is achieved, *inter alia*, by strategies such as the short selling of equities. This strategy refers to the sale of equities not owned by the investor, which the investor believes are currently over-valued. Thus there exists an expectation in respect of such equities that their market value will decrease in the future.

It is currently estimated that about US \$1 trillion assets are invested in Hedge Funds worldwide.² The world's first Hedge Fund originated in the USA: the Alfred Winslow Jones Investment Partnership, established in 1949, marked the start of the growth of the industry.³ Nowadays a large range of Hedge Funds, estimated at over 8000⁴, with different strategies, is available internationally. The first Hedge Funds arose in South Africa in 1997. Today, there are 83 funds with R10.2 billion of assets under management.⁵ This lower relative number of funds is most likely due to the much greater size of share markets and the greater choice of listed instruments overseas. All South African Hedge Funds are currently unregulated. This means that these funds are operated privately rather than being regulated by the Financial Services Board (FSB) and therefore cannot market themselves as investment funds to the general public.⁶

Discussion is currently underway within the Financial Services industry to bring Hedge Funds into the regulatory net. A proposal for regulation was published in September 2004 by the FSB, together with the local chapter of the Alternative Investment Management Association (AIMA). In this document, it was noted that the new Collective Investment Schemes Control Act, No 45

¹ Definition of a Collective Investment Scheme in section 1 of the CISCA; The Regulation of Hedge Funds in South Africa, a discussion paper by D Bouwmeester, Werksmans Attorneys, 14 October 2004

² Hedge Funds Report, KPMG International, 2005

³ Cape Times Business Report, 12 April 2005

⁴ Hedge Funds Report, KPMG International, 2005

⁵ Kevin Shames, Chairman of the South African chapter of the Alternative Investment Management Association (AIMA), at a meeting of the Old Mutual Investors Club, 20 September 2005, Cape Town

⁶ Cape Times Business Report, 12, 13 & 14 April 2005

of 2002 (CISCA) catered for the regulation of potentially new types of asset portfolios, such as Hedge Funds.⁷ It therefore followed that regulation of Hedge Funds could be achieved by the Minister simply declaring Hedge Funds to be a new type of Collective Investment Scheme.⁸ Such schemes enjoy specific tax concessions within the Income Tax Act, for example that, in general, double taxation (within the investment fund and in the hands of the investor) is avoided.⁹ Regulation of Hedge Funds may not, on the other hand, necessarily be achieved through the avenue of existing legislation pertaining to Collective Investment Schemes and in this regard, it may result in undesirable consequences. Of significance here are the potential tax consequences. Since the financial services industry is uncertain as to the exact means by which regulation of Hedge Funds is to be achieved, it has been stated that there would only be an incentive to apply for regulation if there were neither capital gains tax nor income tax within the Hedge Fund, with taxes only payable by the investor, rather than the Fund, when units in the Fund were sold.¹⁰ In short, regulation of Hedge Funds would only be desirable, from a tax point of view, if double taxation of both the Fund and investor is avoided, presumably by similar mechanisms currently available to Collective Investment Schemes in the Income Tax Act.

This thesis will compare the tax treatment of the returns on an investment in a Collective Investment Scheme with that of the returns on a similar investment in a Hedge Fund. Such a Hedge Fund might be housed within a company, a trust or a partnership. The thesis will test the validity of the assertion that Collective Investment Schemes, formerly Unit Trusts¹¹, and the investors in such funds, unilaterally enjoy beneficial tax treatment in contrast to that enjoyed by a Hedge Fund and its investors in the currently unregulated environment. It will be confirmed that the taxation of investment returns in Collective Investment Schemes is, in many instances, more favourable than that applicable to a Hedge Fund. However, it is also concluded that, under certain circumstances, the investment returns of a Hedge Fund are, in fact, subject to less, or the same, taxation overall as similar returns derived from a Collective Investment Scheme. In the

⁷ The Regulatory Position of Hedge Funds in South Africa, jointly contributed to by members of the FSB, ACI and AIMA, 3 September 2004

⁸ Part 4.4 of the discussion paper referred to in the previous footnote

⁹ For example, it was stated in the Cape Times Business Report, 8 April 2005 that unit trusts are exempt from CGT. Certain provisions in the Income Tax Act, which are explored in detail later in this thesis, exempt income from taxation within a Collective Investment Scheme, with the proviso that it constitutes a taxable receipt within the hands of the investor, thus averting double taxation of the same income within both the Collective Investment Scheme and the investor

¹⁰ Kevin Shames, quoted in The Financial Mail, 19 November 2004, page 3

event that Hedge Funds become a regulated investment in their own right, separate and distinct from Collective Investment Schemes, it is important that they enjoy equitable tax treatment to other pooled forms of investment. An investor who chooses to invest in a regulated Hedge Fund in the future should not be prejudiced with respect to the taxation of returns that he might otherwise have faced had he chosen instead to invest in a Collective Investment Scheme.

What is the difference between Hedge Funds and Traditional Investment Funds?

Traditional investment funds typically invest in assets such as equities and bonds. The investment strategy is based on the principle that these assets will generate income and/or grow in market value over time, thus imparting investment growth.¹² An active investment strategy would result in the continual replacement of shares considered to be over-valued with shares considered to be under-valued. Historically, the compounded average annual change in share markets has been determined at near 5% in the US market.¹³ Thus, even if a market correction occurs, there is a good chance that, by simply holding onto the investment, the market value will eventually increase again, restoring the value temporarily lost. This strategy is called a “long only” approach to investment, and it means that the fund beneficially owns all the assets in which it invests and from which it seeks investment return. The returns of a traditional, long-only investment fund tend to track the overall movement of the market.¹⁴ This correlation results in decreased fund market value when markets lose value, and therefore is of concern to the investor. Hedge Fund investment strategy was developed as a means to increase asset value during a market downturn, i.e. to break the linkage between Fund market value and market buoyancy. The term “absolute return funds” may also be used to refer to Hedge Funds. Whilst this term embodies one of the main aims of Hedge Fund strategy, namely, to produce a positive investment return irrespective of the market trend, those in the Hedge Fund industry point out that Hedge Funds are, in fact, a subset of “absolute return” funds, since not all funds referred to in the phrase “absolute return” are Hedge Funds *per se*. For example, some Collective Investment Schemes have been marketed as “absolute return” funds, although they are not practising the strategies unique to Hedge Funds and by which means they generate “absolute

¹¹ The Unit Trusts Control Act was replaced with the CISCA with effect from 3 March 2003, thereby marking the inception of the term “Collective Investment Scheme” in place of “UT” although the latter term is still widely used within the media to refer to CISs

¹² W Brown, F Liebenberg, Old Mutual Investors’ Club, 26 April 2005

¹³ <http://www.crestmontresearch.com/content/market.htm> downloaded 26 August 2006

returns". Similarly, Hedge Funds are merely a subset of all those types of funds referred to in the phrase "alternative investment funds". This term encompasses a wider range of funds than just Hedge Funds, and includes all investments which are not traditional bond/equity long-only funds. Thus "alternative investments" refer, *inter alia*, to private equity investments, venture capital, currencies, commodities and real estate, as well as Hedge Funds.¹⁵

The concept of short sale

In order to maintain an investment portfolio's value during market corrections, Hedge Funds introduced the concept of the short selling of securities. The term "short" indicates that the Hedge Fund does not own the shares that it wishes to sell and therefore it is required to borrow the shares from a third party. Any asset can be sold short, although in the context of Hedge Funds, this usually applies to shares. Other financial assets such as bonds and gold coins can also be sold short, as can non-financial assets such as sugar or wheat. In fact, any asset which exists as one of numerous identical units can be sold short. In law, identical units are referred to as "fungibles"¹⁶ and the loaning thereof gives rise to a loan for consumption. A borrower in a loan for *consumption* becomes the owner of the item borrowed and is only obliged to return what is *similar*, rather than is the position in a loan for *use*, where the item borrowed is unique (e.g. one's house or one's car) which must be returned *in specie* to its owner.¹⁷

In the context of this thesis, "short selling" indicates the sale of shares. The borrowing of shares for the purposes of a short sale has an interesting added feature in that shares are registered assets. Although the ordinary listed shares of a company are all equivalent to one another, borrowing shares for the purpose of a short sale requires the borrower, i.e. the Hedge Fund, not only in law, but also technically, to become the owner of the shares. This means that the shares must be transferred into the name of the borrower. When the Hedge Fund subsequently sells the shares, the sale of the shares gives rise to a receipt of income in the hands of the Hedge Fund. The contract between the lender and the borrower of the shares provides that the Hedge Fund will reimburse the lender for any dividends declared during the term of the loan.¹⁸

¹⁴ Hedge Funds in South Africa: The Investment Case, SJB Peile & WS van der Merwe, 13 October 2004, p4, awaiting publication at time of this thesis

¹⁵ Part 3.20-3.30 of the discussion paper referred to in footnote 7; p2 of the paper referred to in footnote 14

¹⁶ Per discussion with B. Ger & K Huxham in 2005

¹⁷ CIR v Genn & Co (Pty) Ltd, 20 SATC 113

¹⁸ Per discussion with SJB Peile of African Harvest Alternative Investments, January 2006

The arrangement between the lender of the shares and the Hedge Fund as the borrower is that the shares would be returned at some specified time in the future. These must be securities that the Hedge Fund strategist believes are relatively over-valued and therefore should decrease in market value during the term of the loan. The Hedge Fund promptly sells the seemingly over-valued shares and banks the proceeds. In a successful short sale trade, the share price of the shorted security would decline over the contracted period. At the specified termination date, the Hedge Fund purchases the equivalent number of the shares, which are then returned to the owner. Since the Hedge Fund buys the shares at a lower price than that at which they were sold originally, a trading profit is realized for the Hedge Fund.

How does the Income Tax Act view the borrower and the lender in a contract of short sale?

The introductory paragraph to Practice Note No. 5¹⁹, issued by SARS on 14 April 1999, observes that the JSE was, at that time, lagging behind the rest of the world's equity markets with respect to its clearance and settlement procedures. The concept of "securities lending" was recommended as a means to align the liquidity, pricing efficiency and attractiveness of the South African equity market as an investment option, with its overseas counterparts. The international concept of a lending arrangement was thus legislated into the Stamp Duties Act, No. 77 of 1968, and the Income Tax Act, in 1996.

Section 1 of the Income Tax Act, with effect from 22 December 2003, defines a "securities lending arrangement" to mean a lending arrangement as defined in the Uncertificated Securities Tax Act, No 31 of 1998.

The definition of a lending arrangement in section 1 of the Uncertificated Securities Tax Act reads as follows:

"(a) a person (hereinafter referred to as the lender) lends securities to another person (hereinafter referred to as the borrower) in order to enable that borrower to effect delivery (for any purpose other than for delivery to any lender in relation to that borrower unless the borrower can demonstrate that the arrangement was not entered into for purposes of the

avoidance of any tax and was not entered into for purposes of keeping any position open for more than 12 months) of the security within 10 business days after the date of transfer of those securities from the lender to the borrower in terms of that arrangement;

(b) that borrower in return contractually agrees in writing to deliver securities of the same kind and quality to that lender within a period of 12 months from the date of transfer of those securities from the lender to the borrower in terms of that arrangement;

(c) that borrower is contractually required to compensate that lender for any distributions in respect of the securities which that lender would have been entitled to receive during that period had that arrangement not been entered into; and

(d) that arrangement does not affect the lender's benefits or risks arising from fluctuations in the market value of the securities:

Provided that where

- (i) that borrower has not delivered on the securities within the period contemplated in paragraph (a); or*
- (ii) that borrower has not returned securities as contemplated in paragraph (b) to the lender within the period contemplated in that paragraph,*

that arrangement shall not be deemed to be a lending arrangement."

The definition of a lending arrangement in the Stamp Duties Act was similar to the above definition, but has been repealed.²⁰ The transfer of marketable securities in terms of the Stamp Duties Act's definition of a lending arrangement was exempt from stamp duty.²¹ The change in beneficial ownership in securities in terms of a lending arrangement, as defined in section 1 of the Uncertificated Securities Tax Act, is exempt from uncertificated securities tax in terms of section 6(1)(b)(iv) of that Act. The Income Tax Act treats the borrower and the lender in a

¹⁹ SARS Practice Note No. 5: Stamp Duty, Income Tax, Secondary Tax on Companies, Tax on Retirement Funds, Value-Added Tax and Uncertificated Securities Tax implications of lending arrangements in respect of marketable securities

²⁰ Stamp Duties Act, section 23(1), definition of a "lending arrangement" deleted by section 157(a) of Act No. 45 of 2003

²¹ Stamp Duties Act, exemption (nB) of Item 15 of Schedule 1, deleted by section 163(1)(h) of Act No. 45 of 2003

securities lending arrangement such that the lender of loaned securities is deemed still to be the owner thereof, and no gain or loss arises in the hands of the lender or borrower from the transfer of the loaned securities between the lender and the borrower. This principle applies irrespective of whether the lender is an investor in securities or a dealer, as is illustrated in the following extracts from the Income Tax Act.

In terms of section 9B of the Income Tax Act, a taxpayer may elect that any amount received by or accrued to or in favour of him as a result of the disposal of an “affected share” be deemed to be of a capital nature. An “affected share”, by definition²², must be a share in a South African listed company which has been held by the taxpayer for a continuous period of at least five years. Section 9B(1)(e) of the Income Tax Act provides that where any share has been lent in terms of a securities lending arrangement, such share shall be deemed not to have been disposed of by the lender. Where any share is returned to the lender in terms of such an arrangement, such share and such other share shall be deemed to be one and the same share in the hands of the lender.

If the lender holds the loaned securities as trading stock, section 22(4A)(a) of the Income Tax Act provides that the borrower is deemed not to have acquired such securities. The return of the equivalent securities by the borrower to the lender is deemed likewise not to be an acquisition of the shares by the lender. Section 22(9)(a) of the Income Tax Act further provides that where the trading stock of any person includes securities lent to a borrower in terms of a securities lending arrangement, and the same or equivalent securities have not been returned by the borrower to the lender by the end of the year of assessment, then the securities shall be deemed to be trading stock still held by the lender. Likewise, in terms of 22(9)(b) of the Income Tax Act, the loaned securities held by the borrower shall be deemed not to be trading stock in the borrower’s hands.

The Eighth Schedule mirrors the same deeming principle for the borrower and the lender as was seen in sections 9B and 22(4A) and 22(9) of the Income Tax Act. In respect of the disposal of securities constituting capital assets, paragraph 11(2)(h) of the Eighth Schedule states that there is no disposal of an asset “by a lender to a borrower or by a borrower to a lender where any security has been lent by a lender to a borrower in terms of a securities lending arrangement.”

²² Section 9B(1) of the Income Tax Act

Illustration of gain and loss through leverage of short sale

In order to achieve a profit in a short sale, the prediction of future market value is clearly of critical importance. In terms of a long-only investment policy, a traditional fund is not permitted to sell an asset which the fund does not own and is therefore precluded from pursuing a strategy of short selling. This is presumably due to the inherent risk attached to the short sale of shares. If the share price, after the shorting transaction, does not fall, but instead rises, the Hedge Fund has a potential uncapped loss, as it is contractually bound to purchase equivalent shares to return them to their original owner, irrespective of the share price. In practice, the Hedge Fund's exposure may be even greater. The Hedge Fund receives cash in return for the short sale of the shares. The Hedge Fund may choose to bank the money and earn interest. The alternate choice is for the Hedge Fund to purchase new assets. The Hedge Fund would purchase new assets if it can expect to generate a higher rate of return than the prevailing interest rate on cash deposits. This is an example of leverage: the borrowing of money in order to acquire an investment which derives a higher rate of return than the cost of borrowing.²³ Should the assets purchased by the Hedge Fund with the proceeds of the short sale decrease in value concomitantly with the increase in value of the borrowed shares, the exposure of the Hedge Fund is the sum of these two losses. This is illustrated below:

²³ Financial Management, Correia C et al, Third Edition, Juta, 1993, p582

Table 1

Illustration of the leveraging of loss through short sale

Period illustrated: 1 month	Income	Assets	Liabilities	NAV
<u>Opening balance:</u>				
<u>Borrow R100 Didata shares on day 1</u>	-	<u>R100</u>	<u>(R100)</u>	-
<i>Transactions through month:</i>	<i>Movement:</i>			<i>Movement:</i>
Sell Didata shares short for R100	-			-
Purchase R100 Google shares	-			-
Sell Google shares for R50, at month-end	<i>(R50)</i>	<i>(R50)</i>		<i>(R50)</i>
Reacquire Didata shares for R200, at month-end	-	R150	<i>(R150)</i>	<i>(R150)</i>
Settle liability to Didata share-owner	<i>(R100)</i>	<i>(R200)</i>	R100	<i>R100</i>
<u>Closing balance</u>	<u>(R150)</u>	<u>Rnil</u>	<u>(R150)</u>	<u>(R150)</u>

In the example (Table 1), the Hedge Fund used the proceeds from the sale of borrowed Didata securities to purchase Google securities, which promptly dropped in value. The Didata shares then *gained* market value, contrary to the Hedge Fund strategist's expectation. Overall, the Fund incurred a loss of R150 by the end of the month.

In contrast, a traditional, long-only fund would only be able to purchase the Google shares, using its own capital. The loss over the period illustrated would therefore be restricted to the R50 loss. This example illustrates the power of leverage, which results in the Hedge Fund

showing greater gain or loss depending on the market conditions. Leverage can, of course, also enhance fund value, as illustrated in the next example.

Table 2

Illustration of the leveraging of gain through short sale

Period illustrated: 1 month	Income	Assets	Liabilities	NAV
<u>Opening balance:</u>				
<u>Borrow R100 Didata shares on day 1</u>	-	<u>R100</u>	<u>(R100)</u>	-
<i>Transactions through month:</i>				
	<i>Movement:</i>			<i>Movement:</i>
Sell Didata shares short	-			-
Purchase R100 Google shares	-			-
Sell Google shares for R200, at month-end	R100	R100		R100
Reacquire Didata shares at month-end, for R50	-			-
Settle liability to Didata share-owner	R50	(R50)	R100	R50
<u>Closing balance</u>	<u>R150</u>	<u>R150</u>	<u>Rnil</u>	<u>R150</u>

In this example, the Hedge Fund uses the proceeds from the short sale of the Didata shares to invest temporarily in Google shares, which then gain market value over the month. Thus, the Fund makes a R100 profit on the sale of the Google shares at the month end. Furthermore, the shorted Didata shares lose market value, as anticipated, and the Fund settles the liability to the Didata share owner at a profit of R50. Overall, the Hedge Fund reflects an increase in net asset

value of R150 by the end of the month. The traditional, long-only fund would be restricted to making only the R100 profit realized by the sale of the Google shares, which it purchased using its own capital. Leverage cannot be used by a long-only fund as these funds fall under the regulation of the CISCA. (The relevant sections of the CISCA are shown in Box 1, together with an explanation.)

Successful Hedge Fund strategy requires not only an accurate prediction of share market values but also exquisite timing in performing the transactions illustrated in Tables 1 and 2. The manager of a long-only share portfolio cannot profit from identifying over-valued shares *outside* of the portfolio, whereas a Hedge Fund strategist would be able to exploit this scenario.²⁴ Short selling is one of several strategies employed by Hedge Funds to exploit market inefficiencies and actively reduce risk associated with market downturns. Of the approximately 14 distinct strategies identified, some of the more prevalent strategies include options and derivatives trading and arbitrage trading.²⁵ These strategies are discussed in Box 1.

Options and derivatives trading

An option or derivative refers to a contract, the market value of which is based on the performance of an “underlying”.²⁶ The underlying could be a financial instrument, an index such as the All Share Index, or any type of investment or commodity, such as wheat futures. “Derivative” trading refers to the fact that there is no intention on behalf of the trader to acquire the underlying itself. Rather, the trader intends to trade only in the derivative contract. Profits are generated by accurately predicting the performance of the underlying, without any intention of acquiring the underlying itself.

²⁴ p6 of the paper referred to in footnote 14

²⁵ Magnum Funds, <http://www.magnum.com/hedgefunds/articles/1999: About Hedge Funds> downloaded 28/02/2005

²⁶ Paragraph 9 of AC133

Box 1

Prohibition of leverage by the CISC A

In terms of section 85(2) of the CISC A, assets may be lent, but subject to the terms of section 95. Section 95(1) (b) of the CISC A confirms that assets, other than money, may be lent.

Section 95(2) of the CISC A permits a portfolio manager, other than of a Collective Investment Scheme in securities, to borrow money for the purposes and subject to the limits and conditions determined in the deed. "Deed" is a defined term in section 1, and refers to the document of incorporation whereby a Collective Investment Scheme is established, and in terms of which, it is administered. The Schedules to the CISC A specify what the deeds of a Collective Investment Scheme in securities and a Collective Investment Scheme in properties should contain. Schedule 1, applicable to a Collective Investment Scheme in securities, and Schedule 2, applicable to a Collective Investment Scheme in property, both require a provision concerning *"the limits, terms and conditions under which a manager may for the account of a portfolio borrow money."* A Collective Investment Scheme in securities is thus permitted to borrow money, but reference must be made to section 96 of the CISC A for the relevant conditions under which this may take place.

Section 96 empowers a manager, of only a Collective Investment Scheme in securities, to borrow money, but specifically for the purpose of bridging insufficient liquidity in a portfolio. It states that *"In the case where insufficient liquidity exists in a portfolio or where assets cannot be realized to repurchase or cancel participatory interests, the manager of a collective investment scheme in securities may borrow the necessary funds for such repurchase or cancellation on security of the assets and for the account of the portfolio in question, from a registered financial institution at the best commercial terms available and until assets can be realized to repay such a loan: Provided that the maximum amount so borrowed may not exceed 10 per cent of the market value of such portfolio at the time of borrowing."*

The type of borrowing activities undertaken in a Hedge Fund would not necessarily be permitted in terms of section 96 of the CISC A, as the extent of leverage may exceed 10% of the fund value. Furthermore, the borrowings would be for the purposes of trade, and not to bridge insufficient liquidity.

Section 89(1) of CISCA states that *"A manager may not be registered or allowed to continue as a manager, unless at the time of registration and at all times thereafter the manager has net assets in liquid form which exceed the minimum capital requirement determined under section 88."*

Section 88 requires a Collective Investment Scheme manager to constantly maintain *"in liquid form, capital, for the matters and risks determined by the registrar"*. The *"matters and risks determined by the registrar"* does not appear to be a defined term in the CISCA. Section 87 of the CISCA defines *"liquid form"*, for the purposes of sections 88 and 89, to mean *"any asset which is capable of being liquidated within seven days."*

Even before consideration of the matters and risks the registrar may have in mind, section 89(1) of the CISCA presents a prohibitive hurdle for Hedge Funds. This is because Hedge Fund strategies extend to the borrowing of capital, e.g. for short sales, and, through the leverage techniques illustrated in Table 1, the fund may not always be in a position of net assets, and if the Hedge Fund is in a position of net assets, these assets may not necessarily be of a liquid form. Furthermore, Hedge Fund strategies often cannot easily be unwound or realized profitably at short notice, i.e. within seven days, as is referred to in the definition of *"liquid form"* in section 87 of the CISCA. This leads to the imposition by Hedge Fund managers of limited opportunities for the entry into and exit of investors from Hedge Funds. Some Funds only permit cash flows to take place at month-end, whilst others impose even more restrictive conditions and may only permit redemptions to take place once a quarter.²⁷

²⁷ *Cape Times Business Report*, 13 April 2005, (in which it was reported that the FSB would not sanction a lock-up period for investment in Hedge Funds as long as 31 days); p14 of the paper referred to in footnote 14

Arbitrage

Arbitrage, in the context of shares, refers to the exploitation of a deviation from the predictable relationship between the market prices of related securities.²⁸ For example, a company may have listed equities and convertible bonds available for sale on the stock exchange. If a relationship exists between the relative pricing of these two forms of capital, an arbitrageur will exploit any temporary deviation in their relative prices, on the assumption that the historic relationship will ultimately prevail. Thus, if the convertible bonds usually trade at a 5% discount to the equities, a deviation to a 3% discount, precipitated by a drop in the equities share price, would prompt the purchase of the company's equities insofar as these are temporarily undervalued with respect to the convertible bonds.

A typical arbitrage transaction might exploit a price spread between related securities of only a few basis points, as illustrated in the preceding paragraph. To generate an increased return, an arbitrageur might leverage the transaction in order to facilitate the purchase of additional undervalued securities. The undesirable effect of leverage used for the amplification of arbitrage returns is exemplified in the collapse of the Hedge Fund, Long-Term Capital Management (LTCM). The fund was set up in 1993 in the USA by a team of traders and academic economists. The fund took speculative positions by exploiting spreads, some less than 12 basis points apart, in global equity and interest instruments. As an example, the interest rate on a medium quality corporate bond is historically one percentage point more than the rate on a 30-year Treasury bond. If the gap widened to *more* than one percentage point, the fund assumed that it could bet with confidence that the gap would close in the future, yielding a small profit per position held. It was further assumed that this was a low risk strategy. To amplify the profit to a commercially viable level, LTCM employed leverage at extremely high ratios. Starting with capital from investors of \$2.2 billion in 1993, LTCM used this as collateral to eventually leverage \$1.25 trillion worth of securities. In 1998, however, the normal market equilibrium upon which the fund strategy was based was derailed for longer than predicted. This was precipitated by the Russian debt crisis. LTCM's speculative positions no longer yielded a profit. Daily losses of hundreds of millions of dollars resulted in a \$3.65 billion cash lifeline being thrown to the US Federal Reserve Bank by various international financial institutions. This was

²⁸ Magnum Funds, [http://www.magnum.com/hedgefunds/articles/1999: About Hedge Funds](http://www.magnum.com/hedgefunds/articles/1999:AboutHedgeFunds) downloaded 28/02/2005

used to unwind the fund and place it into liquidation. It is unfortunate that eight years later, the general perception of Hedge Fund risk is still inextricably linked to LTCM. LTCM failed to institute proper risk management practices, which would have mitigated or even prevented the financial loss which ultimately took place.²⁹

Having discussed the manner in which Hedge Funds differ from traditional, long-only funds, one may ask whether there exists an all-encompassing definition of a Hedge Fund? The answer from those familiar with the industry seems to be that none exists.³⁰ Texts on the issue decline to define categorically what a Hedge Fund is, and rely rather on listing the characteristics of Hedge Funds as a means of determining the types of funds envisaged by the term. One Hedge Fund investment company defines the primary aim of a Hedge Fund as being: “to reduce volatility and risk, whilst attempting to preserve capital and deliver positive returns under all market conditions”.³¹ The joint discussion paper on the proposed regulatory approach to Hedge Funds noted that most jurisdictions define Hedge Funds merely by listing their essential and/or unique characteristics. Having analysed the identifiable criteria used by a number of international bodies, the paper proposed a preliminary definition of a Hedge Fund in terms of the following common characteristics:

- Use of short asset exposures or short selling to reduce risk or volatility, preserve capital or enhance returns
- Use of leverage, resulting in an excess of the gross exposure of the fund assets over the available capital in the fund
- Remuneration of the fund manager mainly via a performance-linked fee, typically 20% (as opposed to a traditional fund, where this is linked to a percentage of the assets under management)

Where either of the first two features is present, it was suggested that the fund should be classified as a Hedge Fund.³²

²⁹ Long Term Capital Management, Silicon Valley, USA, <http://mt.sopris.net/mpc/finance/lcm.html>

³⁰ An Introduction to Hedge Funds, W Connor & M Woo, London School of Economics, September 2003, paragraph 1.1; p11 of the paper referred to in footnote 14

³¹ Magnum Funds, <http://www.magnum.com/hedgefunds/articles/1999:AboutHedgeFunds> downloaded 28/02/2005

³² Part 3.15-3.30 of the discussion paper referred to in footnote 7

Proposed regulation of the Hedge Fund industry

The Collective Investment Schemes Control Act, No. 45 of 2002 replaced the Unit Trusts Control Act, No.54 of 1981 with effect from 3 March 2003. The CISCA provides a framework for the regulation of collective investment products in which members of the public are invited to participate. However, investment funds which adopt typical Hedge Fund strategies, such as leverage and short-selling, are not able to comply with the provisions of the CISCA (refer to Box 1) and are required to structure their funds independently of this Act.³³ Thus, Hedge Funds are currently unregulated investment products and as such, are not permitted to invite members of the public to participate therein i.e. Hedge Funds are precluded from marketing themselves, as an investment product, to the general public. The Financial Services Board (FSB), which is responsible for the regulation of all publicly-held investments in South Africa, is currently considering the case for the regulation of the Hedge Fund industry. The main issues in respect of the regulation of Hedge Funds with which the Board and the industry as a whole are grappling are discussed briefly below.³⁴

Transparency

Effective regulation would require Hedge Funds to disclose their investment strategies so that the FSB could ensure that public funds were not being excessively exposed to risk. Hedge Fund managers are reluctant to disclose their strategies, as they feel that this would compromise their competitive advantage.

Pricing frequency

An investor may redeem his/her investment in a collective investment scheme within 24 hours. Market valuation of the investment, by reference to a listed exchange, is possible on a daily basis. The international norm for the minimum lock-up period of a Hedge Fund investment is only once a quarter. The FSB, acting in the public's interest, requires a more frequent investment redemption policy to be instituted and considers that even 31 days is not acceptable.

³³ The Regulation of Hedge Funds in South Africa, D Bouwmeester, Werksmans Attorneys, 14 October 2004

³⁴ These issues were discussed more fully in the Cape Times Business Report, 13 April 2005

Illiquidity

The FSB has stated that it only wishes to regulate liquid funds. Hedge Funds tend to be less liquid than collective investment schemes on account of their investment strategies of leverage and short-selling.

Compliance costs

Regulation may well boost the growth of the industry, in that advertising and marketing of investment in Hedge Funds would be possible, but it would come at the cost of compliance with those regulations. This would decrease the profitability of Hedge Funds.

Tax consequences

The industry is uncertain of the tax consequences that regulation would impose upon the Hedge Fund industry. Collective investment schemes enjoy unique tax benefits conferred upon them specifically by the Income Tax Act. The means by which regulation will be achieved, and the consequent tax implications for Hedge Funds, could determine whether such Funds will seek to register and become regulated or not.

Conclusion

This chapter has discussed what a Hedge Fund is and highlighted the differences in strategy adopted by a traditional, long-only fund versus those adopted by a Hedge Fund. It has also looked at specific provisions in the CISCA which preclude hedge funds from being regulated under this Act at present.

The Income Tax Act relies on the definitions provided in the CISCA when it refers specifically to Collective Investment Schemes³⁵, and therefore the next task, in Chapter 2, is to examine the definitions in the CISCA which are of relevance in interpreting these specific provisions in the Income Tax Act. The relevance (or otherwise) of these definitions in relation to Hedge Fund investments is also considered.

³⁵ For example, part (e) of the definition of a company in section 1, section 10(1)(k)(i)(aa) and (bb) and section 11(s) of the Income Tax Act

The thesis will, in Chapter 4, compare the taxation of a Hedge Fund with that of a Collective Investment Scheme, which leads to an analysis of the provisions of the Income Tax Act specific to Collective Investment Schemes.

2 Collective Investment Schemes

Section 1 of Part 1 of the CISCA defines a Collective Investment Scheme as:

*“a scheme, in whatever form, including an open-ended investment company, in pursuance of which **members of the public** are invited or permitted to invest money or other assets in a portfolio, and in terms of which-*

- (a) two or more investors contribute money or other assets to and hold a participatory interest in a **portfolio** of the scheme through shares, units or any other form of a participatory interest; and*
- (b) the investors share the risk and the benefit of investment in proportion to their participatory interest in a portfolio of a scheme or on any other basis determined in the deed,*

but not a collective investment scheme authorised by any other Act.”

Members of the public³⁶

Members of the public are invited to invest in a Collective Investment Scheme. The CISCA, in defining the term “members of the public” excludes:

“persons confined to a restricted circle of individuals with a common interest who receive the invitation in circumstances which can properly be regarded as a domestic or private business venture between those persons and the person issuing the invitation.”

Unregulated investment funds are not permitted to market themselves to the general public.³⁷ As a result, a Hedge Fund cannot qualify in terms of this requirement of the definition of a Collective Investment Scheme. This does not mean, however, that there can be no listed Hedge Funds. A company may list on the JSE and embark on the business of running a Hedge Fund,

³⁶ Definition is in Section 1 of Part 1 of the CISCA

³⁷ Cape Times Business Report, 14 April 2005

provided that it markets itself as a company. It may not list as an investment fund, however, as it would then be promoting investment by the general public into an unregulated fund.³⁸

Portfolio³⁶

“Portfolio” is a defined term in the CISCA. This is an important term in that it features in the CISCA’s definition of a Collective Investment Scheme, and is also referred to in the definitions of “assets”, “income accruals”, “investor”, “members of the public”, “open-ended investment company” and “participatory interest”. A portfolio means:

*“a group of assets including any amount of cash in which **members of the public** are invited or permitted by a manager to acquire, pursuant to a collective investment scheme, a participatory interest or a participatory interest of a specific class which as a result of its specific characteristics differs from another class of participatory interests.”* (emphasis added)

The reference to “members of the public” in the definition of “portfolio” further precludes Hedge Funds which are unable to market themselves as an investment to the public in their unregulated state.

Collective Investment Schemes recognized in terms of the CISCA

The CISCA defines six different types of Collective Investment Schemes, of which only three are specifically mentioned by the Income Tax Act. The amendments to the Income Tax Act, promulgated on 13 December 2002, replaced references to Unit Trusts and reflected the terminology of the new CISCA.

Collective Investment Scheme in securities

Section 39 of the CISCA defines a Collective Investment Scheme in securities to mean:

“a scheme, the portfolio of which consists, subject to this Act, mainly of securities.”

Section 41 restricts the administration of a Collective Investment Scheme in securities. No person other than a *company*, duly registered as a manager under section 42, may act as a

³⁸ Per discussion with SJB Peile of African Harvest Alternative Investments, January 2006

manager of a Collective Investment Scheme in securities, although the vehicle in which the Collective Investment Scheme in securities is conducted is not similarly restricted. Such management company is further defined to mean a “company” under the Companies Act, 1973. Such a company is one which has available capital and reserves for employment in the Collective Investment Scheme in terms of section 88 of the CISCA.

Collective Investment Scheme in property

Unless the context of this part of the CISCA indicates otherwise, section 47(1) states that a Collective Investment Scheme in property includes:

“a scheme the portfolio of which consists of property shares, immovable property, assets determined under subsection (2) or any investment permitted under section 49.”

Section 47(2) affords the Registrar of collective investment schemes at the FSB the right to determine assets, other than those referred to in the definition of “Collective Investment Scheme in property”, which may be included in a portfolio of a Collective Investment Scheme in property.

Section 48 restricts the administration of Collective Investment Scheme in property. No person other than a company duly registered as a manager in terms of section 51 may act as a manager of a Collective Investment Scheme in property, although the vehicle in which the Collective Investment Scheme in property is conducted is not similarly restricted. Such company is further defined to mean a company under the Companies Act, 1973. Such a company is one which has available capital and reserves for employment in the Collective Investment Scheme in terms of section 88.

Other types of Collective Investment Scheme defined in the CISCA

The CISCA further defines:

- a Collective Investment Scheme in participation bonds³⁹
- a declared Collective Investment Scheme⁴⁰ and

³⁹ Section 52 of Part VI of the CISCA

- a foreign Collective Investment Scheme.⁴¹

Collective Investment Scheme in participation bonds

A “participation bond” is defined as a mortgage bond over immovable property in the CISCA.³⁹ The Collective Investment Scheme in participation bonds is therefore a fund, the assets of which comprise assets in the form of participation bonds, in which members of the public are invited to invest. The Income Tax Act makes no specific mention of this type of Collective Investment Scheme.

Declared Collective Investment Scheme

Section 63 of the CISCA enables the Minister, by means of a notice in the Gazette, to declare a specific type of business to be a Collective Investment Scheme. A “declared” Collective Investment Scheme is thus an open-ended definition.⁴⁰ It is possible that the Minister could use this avenue to declare Hedge Funds to be a Collective Investment Scheme.⁴² These funds could then fall under the jurisdiction of the CISCA as a “declared Collective Investment Scheme”. The Income Tax Act makes no specific mention of declared Collective Investment Schemes.

Foreign Collective Investment Scheme

The section 1 definition of a Collective Investment Scheme in the CISCA states that a Collective Investment Scheme authorized by any other Act is not recognized as a Collective Investment Scheme by the CISCA. However, section 65 of the CISCA permits the Registrar of collective investment schemes to approve of any foreign Collective Investment Scheme which conforms to the four stated requirements in section 65(1). These requirements are that

- (a) the application is presented in the required format
- (b) a copy of the approval or registration of the foreign collective scheme by the relevant foreign jurisdiction is submitted

⁴⁰ Section 62 of Part VII of the CISCA

⁴¹ Section 65 of Part VIII of the CISCA

⁴² This method of bringing about regulation of the Hedge Fund industry is referred to on page 15 of the paper referred to in footnote 7

(c) The foreign collective scheme can comply with the conditions determined by the Registrar of collective investment schemes

(d) The fee determined by the Registrar has been paid.

Section 65(2) of the Cisca provides for a foreign Collective Investment Scheme, approved in terms of the requirements of section 65(1), to be regarded as a financial institution for the purposes of section 15A of the Financial Services Board Act, No. 97 of 1990. The Income Tax Act refers only once to a foreign Collective Investment Scheme in paragraph (e)(ii) of the definition of a company in section 1.

Conclusion

This chapter has reviewed some of the definitions in the Cisca to which those provisions of the Income Tax Act, which are specific to Collective Investment Schemes, refer. These definitions will be referred to again in Chapter 4, where the taxation of Collective Investment Schemes is compared to that of Hedge Funds.

Hedge Funds have traditionally been regarded as the investment choice of the wealthy. In their unregulated state, marketing to the general public has hitherto not been possible, with the result that only the well-informed and sophisticated type of individual investor would normally be familiar with Hedge Funds as a means of investment. With regulation in the pipeline, it is envisaged that Hedge Funds may become more accessible to the general public, however, the current minimum entry-level amount required to be invested in a Hedge Fund is typically prohibitive to the majority of investors. Minimum investment amounts from R250 000 to R5 million have been quoted, and each Hedge Fund would be in a position to determine its own entry-level amount.⁴³ As a result, current investors would typically be high-income individuals. Retirement funds are also major investors in Hedge Funds, as they have large amounts of capital to invest, and they need to provide positive returns on capital, even in a bear market. The next Chapter addresses the taxation of Retirement Funds because of the fact that Retirement Funds are a major investor in Hedge Funds, and will continue to remain so, even in the event that the Hedge Fund industry achieves regulation. The taxation of Retirement Funds is governed by the

Taxation on Retirement Funds Act, No. 38 of 1996 (TORFA). It is important to examine the taxation of income and capital gains within a Retirement Fund in order to determine the full extent of the taxation of investment returns from a Collective Investment Scheme as compared to a Hedge Fund. This comparison will be addressed in Chapter 4.

⁴³ R250 000 quoted in Cape Times Business Report, 13 April 2005; R5 million quoted by Kevin Shames, Chairman of the South African chapter of the Alternative Investment Management Association (AIMA), at a meeting of the Old Mutual Investors Club, 20 September 2005, Cape Town

3 Taxation of retirement funds

The nature of investments and the extent to which a registered Retirement Fund may invest therein is restricted in terms of the provisions of Regulation 28 of the Pensions Fund Act, No. 24 of 1956.⁴⁴ Classification in terms of Regulation 28 takes place by a consideration of the nature of the underlying investment. Of the various categories or kinds of investment strategies listed in Regulation 28, Hedge Funds i.e. the short selling of equities *per se* are not mentioned. Thus the unique investment strategies of a Hedge Fund may fall for classification under category 10 of the Regulation, termed “other assets”. A maximum of 2.5% of the fair value of a registered fund’s assets may be invested in “other assets”. Thus, retirement funds cannot currently incur significant direct exposure to local Hedge Funds. Many Retirement Funds, however, do have greater exposure to Hedge Funds indirectly through their investment in international “fund of hedge funds”. A “fund of funds” is one that invests in other hedge funds.⁴⁵ Such funds are often listed on international exchanges and are treated as equity for regulatory purposes. Regulation 28(1)(c) provides that the total fair value of investments in assets in territories outside the Republic shall not exceed 15% of the total fair value of assets in a registered fund. A South African Retirement Fund may thus have exposure of up to 17.5% in Hedge Fund type investment strategies if the full 15% allocation to foreign assets is made to Hedge Funds. Furthermore, a Hedge Fund’s equity investments may provide grounds for its classification under the equity categories of the Regulation, in which case, greater exposure may be permissible.

The TORFA came into operation on 1 March 1996. This Act determines the tax in respect of any “fund”, which, in section 1 of the TORFA, is defined to mean an Untaxed Policy-holder Fund or a Retirement Fund. The taxation of investment returns in Chapter 4 could not be considered for all possible investors. Although the TORFA address the taxation of the Untaxed Policy-holder Fund and Retirement Funds, the discussion in this thesis will be limited hereafter to a consideration of the taxation of Retirement Funds only.

Retirement Funds are defined in section 1 of the TORFA to include pension, provident and retirement annuity funds. Tax is levied in terms of section 2 of the TORFA at a rate of 18% of the “taxable amount”, which is determined in section 4 for an Untaxed Policy-holder Fund and

⁴⁴ Published in the Government Gazette, January 1962

in section 5 for a Retirement Fund. On 15 February 2006, the Minister of Finance announced that the tax rate on retirement funds would be halved to 9% with effect from 1 March 2006.

The income of a fund

Any word or expression, to which a meaning has been assigned in the Income Tax Act, bears the same meaning for purposes of the TORFA, unless the context within such word or expression is used indicates otherwise.⁴⁵ The “income” of a fund, in respect of any tax period, is determined in accordance with the following formula in section 3 of the TORFA:

$$A = I + (R - E) + D$$

In which

“A” represents the income to be determined;

“I” represents the *gross* amount of interest received by or accrued to the fund during the tax period;

“R” represents the *gross* amount of rental income received by or accrued to the fund during the tax period;

“E” represents expenditure incurred by the fund directly in the production of the rental income represented by “R”, and the appropriate portion of any allowance, calculated in respect of the rental income-bearing asset (limited to a maximum of the value for “R”) and which would be allowed as a deduction in terms of the provisions of the Income Tax Act; and

“D” represents the amount of any foreign dividends received by or accrued to the fund during the tax period, which are not exempt from tax in terms of section 10(1)(k)(ii) of the Income Tax Act.

Thus, the income of a fund is calculated as the sum of its receipts and accruals in respect of the gross interest received, nett rental income and total foreign dividends, which are not otherwise exempt in terms of section 10(1)(k)(ii) of the Income Tax Act. It is notable that annuities,

⁴⁵ Hedge Fund Center, <http://www.hedgefundcenter.com/wrapper.cfm?article>, downloaded on 20/08/2002

⁴⁶ The TORFA, section 1

trading profits, local dividends and capital gains are not taxable in terms of the above definition of income in the TORFA. A Hedge Fund investment may give rise to various categories of receipts or accruals, such as interest, dividends, trading profits and capital gains (see Chapter 4). To the extent that the Hedge Fund bears investment returns in the form of trading profits, local dividends and capital gains, this would be beneficial, as such accruals, by virtue of section 3 of the TORFA, do not constitute “income” in the hands of the Retirement Fund. “Interest” and “rental income” are defined terms in the TORFA.⁴⁷

Thus “rental income”⁴⁷ includes:

(a) *“any royalty;*

(b) *any premium or like consideration contemplated in paragraph (g) of the definition of “gross income” in section 1 of the Income Tax Act ;*

(c) *any dividend (other than capital profits) distributed by a fixed property company; and*

(d) *any consideration payable by a borrower to the lender in terms of a “lending arrangement”, as defined in section 23(1) of the Stamp Duties Act as consideration for the use of any marketable security, in so far as such amount is not included in paragraph (a) of the definition of “interest””*

The lending arrangement referred to in part (d) of the definition above refers to what was described in Chapter 1 as a securities lending arrangement. It is frequently encountered in practice that a Retirement Fund would be the lender of shares to a Hedge Fund for the purpose of a short sale of these shares by the Hedge fund. It is also invariably true that these shares would constitute capital assets (as opposed to trading stock) in the lender’s investment portfolio.⁴⁸ The consideration payable by the Hedge Fund, as the borrower, to the Retirement Fund, as the lender of the shares in a scrip-lending arrangement (i.e. the scrip lending fee), is to be included in the Retirement Fund’s rental income.

“Interest”⁴⁷ includes:

⁴⁷ Definitions in section 1 of the TORFA

⁴⁸ Per discussion with SJB Peile, January 2006

- (a) any amount contemplated in the definition of “interest” in section 24J(1) of the Income Tax Act;*
- (b) any amount deemed to be interest in terms of section 8E of the Income Tax Act; and*
- (a) any amount contemplated in terms of section 24K of the Income Tax Act”*

Manufactured interest and dividends

Securities lending arrangements in respect of interest-bearing instruments normally provide that the borrower will compensate the lender for any coupon or other interest received by the borrower, who is the registered owner of the interest-bearing instrument during the term of the lending arrangement.⁴⁹ This “manufactured interest” is specifically provided for in part (b) of the definition of “interest” in section 24J(1) of the Income Tax Act. Thus, where a Retirement Fund is the lender of an interest-bearing instrument in terms of a “lending arrangement”, as defined in section 24J(1) of the Income Tax Act, any compensation received by the Fund, for coupon or other interest received by the borrower during the tenure of the arrangement, would fall into the Retirement Fund’s income.

It should be noted that section 24J(1) of the Income Tax Act’s definition of a “lending arrangement” is broader and simpler than the Income Tax Act’s definition in section 1. Section 1 of the Income Tax Act relies on the definition of a securities lending arrangement as it stands in the Uncertificated Securities Tax Act (refer to the definition on pages 13-14). In this latter definition, there is a limitation of the lending arrangement to one which is settled within a period of twelve months. Section 24J(1) of the Income Tax Act’s definition of a “lending arrangement” refers to the loan of an “instrument” (as opposed to “securities”) and there is no mention of the twelve month limitation i.e. manufactured interest falls into the section 24J(1) definition of “interest”, irrespective of whether the lending arrangement is for a period of less than twelve months, or not.

Securities lending arrangements also normally provide that the borrower shall pay to the lender a “manufactured dividend” in lieu of any dividends declared in respect of the security during the tenure of the lending arrangement. The “manufactured dividend” may include adjustments for

⁴⁹ Practice Note 9, issued by SARS, 14 April 1999

the effects of Income Tax or Secondary Tax on Companies. Any payment made by the borrower to the lender as a “manufactured dividend” is not a dividend for Income Tax purposes. The “manufactured dividend” received by a Retirement Fund does not constitute “interest” or “rental” as defined in the TORFA, and is accordingly, not taxable income. However, for any other person who receives a “manufactured dividend” it will constitute gross income and will not qualify for the exemption in section 10(1)(k) of the Income Tax Act. If a Hedge Fund makes payment of a “manufactured dividend”, it will be able to deduct the expense in the determination of its taxable income if the expense meets the requirements of section 11(a) of the Income Tax Act.

VAT implications of manufactured dividends and interest

In terms of the Value-Added Tax Act, No. 89 of 1991 (VAT Act), the supply of goods or services by a vendor in the course or furtherance of any enterprise carried on by him is subject to VAT at the standard rate, unless the supply is specifically exempt, or subject to VAT at the zero rate.

The supply of financial services is exempt from VAT in terms of section 12(a) of the VAT Act, except where such services are subject to VAT at the zero rate. Securities lending is deemed to be a financial service, in terms of paragraphs (c), (d) and (f) of section 2(1)⁵⁰ of the VAT Act.

In terms of the proviso to section 2(1) of the definition of “financial services” in the VAT Act, the fee charged by a lender, for securities loaned in terms of a securities lending arrangement, precludes the lending of the securities from being deemed to be a financial service. Such fee is contemplated in part (d) of the definition of “rental income” in section 1 of the TORFA, and is, accordingly, subject to VAT at the standard rate.

A “manufactured dividend” or “manufactured interest” is, however, regarded as consideration for the supply of a financial service, as envisaged in section 2(1)(c), (d) and (f) of the VAT Act and does not constitute a fee, commission or similar consideration, as envisaged in the proviso

⁵⁰ Section 2(1) of the VAT Act: “(c) the issue, allotment, drawing, acceptance, endorsement or transfer of ownership of a debt security; (d) the issue, allotment or transfer of ownership of an equity security; (f) the provision by any person of credit under an agreement by which money or money’s worth is provided by that person to any other person who agrees to pay in the future a sum or sums exceeding in aggregate the amount of such money or money’s worth”

to section 2(1) of the VAT Act. Such consideration is therefore in respect of the supply of a financial service and is exempt from VAT in terms of section 12(a) of the VAT Act.⁵¹

If a single amount is payable to a lender and such amount constitutes both a fee or commission and a “manufactured dividend” or “manufactured interest”, it is essential that, for purposes of section 10(22) of the VAT Act, the amounts attributable to the fee or commission and that attributable to the “manufactured dividend” or “manufactured interest” be indicated at the time the agreement is entered into. Failing a split into the separate elements, the full amount will be subject to VAT.⁵²

Conclusion

This Chapter has examined the provisions of the TORFA relevant to the determination of tax in Retirement Funds. This is of relevance to the determination of the overall tax on investment returns in Chapter 4.

The next Chapter of the thesis compares the taxation of investment returns of Collective Investment Schemes with that of Hedge Funds. In order to properly achieve this objective, it is necessary to examine taxation within the investment fund, as well as to follow through with an examination of the further taxation of the return in the hands of the investor. It was not possible to consider the taxation of investment returns in the hands of all investors. Two investors were therefore selected, who, for reasons already discussed in the conclusion to Chapter 2, are considered to be typical investors in Hedge Funds. These are a wealthy individual and a Retirement Fund.

⁵¹ Practice Note 5, issued by SARS on 14 April 1999

⁵² Practice Note 5, issued by SARS on 14 April 1999

4 Comparison of the taxation of a Collective Investment Scheme to that of a Hedge Fund

The definition of a Collective Investment Scheme in section 1 of the CISCA refers to the investment as:

“... a scheme, in whatever form, including an open-ended investment company, in pursuance of which members of the public are invited or permitted to invest ...”

Investors may hold a participatory interest in the scheme “through shares, units or any other form of participatory interest”.⁵³ Thus, the CISCA is not prescriptive as to the type of entity in which the investment scheme may be run. It must, however, be an entity in which members of the public are able to hold an interest. Irrespective of the entity which is chosen, the Income Tax Act then imposes its framework for taxation upon the Collective Investment Scheme. The Income Tax Act recognizes the existence of pooled investment schemes in the form of Collective Investment Schemes and makes mention of a number of provisions that are specific to them. (These provisions will be discussed in detail below.)

Hedge funds, in contrast, are privately operated investment schemes.⁵⁴ Hedge Funds are not permitted to market themselves to the general public as they are not regulated under the current legislative framework of the CISCA.⁵⁴ A Hedge Fund may, similarly to a Collective Investment Scheme, be housed in any form of entity and these may include a company, a trust, or a partnership. There are various means by which persons invest in Hedge Funds. They may have a direct interest, such as shares or a partnership interest, or they may invest indirectly through an insurance policy linked to an investment in the Hedge Fund itself.⁵⁵ Insurers may only invest in a Hedge Fund if it is housed in a structure offering limited liability.⁵⁵ This arrangement ensures that any financial loss in the fund would be limited to the insurer’s initial capital contribution.

A form of investment in Hedge Funds, which are housed in companies, is via linked units. This is known as a “linked unit Hedge Fund”.⁵⁶ Instead of just holding shares, the investor holds an equal number of shares and debentures. The practical effect of this arrangement is that the

⁵³ Part (a) of the definition of a Collective Investment Scheme in section 1 of the CISCA

⁵⁴ Refer to Chapters 1 and 2 of the thesis

⁵⁵ p3 of the paper referred to in footnote 14

investor may potentially receive two forms of return i.e. dividends and interest, and these have different tax implications for the fund and the investor, as illustrated below.

Since Hedge Funds tend to attract wealthy investors due to the high entry level of such an investment⁵⁷, it will be assumed that the individual investor used for illustrative purposes throughout this Chapter is in employment (i.e. under 65 years of age, with salary as a main form of income) and earns taxable income at a level that would be subject to tax at the maximum marginal rate of 40%.⁵⁸ It will also be assumed that such individual has used his annual interest exemption⁵⁹, foreign dividend/interest exemption⁶⁰ and annual exclusion of nett capital gains/losses⁶¹ against other income and/or capital gains or losses, as the effect of these exemptions will not be taken into consideration in the illustrations to follow.

Except where otherwise stated, it is to be assumed that dividends are local dividends and therefore exempt from taxation in terms of section 10(1)(k)(i) of the Income Tax Act, subject, in turn, to the provisions of subsections (aa) to (dd) of that section. It should also be assumed that foreign dividends, where specifically mentioned, would not constitute any of the types referred to in section 10(1)(k)(ii) of the Income Tax Act.

⁵⁶ Per discussion with J Gillmer, Deneys Reitz, June 2005

⁵⁷ Refer to the Conclusion in Chapter 2 for the discussion on the minimum entry-level investment in Hedge Funds

⁵⁸ In the 2006 year of assessment, the maximum marginal rate applies to individuals with taxable income in excess of R300 000 (2007: R400 000)

⁵⁹ In the 2006 year of assessment, interest received by persons under 65 years of age of up R15 000

(2007: R16 500) per annum is exempt in terms of section 10(1)(i)(xv)(bb)(B) of the Income Tax Act

⁶⁰ In the 2006 year of assessment, up to R2 000 (2007: R2 500) of the interest exemption referred to in footnote 52 may be used against foreign interest and/or dividends received in terms of section 10(1)(i)(xv)(aa) of the Income Tax Act

⁶¹ In the 2006 year of assessment, a natural person's annual net capital gain or loss is reduced by R10 000 (2007: R12 500) in terms of paragraph 5 of the Eighth Schedule

Table 3

Comparison of the effective tax rate in a linked unit Hedge Fund set up in a company (“the Hedge Fund Company”), assuming that a profit of R100 is paid either as interest or as a dividend

	<i>Paid as Interest</i>	<i>Paid as a Dividend</i>
Nett profit before interest	R100.00	R100.00 *
Interest on debentures	R100.00	-
Nett profit before tax	-	R100.00
Tax at 29%	-	R29.00
Nett profit after tax	-	R71.00
Dividend proposed	-	R71.00
STC at 12.5%	-	R8.875 **
Dividend paid	-	R62. 125
<i>Effective tax rate</i>	-	<i>37.875%</i>

*It has been assumed that the nett profit of the fund is not comprised of dividend income of the type referred to in section 64B(3) of the Income Tax Act, which would have avoided the incurrance of STC, marked **, as the nett dividend declared would then be nil in terms of the application of section 64B(2) of the Income Tax Act.

Where the profit has been distributed to the investor as interest paid on debentures in Table 3 above, it has been assumed that this constitutes a deductible expense in terms of section 24J(2) of the Income Tax Act, incurred in the production of the Hedge Fund’s income and that such

income has been derived from trading activities. The activities of the Hedge Fund could be described as an “active” investment strategy in which transactions are embarked upon in the context of a scheme of profit-making i.e. a Hedge Fund would fail to win the argument that profits from share transactions were merely incidental to its investment activities, as was argued by the taxpayers in cases such as *African Life Investment Corporation (Pty) Ltd v SIR (31 SATC 163)*, *Barnato Holdings Limited v SIR (40 SATC 75)* and *CIR v Nussbaum (58 SATC 283)*. It is noted in Practice Note 31, published by SARS on 3 October 1994, that a non-moneylender who incurs interest on capital funds invested is not engaged in a trade. It is, however, not necessary to discuss whether the Hedge Fund constitutes a money-lender or not in order for it to be assured of a deduction for interest incurred on the basis of trading. The Practice Note correctly states that it is the *intention* of the person who borrows the money which is decisive of the matter of trade, and where this intention is speculative, then that person is engaged in a scheme of profit making and is thus trading. To paraphrase the words used in the judgment of *Burgess v CIR (55 SATC 185)*, a Hedge Fund’s shorting of shares is “a speculative enterprise *par excellence* and could properly be described as a venture as envisaged in the definition of “trade”” On this basis, the interest expenditure is considered to be deductible in terms of section 24J(2) of the Income Tax Act, as illustrated in Table 3.

Table 3a

Comparison of the effective overall tax rate for an individual versus a retirement fund on receiving the interest distribution

Investor	<i>Individual</i>	<i>Retirement fund</i>
Interest received	R100.00	R100.00
Tax	R40.00	R9.00
<i>Effective tax rate overall</i>	<i>40%</i>	<i>9%</i>

Table 3b

Comparison of the effective overall tax rate for an individual versus a retirement fund on receiving the dividend distribution

Investor	<i>Individual</i>	<i>Retirement fund</i>
Dividend received	R62. 125	R62. 125
Tax	-	-
<i>Effective tax rate overall</i>	<i>37.875%</i>	<i>37.875%</i>

The overall effective tax rates in Tables 3a and 3b indicate that an individual would prefer to receive dividends as a return on shares held whereas a Retirement Fund would elect to receive interest. The “overall effective tax rate” is defined, for the purposes of Chapter 4, as: the sum of the tax in the Fund and the tax in the recipient investor, as a percentage of the income received by the fund.

The one exception to the rule illustrated above would be where the Hedge Fund Company *receives* dividend income. As this is exempt income in terms of section 10(1)(k)(i) of the Income Tax Act and the Hedge Fund Company would only pay STC on nett dividends declared, it would have an effective tax rate of 0%. The Retirement Fund would not then opt to receive this as interest, on which it would be liable for 9% tax. It would rather receive this as dividend income and thus pay 0% tax.

The other exception would concern the Hedge Fund Company’s receipt of income in the form of a capital gain. The individual investor would elect to receive this as a dividend, thus incurring an overall effective tax rate of 25.1875%⁶² (the CGT and STC paid within the company). Paid

⁶² On R100 capital gain paid out as a dividend, CGT of R14.50 and STC of R10.6875 would be payable, resulting in an effective tax rate of 25.1875% in the Hedge Fund Company

out as interest, the individual's receipt would be subject to an overall effective tax rate of 48.7%.⁶³ In the hands of the Retirement Fund, however, the election between receiving the income as a dividend or as interest on the debentures held within in the Hedge Fund Company would depend on whether the income accrued to the Retirement Fund before or after 1 March 2006. This is illustrated in Table 4 below.

Table 4

Comparison of effective tax rate in a linked unit Hedge Fund in which a capital gain is either distributed as interest on debentures or a dividend

	<i>Paid as Interest</i>	<i>Paid as a Dividend</i>
Capital gain	R100.00	R100.00
Taxable capital gain	R50.00	R50.00
Tax at 29%	R14.50	R14.50
Interest paid on debentures	R85.50	-
Dividend proposed	-	R85.50
STC at 12.5%	-	R10.688
Dividend paid	-	R74.812
<i>Effective tax rate</i>	<i>14.50%</i>	<i>25.188%</i>

⁶³ On R100 capital gain paid as interest expense to the individual debenture holder, the company would pay R14.50 CGT and the individual would pay R34.20 income tax, resulting in an overall effective tax rate of 48.70%

The capital gain is subject to CGT in the Hedge Fund Company of 14.5%.⁶⁴ If this gain is paid to the debenture holder as interest, the interest cost is deducted as an expense incurred in the production of the Hedge Fund Company's income in terms of section 24J(2)(b) of the Income Tax Act and no further tax is incurred in the Hedge Fund Company. If however, the gain is distributed as a dividend, STC is payable. The distribution is then received by the Retirement Fund (Table 4a).

Table 4a

Comparison of overall effective tax rate for a Retirement Fund on interest versus dividend returns received from a linked unit Hedge Fund paying out a capital gain before and after 1 March 2006

Retirement Fund	<i>Interest received before 1 March 2006</i>	<i>Interest received on/after 1 March 2006</i>	<i>Receipt of dividend</i>
Income receipt	R85.50	R85.50	R74.812
Tax	R15.39	R7.695	-
<i>Effective tax rate overall</i>	<i>29.89%</i>	<i>22.195%</i>	<i>25.188%</i>

From Table 4a, it can be seen that, based on the tax rate of 18%, applicable to Retirement Funds before 1 March 2006, the Retirement Fund would elect to receive the capital gain as a dividend, whereas once the tax rate on Retirement Funds dropped to 9%, with effect from 1 March 2006, the Retirement Fund would elect to receive the gain as interest, as the overall effective tax rate (22.195%) is less than that for the receipt of the amount as a dividend (25.188%).

⁶⁴ Section 26A of the Income Tax Act, read with paragraph 10(c) of the Eighth Schedule

4.1 Comparison of a Collective Investment Scheme in securities to a Hedge Fund housed in a Company

The appropriate Collective Investment Scheme with which to compare the tax treatment of a Hedge Fund housed in a company is a Collective Investment Scheme in securities. This is because section 1 of the Income Tax Act defines a “company” to include a Collective Investment Scheme in securities, as well as a foreign Collective Investment Scheme. Thus, whilst a Collective Investment Scheme in securities may be housed in any form of entity in terms of the Cisca, the Income Tax Act deems the structure to be a company for the purpose of tax. The relevant part of the definition of a company⁶⁵ reads as follows:

“Company” includes..... (e) any

- (i) portfolio comprised in any collective investment scheme in securities contemplated in Part IV of the Collective Investment Schemes Control Act, 2002, managed or carried on by any company registered as a manager under section 42 of that Act for purposes of that Part; or*
- (ii) arrangement or scheme carried on outside the Republic in pursuance of which members of the Republic are invited or permitted to invest in a portfolio of a collective investment scheme, where two or more investors contribute to and hold a participatory interest in a portfolio of the scheme through shares, units or any other form of participatory interest; ...”*

It will be assumed that the company in which the Hedge Fund is housed (“the Hedge Fund Company”) only issues shares as a means of investment, i.e. that it is not a linked-unit structure. This will be compared in this next part of the thesis to a Collective Investment Scheme in securities, which, in terms of the definition quoted above, is to be treated as a company for tax purposes.

⁶⁵ Section 1 of the Income Tax Act

Taxable income

This analysis will commence by comparing the tax consequences arising from the receipt and subsequent distribution of taxable income by a Hedge Fund Company with that by a Collective Investment Scheme in securities.

Table 5

Comparison of the overall effective tax rate on taxable income received by a Hedge Fund housed in a Company with a Collective Investment Scheme in securities (this table may also be referred to as illustrative of the tax consequences for foreign dividend income)

Entity	<i>Hedge Fund Company</i>	<i>Collective Investment Scheme in securities</i>
Income received	R100.00	R100.00
Tax at 29%	R29.00	-
Nett profit	R71.00	R100.00
Dividend proposed	R71.00	R100
STC at 12.5%	R8.875	-
Dividend paid out	R62.125	R100.00
<i>Effective tax rate in fund</i>	<i>37.875%</i>	<i>0%</i>

The taxable income received could be trading profits, such as might arise from the short sale of shares, or interest income, derived from cash balances held. This income is subject to normal tax in the company at 29% in terms of section 5(1) of the Income Tax Act read with sub-section

(d). In addition, Secondary Tax on Companies (STC) is payable on the nett amount of dividends declared in terms of section 64B(2) of the Income Tax Act:

“There shall be levied and paid for the benefit of the National Revenue Fund a tax, to be known as the STC, which is calculated at the rate of 12.5 per cent of the nett amount, as determined in terms of subsection (3), of any dividend declared on or after 14 March 1996 by any company which is a resident.”

It has been assumed that the Hedge Fund has no dividend credits with which to offset the dividend declared, the effect of which would be to reduce the amount subject to STC.

In contrast, not only is the taxable income received by the Collective Investment Scheme in securities exempt from tax in terms of section 10(1)(iA) of the Income Tax Act:

“There shall be exempt from normal tax – ...

(iA) in the case of any portfolio of a collective investment scheme referred to in paragraph (e)(i) of the definition of a “company” in section 1, so much of the income received by or accrued to such portfolio as has been distributed, or as the Commissioner is satisfied will be distributed, by way of a dividend or a portion of a dividend, to persons who have become entitled to such dividend by virtue of their being holders of participatory interest in such portfolio”

but STC is also not levied, as a Collective Investment Scheme in securities enjoys an exemption in terms of section 64B(5)(j) of the Income Tax Act⁶⁶:

“There shall be exempt from the STC – ...

(j) any dividend declared by a company contemplated in paragraph (e)(i) of the definition of “company” in section 1”

The dividend declared by either the Hedge Fund housed in a Company or the Collective Investment Scheme in securities (Table 5) has different tax consequences in the hands of the recipients (Tables 6 and 7).

⁶⁶ This statement seems to conflict with point 6 on page 284 of Huxham & Haupt, Notes on South African Income Tax 2005. This appears to have been amended in the 2006 version.

in paragraph (e)(i) of the definition of “company” in section 1 out of income derived by that portfolio which is exempt from tax in the hands of that portfolio under paragraph (iA), is deemed to be interest”

Section 10(1)(k)(i)(bb)(A) of the Act reiterates that dividends distributed by a Collective Investment Scheme in securities out of income which is exempt by virtue of section 10(1)(iA) will not constitute exempt income in the hands of the recipient:

“There shall be exempt from normal tax – ...

(1)(k)(i) “dividends (other than foreign dividends) received by or accrued to or in favour of any person: Provided that this exemption shall not apply – ...

(bb) to so much of any dividend as has been distributed by any portfolio of any collective investment scheme constituting a company in terms of paragraph (e)(i) of the definition of a company in section 1 –

(A) out of income derived by such portfolio which is exempt from tax in the hands of such portfolio under the provisions of paragraph (iA)”

Thus, under either section 10(1)(h) or section 10(1)(k)(i)(bb)(A), read with section 5(1)(c) of the Income Tax Act, the individual is subject to normal tax at his marginal rate on the dividend received from the Collective Investment Scheme in securities.

Comment on investment decision

Investment in a Collective Investment Scheme becomes tax inefficient for the individual investor on a marginal tax rate of 38% and above. Although double taxation is avoided in the Collective Investment Scheme in securities through the workings of sections 10(1)(iA) (normal tax) and 64B(5)(j) (STC) of the Income Tax Act, this income is subject to a higher rate of taxation in the individual’s hands than the overall effective tax rate of 37.875% on dividends paid by the Hedge Fund Company.

The tax consequences are very different if the dividend is received by a Retirement Fund. The following tax implications arise (Table 7):

Table 7

Comparison of the overall effective tax rate on a dividend received by a Retirement Fund out of taxable income from a Hedge Fund housed in a Company or from a Collective Investment Scheme in securities

<i>Source of dividend (Table 5)</i>	<i>Hedge Fund Company</i>	<i>Collective Investment Scheme in securities</i>
Dividend received	R62. 125	R100.00
Tax at 9%	-	-
<i>Effective tax rate in retirement fund</i>	<i>0%</i>	<i>0%</i>
<i>Effective tax rate overall</i>	<i>37.875% (Table 5)</i>	<i>0%</i>

Section 3(e) of the TORFA only includes those foreign dividends, which are not exempt in terms of section 9E of the Income Tax Act, in the “income” of a fund. Since local dividends do not constitute “income” as defined, the Retirement Fund is not taxed on the receipt of the dividend from either the Hedge Fund housed in a Company or from a Collective Investment Scheme in securities. The TORFA has no equivalent of section 10(1)(h) of the Income Tax Act in respect of dividend income received from a Collective Investment Scheme in securities out of income which was exempt in the Collective Investment Scheme in terms of section 10(1)(iA) of the Act. As the dividend received was of local origin (per assumption noted on page 40), it is not included in the income of the Retirement Fund for tax purposes and therefore no tax is payable in the Retirement Fund.

Comment on investment decision

A Retirement Fund which invests in a Collective Investment Scheme in securities reaps full benefit from the operation of sections 10(1)(iA) (in respect of normal tax) and 64B(5)(j) (in respect of STC) of the Income Tax Act, as a 0% overall effective tax rate applies. In contrast, an investment in a Hedge Fund Company incurs an overall effective tax rate of 37.875% due to the normal tax and STC provisions applicable to this entity.

Foreign dividend income

Next are compared the tax consequences arising from the receipt and subsequent distribution of foreign dividends by a Hedge Fund Company with that by a Collective Investment Scheme in securities.

It is assumed that both the Funds have dividend-bearing offshore investments and that none of the foreign dividend exemptions in section 10(1)(k)(ii) of the Income Tax Act are applicable. Refer to Table 5 above, as the same tax provisions apply to the receipt of foreign dividend income that applied to the receipt of taxable income illustrated in Table 5. Thus, a Hedge Fund Company is taxed at 37.875% on this income whereas the Collective Investment Scheme in securities is not taxed at all in terms of the provisions of section 10(1)(iA) of the Income Tax Act.

The consequences of distributing the foreign dividend income from the Hedge Fund housed in a Company versus the equivalent distribution from the Collective Investment Scheme in securities are compared below.

Table 8

Comparison of the overall effective tax rate on a dividend declared out of foreign dividend income (refer to Table 5) by a Hedge Fund Company and received by an individual or a Retirement Fund

Investor	<i>Individual</i>	<i>Retirement fund</i>
Dividend received (ex Company)	R62.125	R62.125
Tax	-	-
<i>Effective tax rate in individual</i>	<i>0%</i>	<i>0%</i>
<i>Effective tax rate overall</i>	<i>37.875%</i>	<i>37.875%</i>

The Hedge Fund Company's distribution is received by both the individual and the Retirement Fund as a *local* dividend, despite the fact that it was paid out of foreign dividend income. It is thus exempt from tax in the hands of both investors in terms of section 10(1)(k)(i) of the Income Tax Act. In contrast, the distribution is taxable in the individual's hands if the distribution is from the Collective Investment Scheme in securities (Table 9), due to the application of the proviso of paragraph (k) of the gross income definition in section 1 of the Income Tax Act, which reads as follows:

"Gross income", in relation to any year or period of assessment, means – ...

(k) any amount received or accrued by way of a dividend: Provided that where any foreign dividend declared by a foreign company –

(i) is received by or accrues to a portfolio of a collective investment scheme referred to in paragraph (e)(i) of the definition of "company"; and

(ii) is distributed by that portfolio by way of a dividend, or a portion of a dividend, to any person who is entitled to that dividend by virtue of being a holder of any participatory interest in that portfolio,

that foreign dividend shall, to the extent that it is declared to that person as contemplated in subparagraph (ii), be deemed to have been declared by that foreign company directly to that person and to be a foreign dividend which is received by or accrued to that person”

Table 9

Comparison of the overall effective tax rate on a dividend declared out of foreign dividend income (Table 5) by a Collective Investment Scheme in securities and received by an individual or a Retirement Fund

Investor	<i>Individual</i>	<i>Retirement Fund</i>
Dividend received (ex Collective Investment Scheme)	R100.00	R100.00
Deemed foreign dividend	R100.00	-
Tax	R40	-
<i>Effective tax rate in individual</i>	<i>0%</i>	<i>0%</i>
<i>Effective tax rate overall</i>	<i>40%</i>	<i>0%</i>

The effect of paragraph (k) of the gross income definition in section 1 of the Income Tax Act is to make the Collective Investment Scheme in securities tax transparent with respect to its receipt of foreign dividends. The individual investor is deemed to receive the foreign dividends directly from the offshore investment. The foreign dividends received constitute taxable income by virtue of section 10(1)(k)(i) of the Income Tax Act and are subject to the investor’s marginal tax

rate of 40%. The Retirement Fund investor is, however, unaffected by the provisions of the Income Tax Act definition of “gross income” for the following reason: section 16 of the TORFA lists provisions of the Income Tax Act which are to apply equally to the taxation of funds. The “gross income” definition is not included in this list and thus the retirement fund receives the dividend from the Collective Investment Scheme as a local dividend, which, as discussed above, is not recognized as “income” in a retirement fund for tax purposes.

Comment on investment decision

This is an example of an unfavourable tax provision for the Collective Investment Scheme in securities in comparison to the Hedge Fund Company. It is preferable for the individual investor to invest in the Hedge Fund Company, as the latter is opaque with respect to distributions made out of foreign dividends received by the fund.

The Retirement Fund is indifferent as regards whether it receives foreign dividends from a Collective Investment Scheme in securities or the Hedge Fund Company. Sections 10(1)(iA) and 64B(5)(j) of the Income Tax Act ensure that the foreign dividend receipt is not taxable within the Collective Investment Scheme. The Retirement Fund should receive the distribution as a local dividend from the Collective Investment Scheme. There is no similar provision to paragraph (k) of the gross income definition in section 1 of the Income Tax Act which is applicable to the Retirement Fund.

Section 11(s) dividends

This thesis will next investigate the definition of a section 11(s) dividend and will then compare the tax consequences arising from the receipt and subsequent distribution of such a dividend by a Hedge Fund Company with that by a Collective Investment Scheme in securities.

Section 11(s) of the Income Tax Act states that:

“There shall be allowed as deductions from the income of such person so derived

(s) in the case of a company the shares of which are “property shares” as defined in section 47 of the Collective Investment Schemes Control Act, 2002, the dividends (other than those distributed out of profits of a capital nature) distributed by such company during the year

of assessment on shares included in a portfolio comprised in any collective investment scheme in property managed or carried on by any company registered as a manager under section 42 of that Act for the purposes of Part V of that Act;”

Section 11(s) of the Income Tax Act allows the dividends declared out of rental income of a company (“the property share company”), the shares of which are deemed to be “property shares” in terms of section 47 of the Cisca, to be deductible in the determination of that company’s taxable income. Section 47 of the Cisca defines “property shares” to be:

“shares in and of a fixed property company or a holding company which has no subsidiaries other than fixed property companies which are wholly owned subsidiaries as referred to in section 1(5) of the Companies Act, 1973 (Act No. 61 of 1973)”

No STC is payable on the dividend declared by a property share company in terms of section 64B(5)(b) of the Income Tax Act. This is illustrated in Table 10.

Table 10

The effect of section 11(s) on the effective tax rate of a dividend declared by a property share company

Entity	<i>Property share company (section 47 of the Cisca)</i>
Rental income	R100.00
Dividend declared	R100.00
Nett profit before tax	-
STC	-
<i>Effective tax rate in property share co.</i>	<i>0%</i>

The dividend declared by the property share company (Table 10) constitutes the receipt of taxable income in the hands of a Collective Investment Scheme in property in terms of section 10(1)(k)(i)(aa) of the Income Tax Act.

Section 10(1)(k)(i)(aa) of the Income Tax Act states:

“There shall be exempt from tax – ...

*(k)(i) dividends (other than foreign dividends) received by or accrued to or in favour of any person: Provided that this exemption shall **not** apply –*

(aa) to dividends (other than those distributed out of profits of a capital nature and those received by or accrued to or in favour of any person who is neither a resident nor carrying on business in the Republic) distributed by a company the shares of which are “property shares” as defined in section 47 of the Collective Investment Schemes Control Act, 2002, on shares included in a portfolio comprised in any collective investment scheme in property managed or carried on by any company registered as a manager under section 42 of that Act for purposes of Part V of that Acts”

The dividend declared by the property share company (Table 10) is also seen as taxable income in the hands of a Collective Investment Scheme in securities in terms of section 10(1)(k)(i)(bb)(B) of the Income Tax Act. However, section 10(1)(k)(i)(bb)(B), read with section 10(1)(iA), results in any section 11(s) dividend which is to be distributed to the investor in the Collective Investment Scheme in securities being exempt from tax within the Collective Investment Scheme. Section 10(1)(k)(i)(bb)(B) of the Income Tax Act states:

“There shall be exempt from normal tax

dividends (other than foreign dividends) received by or accrued to or in favour of any person: Provided that this exemption shall not apply

(bb) to so much of any dividend as has been distributed by any portfolio of any collective investment scheme constituting a company in terms of paragraph (e)(i) of the definition of a company in section 1 –

(A) ...; and

(B) out of amounts received by or accrued to such portfolio by way of dividends referred to in section 11(s);”

Since sections 10(1)(k)(i)(aa) and 10(1)(k)(i)(bb)(B) of the Income Tax Act directly refer to the receipt of the section 11(s) dividend by a Collective Investment Scheme in property and a Collective Investment Scheme in securities respectively, it follows that dividends of “property shares” received by *other* entities would remain exempt in terms of section 10(1)(k)(i) of the Income Tax Act. The taxation of section 11(s) dividends in the hands of a Hedge Fund Company and a Collective Investment Scheme in securities is shown in Table 11.

Table 11**Comparison of overall effective tax rate on section 11(s) dividends received by a Hedge Fund Company with that by a Collective Investment Scheme in securities**

Entity	<i>Hedge Fund Company</i>	<i>Collective Investment Scheme in securities</i>
Section 11(s) dividend income	R100.00	R100.00
Tax at 29%	-	-
Nett profit	R100.00	R100.00
Dividend proposed	R100.00	R100.00
Nett amount of dividend	R100.00	R100.00
STC at 12.5%	R12.50	-
Dividend paid out	R87.50	R100.00
<i>Effective tax rate in fund</i>	<i>12.50%</i>	<i>0%</i>

The Hedge Fund Company receives the section 11(s) dividend as a local dividend. It is therefore exempt for normal tax under section 10(1)(k)(i) of the Income Tax Act. The section 11(s) dividend is taxable in terms of section 10(1)(k)(i)(bb)(B) of the Income Tax Act in the hands of the Collective Investment Scheme in Securities, but because the dividend is to be on-distributed, it becomes exempt in terms of the application of section 10(1)(iA) of the Income Tax Act. When the Hedge Fund Company distributes the section 11(s) dividend, the declared dividend is subject to STC. It may not deduct the section 11(s) dividend received in determining the nett amount of the dividend referred to in section 64B(2) of the Income Tax Act. This is due to section 64B(3A)(a) of the Income Tax Act which states that:

“In determining the sum of the dividends which have accrued to a company as contemplated in subsection (3), no regard must be had to-

(a) any dividend contemplated in subsection (5)(b)”

Section 64B(5)(b) of the Income Tax Act refers to:

“any dividend declared by a fixed property company contemplated in section 11(s) which may be allowed as a deduction in the determination of the taxable income of such company in terms of the provisions of that section”

When the Collective Investment Scheme in securities distributes the section 11(s) dividend, however, the section 64B(5)(j) exemption of the Income Tax Act precludes the dividend from being subject to STC:

“There shall be exempt from the STC-

(j) any dividend declared by a company contemplated in paragraph (e)(i) of the definition of “company” in section 1”

The dividend paid by the Hedge Fund Company is exempt in the hands of both an individual and a Retirement Fund as it constitutes local dividend income (Table 12).

Table 12

Comparison of the overall effective tax rate on a dividend declared out of a section 11(s) dividend (Table 11) by a Hedge Fund Company and received by an individual or a Retirement Fund

Investor	<i>Individual</i>	<i>Retirement Fund</i>
Dividend received	R87.50	R87.50
Tax	-	-
<i>Effective tax rate</i>	<i>0%</i>	<i>0%</i>
<i>Effective tax rate overall</i>	<i>12.50%</i>	<i>12.50%</i>

The Retirement Fund receives the section 11(s) dividend paid by the Collective Investment Scheme in securities as a local dividend, with no further tax consequences (Table 13). This is because section 16 of the TORFA, which lists provisions of the Income Tax Act that are to be applied equally to the TORFA, does not include section 10(1)(k)(i)(bb)(B) of the Income Tax Act. Accordingly, the section 11(s) dividend remains tax exempt in the hands of the Retirement Fund.

The section 11(s) dividend paid by the Collective Investment Scheme in securities to the individual investor, however, constitutes taxable income and is subject to taxation at the 40% marginal rate (Table 13). Section 11(s) dividends, distributed by a Collective Investment Scheme in securities, are specifically brought into the taxable income of the investor through section 10(1)(k)(i)(bb)(B) of the Income Tax Act (refer to discussion on page 57-58).

Table 13

Comparison of the overall effective tax rate on a dividend declared out of a section 11(s) dividend (Table 11) by a Collective Investment Scheme in securities and received by an individual or a Retirement Fund

Investor	<i>Individual</i>	<i>Retirement Fund</i>
Dividend received	R100.00	R100.00
Tax	R40	-
<i>Effective tax rate</i>	<i>40.00%</i>	<i>0%</i>
<i>Effective tax rate overall</i>	<i>40.00%</i>	<i>0%</i>

Comment on investment decision

This is another example of where the individual investor in a Hedge Fund Company experiences a lower overall rate of taxation than is the case for the investor in a Collective Investment Scheme in securities.

The Retirement Fund, however, would rather receive section 11(s) dividends from a Collective Investment Scheme in securities than a Hedge Fund Company, since the latter has to pay 12.5% STC on the distribution of the dividend.

Local dividend income

Local dividend income is exempt from income tax in both a Hedge Fund Company and a Collective Investment Scheme in securities by virtue of section 10(1)(k)(i) of the Income Tax Act. Distribution of the local dividend by either entity would result in the dividend declared being capable of full offset against the dividend income received in that dividend cycle, in terms of section 64B(2) of the Income Tax Act. This has been assumed to be the case in the data shown in Table 14. In the event that the distribution were declared, but no dividend income had

accrued within that dividend cycle, a Hedge Fund in a company would have to pay 12.5 % STC on the declared dividend. This would not apply to the Collective Investment Scheme in securities as section 64B(5)(j) of the Income Tax Act exempts any dividend declared by a Collective Investment Scheme in securities from STC.

Table 14

Comparison of the overall effective tax rate on local dividends received by a Hedge Fund Company with that by a Collective Investment Scheme in securities

Entity	<i>Hedge Fund Company</i>	<i>Collective Investment Scheme in securities</i>
Local dividend income	R100.00	R100.00
Tax at 29%	-	-
Nett profit	R100.00	R100.00
Dividend proposed	R100.00	R100.00
Nett amount of dividend	-	-
STC at 12.5%	-	-
Dividend paid out	R100.00	R100.00
<i>Effective tax rate in fund</i>	<i>0%</i>	<i>0%</i>

Section 10(1)(k)(i) exempts local dividends received from either the Hedge Fund Company or the Collective Investment Scheme in securities from taxation in the hands of the individual investor. Local dividend income is also not taxable in the Retirement Fund. An overall effective

tax rate of nil therefore applies for both investors (individual and Retirement Fund) and both entities (Hedge Fund Company and the Collective Investment Scheme in securities).

Comment on investment decision

Tax parity exists between the Hedge Fund in a company and the Collective Investment Scheme in securities with reference to the receipt, and subsequent distribution, of local dividend income.

Capital gains

Hedge Funds holding both long and short positions in equities (“equity long/short Hedge Funds”) represent the most popular Hedge Fund strategy in South Africa.⁶⁷ It is estimated that 93% of South African hedge fund assets are housed in long/short equity funds or equity market neutral funds.⁶⁸ The existence of short and long positions within the same fund raises the question of whether the fund could have capital equity transactions, for tax purposes, notwithstanding the fact that equity is also the trading stock of the fund.

Our case-law history has demonstrated that it is possible for a dealer, such as share-dealer, to hold an asset (shares), which normally forms part of the stock-in-trade of the business, as a long-term investment. However, section 82(a) of the Income Tax Act places the onus upon the taxpayer to satisfy SARS as to the capital nature of the proceeds upon disposal of the asset. The burden of proof upon the taxpayer is more onerous when it comes to proving the capital nature of a profit on the disposal of a particular asset in which he also trades. The Fund would therefore need to have sound evidence to show why the share did not form part of its normal trading activities (*SIR v The Trust Bank of Africa Ltd*, 37 SATC 87). Upon successfully discharging this onus, however, the realised profits would be treated as a capital gain rather than as trading income.

In the case of *Berea Park Avenue Properties (Pty) Ltd v CIR (1995) (57 SATC 167)*, two taxpayers were co-directors and owners of a company in which they conducted a property development business. In addition, they each held a 50% share in a separate construction company in which they developed a block of flats and from which they commenced earning

⁶⁷ p22 of the paper referred to in footnote 14

⁶⁸ Financial Mail Fund Management Supplement, First Quarter 2006

rental income. It was thus their intention to hold the block of flats as a long-term investment. However, their property business ran into financial difficulties and the taxpayers felt obliged to sell the block of flats in order to provide much-needed capital to save their property development business. The court found the proceeds to be of a capital nature because it was satisfied, *inter alia*, that there was an adequate separation of the taxpayers' trading and investment property activities. Nestadt JA stated in his judgement as follows:

“There was, as the court a quo observed, credible evidence that Ellinas and Pashiou were at pains to keep the speculative ventures apart from what they considered to be investments; ‘a clear divide’, as it was referred to. This may, of course, be done. A taxpayer who is a land-jobber may have other property as an investment and which is therefore not part of his trading stock. So it does not follow that all the business affairs of Ellinas and Pashiou were (in the words of the Full Court) ‘interrelated and interdependent’.”

Although the above case dealt with land as the asset, it nevertheless proposes a sensible guideline for any entity which both trades and invests in the same type of asset. A Hedge Fund engaged in long and short positions should maintain a “clear divide” between the two activities so that the profit realized on the disposal of long shares may be taxable as a capital gain, and not combined with trading profits. One aspect of this would be to ensure that the Hedge Fund's balance sheet showed separate line items for its trading and investment shares, appropriately disclosed as short and long-term investments respectively.

If, however, the Fund buys and sells shares on a regular basis, on the pretext of enhancing the dividend yield of the portfolio, it is likely that the court would not accept the capital nature of proceeds on the disposal of these shares, as this activity is seen as a secondary business of share dealing (*CIR v Nussbaum, 58 SATC 283*).

Accepting then, the principle that a Hedge Fund, despite being a share dealer, is still capable of being taxed on the profits from the sale of long-held shares on capital account, the question arises as to how the taxation of a capital gain in a Hedge Fund Company would compare with the taxation of a capital gain in a Collective Investment Scheme in securities. In terms of paragraph 10(c) of the Eighth Schedule to the Income Tax Act, the taxable capital gain in a Hedge Fund Company would be 50% of its nett capital gain on the disposal of an asset. This

would be included in the taxable income of the Hedge Fund in terms of section 26A of the Income Tax Act, which states as follows:

“There shall be included in the taxable income of a person for a year of assessment the taxable capital gain of that person for that year of assessment, as determined in terms of the Eighth Schedule.”

Capital gains therefore do not form part of “income”, by definition, but are included in taxable income through the action of the above section.

The next table compares the tax treatment of capital gains earned within a Hedge Fund Company to that within a Collective Investment Scheme in securities.

Table 15

Comparison of the overall effective tax rate on capital gains in a Hedge Fund Company with that of a Collective Investment Scheme in securities

Entity	<i>Hedge Fund Company</i>	<i>Collective Investment Scheme in securities</i>
Capital gain	R100.00	R100.00
Taxable capital gain	R50.00	-
Tax at 29%	R14.50	-
Nett profit	R85.50	R100.00
Dividend proposed	R85.50	R100.00
STC at 12.5%	R10.688	-
Dividend paid out	R74.812	R100.00
<i>Effective tax rate in fund</i>	<i>25.188%</i>	<i>0%</i>

The distribution of the capital gain to the shareholders from the Hedge Fund Company complies with part (b) of the definition of a dividend in section 1 of the Income Tax Act. Part (b) extends the term “dividend” to include *any* profits distributed, whether capital in nature or not. STC is therefore payable on the dividend distributed. In contrast, the distribution of a capital gain by the Collective Investment Scheme in securities is specifically disregarded for tax purposes in terms of paragraph 61 of the Eighth Schedule:

“A portfolio in a Collective Investment Scheme contemplated in paragraph (e)(i) of the definition of a company in section 1, must disregard any capital gain or capital loss.”

It is unlikely that the Collective Investment Scheme in securities would physically distribute a capital gain. Capital gains would usually be retained within the Collective Investment Scheme, thus increasing the market value of the investor’s participatory interest in the Collective Investment Scheme. Nevertheless, it is possible for the gain to be distributed to the investors. This distribution would, as with the income distributions discussed previously, be exempt from STC in terms of section 64B(5)(j) of the Income Tax Act. Thus there is no tax in the Collective Investment Scheme in securities on capital gains. When a dividend is declared out of a capital gain in either the Hedge Fund Company or the Collective Investment Scheme in securities, this is treated as a local dividend in the hands of the investors. No further tax is therefore payable. Thus, the overall effective tax rate on the capital gain for the investors in the Hedge Fund Company (individual and Retirement Fund) is 25.188% versus a nil overall effective tax rate on the same capital gain declared by the Collective Investment Scheme in securities.

It would appear that the tax treatment of distributions of capital gains by a Collective Investment Scheme in securities has been overlooked in the Income Tax Act as these gains are taxed neither in the Collective Investment Scheme nor in the hands of the investor. Section 10(1)(h) of the Income Tax Act refers to “income” of the Collective Investment Scheme which is exempt from tax in the Collective Investment Scheme itself under section 10(1)(iA) of the Income Tax Act, this income being deemed to be interest received by the investor and therefore taxable. However, distributed capital gains, which are not “income” as defined, would not be taxable in the hands of the investor. Currently, in terms of paragraph 67A(1) of the Eighth Schedule, a capital gain or loss is recognized by an investor in a Collective Investment Scheme only in respect of the disposal of the investor’s participatory interest in the Collective Investment Scheme.

Comment on investment decision

Capital gains distributed by the Collective Investment Scheme are subject to favourable tax treatment for the individual investor compared to the same distribution made by a Hedge Fund Company. This would appear to be more by accident than design. The investor would prefer to receive distributions of capital gains made in the Collective Investment Scheme during his period of holding the participatory interest in the portfolio rather than to wait for realization of these on a disposal of the participatory interest. If the portion of capital gains are not distributed and therefore contribute to the increase in market value of the individual investor's participatory interest, he will pay CGT on that increase when the interest is ultimately disposed of.

The Retirement Fund is disadvantaged by its investment in a Hedge Fund Company compared with that in a Collective Investment Scheme in securities with regard to the distribution of capital gains by these entities. The Hedge Fund Company, in addition to the STC charge on the dividend, is subject to CGT on realizing a capital gain, whereas the Collective Investment Scheme in securities is exempt therefrom in terms of paragraph 61 of the Eighth Schedule.

The Retirement Fund is not subject to tax on capital gains in terms of the TORFA, and any capital gain in the Collective Investment Scheme will therefore not result in CGT for the Retirement Fund, even on the final realization of its participatory interest in the Collective Investment Scheme.

This thesis will now compare the taxation of the investor on disposal of the investment in a Hedge Fund Company with that in a Collective Investment Scheme in securities.

Acquisition and disposal of interest to a third party

An investment in a Collective Investment Scheme in securities could be disposed of either to the fund manager (see below) or to a third party. Similarly, the shares of a Hedge Fund Company may be disposed of to a third party or they could be purchased by the company itself in terms of section 85 of the Companies Act, No. 61 of 1973. It is assumed that the investor holds the interest as a capital investment, and not as trading stock. This is because it is unlikely that an investor would make a trade of speculating on and trading in Hedge Funds *per se*. For a start, pension funds are not permitted to carry on trading transactions in terms of section 10 of the

Pension Funds Act, No. 24 of 1956. Therefore, the initial capital contribution would be for the purpose of acquiring an investment which adds to the fund's income earning structure, rather than being an addition to its trading stock.

An analogy for the Hedge Fund investor's intention in holding the interest in the Fund may be found in the taxpayer's relationship to his activities in *Rand Mines (Mining & Services) Ltd v CIR, 59 SATC 85*. The taxpayer in that case, a mine management company, paid an initial fee as compensation for the cancellation of an existing mine management contract with another mine management company, in order that it could institute its own mine management contract within a newly-acquired group mining company. The taxpayer wanted to deduct the expenditure in terms of section 11(a) on the pretext that it was comparable with the procurement of trading stock, i.e. that by acquiring the management contract, the company could provide management services, which was its stock-in-trade. The court found that this expense was incurred solely to enable Rand Mines to acquire the management contract of the new client and that this cost was not incurred in the ordinary course of its operations as a mine management company. The point was made that the taxpayer did not deal in management contracts *per se* but rather in the provision of management services, thus the initial cost incurred in procuring the contract was of a capital nature. Similarly, the initial outlay to enter into a Hedge Fund would ordinarily be considered to be of a capital nature as the investor's intention would be to derive a return from the investment itself rather than to make a profit by means of arbitrage between different Hedge Funds.

The Eighth Schedule imposes different rules for the additions to the base cost of a listed versus an unlisted investment in the hands of the investor. Since a Hedge Fund may be housed within a listed or an unlisted company (refer to discussion in Chapter 2) the provisions relating to the addition to base cost for both a listed and an unlisted company are illustrated below, and these are compared with the additions to base cost for the Collective Investment Scheme in securities. The tax consequences in the hands of the investor are shown (Table 16) for the acquisition and disposal of an investment in a Hedge Fund in a listed and in an unlisted company, as well as for an investment in a Collective Investment Scheme in securities. As Retirement Funds are not subject to CGT, this section only addresses the consequences for the individual investor. Since the purchase of the R100 000 investment (as in the example in Table 16) was assumed to occur after 1 October 2001, it qualifies as expenditure actually incurred in respect of the cost of the

acquisition of the asset in terms of paragraph 20(1)(a) of the Eighth Schedule and therefore constitutes the base cost of the asset. Paragraph 20(1)(g) extends the definition of “base cost” to include interest incurred on loan finance used to acquire the asset:

“the following expenditure actually incurred which is directly related to the cost of ownership of that asset, which is used wholly and exclusively for business purposes or which constitutes a share listed on a recognized exchange or a participatory interest in a portfolio of a Collective Investment Scheme-

...(iii) interest as contemplated in section 24J on money borrowed to finance directly the expenditure contemplated in items (a) or (e) in respect of that asset (including money borrowed to refinance those borrowings):

Provided that if the asset constitutes a share listed on a recognized exchange or a participatory interest in a portfolio of a Collective Investment Scheme, the expenditure contemplated in sub items (i) to (iii) in respect of that asset must for the purposes of this item be reduced by two-thirds”

It is assumed in the example (Table 16) that the investor incurred R20 000 finance costs in purchasing the investment. These costs qualify as “interest” in terms of section 24J(1) of the Income Tax Act. In the case of shares held in a listed Hedge Fund Company or a Collective Investment Scheme, one-third of finance costs incurred may be added to the base cost of these investments, in terms of the proviso to paragraph 20(1)(g) of the Eighth Schedule. In the case of the privately-held shares in the Hedge Fund Company, unless the shares are used “wholly and exclusively for business purposes”, none of the finance costs may be added to the investment base cost in terms of paragraph 20(1)(g) of the Eighth Schedule. The question arises as to whether the Hedge Fund investment could ever be described as held by the individual “for business purposes”. The concept of “carrying on business” has been discussed in several cases over the years, one of these being ITC 1529 (54 SATC 252). The taxpayer’s income in this case consisted of interest on investments, dividends on shares and rental from stands. This is similar to the scenario assumed of the individual investor in this thesis i.e. the investor holds the Hedge Fund investment passively, with a view to the earning of investment income over the long-term. The judgment concluded that because the words “carrying on business” were not defined in the Act, the necessary test was to look at the activities concerned, as a whole, and ask “whether

these were the sort of activities which in commercial life would be regarded as “carrying on business”. It would seem likely that the “practical man” would not regard the Hedge Fund investors in question as “carrying on business” solely by virtue of their investment. Furthermore, the question of whether investing in shares was carrying on a business was more directly answered in the case of ITC 1501 (53 SATC 314) where the judge stated:

“As to a shareholder, his investing in the shares of a company does not amount to his carrying on business.” Thus, it is concluded that the finance costs could not constitute an addition to the base cost of the privately-held Hedge Fund investment, as it cannot be said of the investor that he holds the investment “wholly and exclusively for business purposes”.

It is further assumed that the investment was sold to a third party for R200 000.

The sale of the shares would constitute a “disposal” of an asset within the meaning of paragraph 11(1)(a) of the Eighth Schedule. Accordingly, a capital gain or loss will have arisen, for which the proceeds and base cost of the asset disposed of must be determined in terms of paragraphs 35 and 20 of the Eighth Schedule respectively. In terms of paragraph 35 of the Eighth Schedule, the proceeds are equal to the amount received or accrued in favour of that person in respect of that disposal. In this example, this would be equal to R200 000. In terms of paragraph 20(1)(a) of the Eighth Schedule, the base cost is comprised of the expenditure actually incurred in respect of the cost of acquisition or creation of the asset (R100 000 in the example below), plus amounts referred to in paragraph 20(1)(g) of the Eighth Schedule, as discussed above. This comprises the R6 667 interest, in the case of the listed Hedge Fund Company and the Collective Investment Scheme. The difference between the proceeds and the base cost is the investor’s capital gain (Table 16).

In terms of paragraph 67A of the Eighth Schedule, the investor in the Collective Investment Scheme must recognize a capital gain on the disposal of the interest in the Collective Investment Scheme. The paragraph, including its title, reads as follows:

“Capital gains and capital losses in respect of interests in Collective Investment Schemes in property

(1) A holder of a participatory interest in a portfolio comprised in any Collective Investment Scheme managed or carried on by any company registered as a manager under section 42 of the Cisca, 2002, for the purposes of Part V of that Act must determine a capital gain or capital loss in respect of any participatory interest in that portfolio only upon the disposal of that interest.

(2) The capital gain or capital loss to be determined in terms of subparagraph (1) must be determined with reference to the proceeds from the disposal of that participatory interest and its base cost.

(3) For the purposes of subparagraph (2) proceeds include the amount of any cash received and the market value on the date of acquisition of any assets acquired by a holder of a participatory interest from the Collective Investment Scheme prior to the disposal of his or her participatory interest to the extent that that amount and that market value do not constitute gross income in the hands of that holder.

(4) Any asset acquired by a holder of a participatory interest as contemplated in subparagraph (3) must be treated as having been acquired for expenditure equal to the market value of that asset on the date of acquisition, which expenditure must be treated as an amount of expenditure actually incurred and paid for the purposes of paragraph 20(1)(a).”

It is submitted that the title (in bold, above the quoted extract) is misleading in restricting the application of the paragraph to a Collective Investment Scheme in property alone. The paragraph itself refers to *any* Collective Investment Scheme, and thus would appear to be of general application to all Collective Investment Schemes and not just to a Collective Investment Scheme in property.

In terms of paragraph 67A(3) of the Eighth Schedule, the proceeds would be R200 000. The base cost would be determined in terms of paragraph 20 of the Eighth Schedule to be the sum of the cost of acquisition of R100 000 (paragraph 20(1)(a)) plus amounts determined under paragraph 20(1)(g) of R6 667, as discussed above. Paragraph 67A(4) of the Eighth Schedule

merely adds a further comment regarding the base cost of any asset that an investor may have acquired from a Collective Investment Scheme, namely, that the market value of the asset on the date of its acquisition shall be treated as its base cost.

Table 16

Comparison of the tax consequences for the individual investor on the acquisition and disposal of an investment under the Eighth Schedule

Entity invested in	Unlisted company Hedge Fund	Listed company Hedge Fund	Collective Investment Scheme*
Purchase investment	R100 000	R100 000	R100 000
Interest on money borrowed to acquire investment	R20 000	R20 000	R20 000
Addition to base cost	-	R6 667	R6 667
<i>Base cost</i>	<i>R100 000</i>	<i>R106 667</i>	<i>R106 667</i>
Proceeds on disposal of investment	R200 000	R200 000	R200 000
<i>Capital gain</i>	<i>R100 000</i>	<i>R93 333</i>	<i>R93 333</i>

* The Collective Investment Scheme refers to any Collective Investment Scheme referred to in the CISCA (see Chapter 2).

Comment on investment decision

The investor would rather invest in a listed Hedge Fund company or Collective Investment Scheme, as one third of any finance costs incurred in purchasing the investment may be added to the base cost, resulting in a lower capital gain when the shares are sold.

Acquisition and disposal of interest back to the Fund itself

A Hedge Fund Company may buy back an investor's shares at the time that the investor disposes of the investment. This is possible in terms of section 85 of the Companies Act. This may be comparable to the requirement of paragraph 2(a) of Schedule 1 to the CISCA, entitled "Matters which must be provided for in the deed of a Collective Investment Scheme in securities" which makes it incumbent upon a portfolio manager to repurchase any number of participatory interests offered to it. The Collective Investment Scheme fund manager's obligation to repurchase the participatory interests of departing investors is not necessarily analogous to the purchase by a Hedge Fund Company of its own shares. This is because the Hedge Fund manager and a Hedge Fund are not necessarily one and the same entity. All Hedge Fund *managers* are required to be approved by the FSB whereas the Hedge Fund itself has no such requirement.⁶⁹ The tax consequences in the hands of the investor are shown for the acquisition and disposal of the shares to the Hedge Fund Company in a share buy-back in terms of section 85 of the Companies Act (Table 17). This illustrates the provisions of the Eighth Schedule applicable to share buy-backs.

⁶⁹ p3 of the paper referred to in footnote 14

Table 17

The tax consequences of the acquisition and subsequent disposal of shares to the Hedge Fund Company in a share buy-back

Investment fund entity	Hedge Fund Company
Purchase investment	R100 000
<i>Consideration received on buy-back</i>	<i>R200 000</i>
Return of investment capital – “proceeds” in terms of para 76(b), Eighth Schedule	R100 000
“Dividend” in terms of para (c) of dividend definition, section 1 of Income Tax Act*	R100 000
STC at 12.5%	R12 500
Dividend paid out	R87 500
Total distribution received	R187 500

*Assumes that paragraph (f) of the dividend definition in section 1 of the Income Tax Act does not apply – see below for explanation.

The issue of the R100 000 shares in the Hedge Fund Company to the shareholder does not constitute a “disposal” by the Fund in terms of paragraph 11(2)(b) of the Eighth Schedule.

Paragraph (c) of the definition of a “dividend” in section 1 of the Income Tax Act states:

“In the event of the partial reduction or redemption of the capital of a company, including the acquisition of shares in terms of section 85 of the Companies Act, 1973, so much of the sum of any cash and the value of any asset given to a shareholder as exceeds the cash equivalent of

- (i) the amount by which the nominal value of the shares of that shareholder is reduced;*
- or*
- (ii) the nominal value of the shares so acquired from such shareholder,*

as the case may be”

The return of the initial R100 000 investment equates to the nominal value of the shares acquired from the shareholder, in terms of the dividend definition above, and therefore constitutes a “capital” distribution in terms of paragraph 74(a) of the Eighth Schedule. The additional R100 000 paid out therefore constitutes a “dividend” in terms of the paragraph (c) of the dividend definition above, as it is an amount over and above the initial R100 000 investment. There is an exemption, however, in terms of paragraph (f) of the dividend definition in section of the Income Tax Act, which states:

“dividend means ... but does not include, subject to the provisions of the first proviso to this definition, any cash and the value of any asset given to a shareholder to the extent to which the cash and the value of the asset represents a reduction of the share premium account of a company”

This means that, should the Hedge Fund Company pay the additional R100 000 out by reducing its share premium account (as opposed to reducing retained and distributable profits), the amount would not constitute a dividend and would therefore be exempt from STC. The reference in paragraph (f) of the dividend definition above to the first proviso refers to a situation where the share premium contains capitalised profits. If the share premium contains capitalized profits, a reduction of the part of the share premium account would *not* be excluded from the dividend definition by paragraph (f), but would retain its nature as a dividend by virtue of paragraph (c) of the dividend definition, and accordingly be subject to STC.

In terms of paragraph 76(b) of the Eighth Schedule to the Income Tax Act, the capital portion of the distribution received in the share buyback should be treated as proceeds from the disposal of the shares.

The dividend portion of the distribution is exempt in the investor's hands by virtue of the provisions of section 10(1)(k)(i) of the Income Tax Act.

4.2 Comparison of a Collective Investment Scheme in property to a Hedge Fund housed in a Trust

The Hedge Fund in this case is housed in a trading trust, "the Hedge Fund Trust". Trusts are currently not widely used as a means of operating Hedge Funds; nevertheless, they retain their status as an alternative structure for this purpose.⁷⁰ Trusts are regulated by the Trust Property Control Act, and are subject to the Master of the High Court. In terms of the trust deed, investors would make an initial capital contribution to the trust. They would also be appointed as beneficiaries of the trust, thus receiving a vested right to a proportion of the income and capital gains of the trust. This proportion would depend on their relative capital contribution. The trust deed should also provide that, on the departure of an investor, the trust would repay the investor's initial capital contribution.

The Income Tax Act defines a Collective Investment Scheme in securities and a foreign Collective Investment Scheme to both be "companies" for tax purposes. It is silent on the definition of other types of Collective Investment Schemes. Some authors have proposed that all other Collective Investment Schemes are to be treated as "trusts" for tax purposes.⁷¹ These other Collective Investment Schemes include Collective Investment Schemes in property, Collective Investment Schemes in participation bonds and declared Collective Investment Schemes. Of these three, the Income Tax Act only specifically refers to a Collective Investment Scheme in property in a number of specific provisions. The SARS Income Tax Practice Manual merely states that any unit portfolio comprised in any Unit Trust Scheme in Securities, other than property shares, managed or carried on by a company registered as a management company under the Unit Trust Control Act is recognized as a "company" for purposes of the Income Tax

⁷⁰ L Kruger, The Framework of Hedge-Fund Taxation in South Africa, Cape Times, 30 November 2004; Per discussion with SJB Peile, January 2006

Act. It does not venture to classify the treatment of other types of Collective Investment Schemes for income tax purposes. Silke states that whilst the portfolio of a Collective Investment Scheme in Securities is regarded as a “company” for tax purposes, one in Property is not regarded as such. However, it goes on to state that the Collective Investment Scheme in Property is subject to tax on any non-distributed income in a manner similar to that for a trust.⁷² Income distributed by a Collective Investment Scheme in property retains its identity in the hands of the investor for tax purposes.⁷³ It therefore seems appropriate, for the purposes of this thesis, to compare the taxation of a Hedge Fund Trust to that of a Collective Investment Scheme in property.

A “trust” is defined in section 1 of the Income Tax Act to mean:

“Any trust fund consisting of cash or other assets which are administered and controlled by a person acting in a fiduciary capacity, where such person is appointed under a deed of trust or by agreement or under the will of a deceased person”

Accepting that a Collective Investment Scheme in property is a trust for tax purposes, an important question is as to whether the trust would be regarded as discretionary or vesting. In a discretionary trust, the trustees have the power not to distribute income or some portion thereof to the beneficiaries. Only income in respect of which the trustees exercised their discretion to distribute becomes vested in the beneficiaries. In contrast, the income of a vested trust vests in the beneficiaries i.e. it accrues to them regardless of whether it is physically distributed to them or not. The intention of a Collective Investment Scheme, as embodied in the Cisca definition of a Collective Investment Scheme, is to provide an investment scheme in which investors share the risk and benefit of investment. In order to ascertain the objects of any Collective Investment Scheme, one must examine the trust deed entered into by the management company of the Scheme.⁷⁴ Huxham and Haupt⁷⁵ note that:

“The Collective Investment Scheme [in property] is not taxed on any income it receives. It merely acts as a conduit for the investors.”

⁷¹ An example being Huxham, K and Haupt, P in Notes on South African Income Tax 2006, Hedron, p282

⁷² Silke on South African Income Tax, De Koker, LexisNexis Butterworths, 2005, para 9.39

⁷³ Silke: South African Income Tax 2004, Arendse, J et al, LexisNexis Butterworths

⁷⁴ SARS Income Tax Practice Manual, LexisNexis Butterworths

⁷⁵ K Huxham and P Hoeft, Notes on South African Income Tax 2006, p282

Since a Collective Investment Scheme in property is described as acting as a conduit for investors, such a Collective Investment Scheme would, under normal trading conditions, distribute *all* its income. It is therefore unlikely that income would be received and retained within the Collective Investment Scheme, thus circumventing the need to consider further whether the Collective Investment Scheme is vested or discretionary. The tax consequences are therefore discussed below under the premise that all income earned by the Collective Investment Scheme during any year of assessment is distributed. Furthermore, it would seem to be more equitable, from a tax perspective, for the investor that the Collective Investment Scheme in property is treated as vested with respect to its receipts and accruals, given the current tax rate applicable to trusts. The trust tax rate is 40%. If a Collective Investment Scheme in property is treated as a discretionary trust, it would mean that undistributed profits would be taxable in terms of section 25(1) of the Income Tax Act at a rate of 40% in the trust. This is unfavourable compared to that for a Collective Investment Scheme in securities, as retained profits in a Collective Investment Scheme in securities would only be taxed at 29%. The taxation of trusts is governed by section 25B of the Income Tax Act. In terms of section 25B(1) of the Income Tax Act, income derived by the trust is for the benefit of the vested beneficiaries, who have vested rights to the amount. Since it is assumed that the trust will distribute all income earned each year, this means that all the income will solely accrue to the trust beneficiaries for tax purposes. In *Trustees of the Hull Trust Fund v CIR (1931 WLD 193, 5 SATC 201)* the court held that where income received by the trust was paid out to the beneficiaries within the same tax year, such income was to be treated for tax purposes as if it had never been received by the trust but had rather been received directly by the beneficiaries. The trust is therefore acting as a “conduit pipe” (*Armstrong v CIR, 10 SATC 1; SIR v Rosen, 32 SATC 249*). Rosen’s case confirmed that, although the *trust* may be the registered shareholder of any Hedge Fund investments, the trust is a mere conduit for passing the dividends onto the deemed shareholder. The deemed shareholder is defined in terms of the section 1 definition of a shareholder in the Income Tax Act:

“(a) in relation to any company referred to in paragraph (a), (b), (c) or (d) of the definition of “company” in this section, means the registered shareholder in respect of any share, except that where some person other than the registered shareholder is entitled, by virtue of any provision in the memorandum or articles of the association of the company or under the terms of any agreement or contract, or otherwise, to all or part of the benefit of the rights of

participation in the profits, income or capital attaching to the share so registered, that other person shall, to the extent that such other person is entitled to such benefit, also be deemed to be a shareholder”

The deemed shareholder is thus, through legal agreement, the beneficial recipient of profits, income or capital arising from the shares, although he is not the registered shareholder. In a vested trust, the deemed shareholders would be the beneficiaries.

The taxation of the profit in the hands of the beneficiaries would depend on the intention of the investors when entering into the trust (usually, this would be a capital intention⁷⁶), as well as the nature of the income constituting such distribution. The conduit effect of income passing through a trust has been well characterized. It was established in *Armstrong v CIR* that the section 10(1)(k)(i) exemption in the Income Tax Act did not apply to the receipt of dividends (by, for example the trustees as the registered shareholders) but rather to the persons who were beneficially entitled to that income. Stratford CJ’s view of the Income Tax Act’s intention, stated in this case, was to “free moneys derived from a source which has already paid the tax [i.e. the company paying the dividend] from again being subject to tax” in the hands of the ultimate beneficiary. Therefore, the person who should enjoy the exemption was the person beneficially entitled to the income i.e. the beneficiaries, and not the one who had the right to sue the company i.e. the trustees.

Dividend paid ex rental profits from section 47 property shares

Section 10(1)(k)(i)(aa) of the Income Tax Act states that income tax exemption does not apply to dividends distributed by “a company, the shares of which are “property shares” as defined in section 47 of the CISCA on shares included in a portfolio comprised in any Collective Investment Scheme in property managed or carried on by any company registered as a manager under section 42 of that Act ...”.

If this section is interpreted to only refer to dividends from section 47 property companies *distributed to a Collective Investment Scheme in property*, then different tax consequences will arise where such dividends are distributed to an entity *other than* a Collective Investment Scheme in property, such as a Hedge Fund Trust. It is on this interpretation that the illustration

⁷⁶ Refer to discussion on page 70

in Table 18 below is based. If, however, property shares can only be held *as part of a Collective Investment Scheme in property*, then all dividends from the shares will be subject to section 10(1)(k)(i)(aa) of the Income Tax Act and there would not be different tax consequences, as all investors would have an interest in a Collective Investment Scheme in property.

Since the Hedge Fund Trust is vested, no monies accrue to the Fund itself and thus no tax is payable in the Trust (Table 18). Similarly, the Collective Investment Scheme in property is treated as a vested trust for tax purposes, and therefore also pays no tax on monies received, for the same reason (Table 18). This is in accordance with the principle of trust taxation in section 25B(1) of the Income Tax Act:

“Any amount received by or accrued to or in favour of any person during any year of assessment in his or her capacity as the trustee of a trust, shall, subject to the provisions of section 7, to the extent to which that amount has been derived for the immediate or future benefit of any ascertained beneficiary who has a vested right to that amount during that year, be deemed to be an amount which has accrued to that beneficiary, and to the extent to which that amount is not so derived, be deemed to be an amount which has accrued to that trust.”

Table 18

Comparison of the overall effective tax rate on a dividend received by an investment fund from a section 47 property company

Entity	<i>Hedge Fund Trust</i>	<i>Collective Investment Scheme in property</i>
Dividend received from s47 property company	R100.00	R100.00
Tax at 40%	-	-
Distribution to beneficiaries	R100.00	R100.00
<i>Effective tax rate in fund</i>	<i>0%</i>	<i>0%</i>

The distribution of the section 47 dividend from the Hedge Fund Trust to the individual investor is treated as the receipt of a local dividend and is therefore exempt in terms of section 10(1)(k)(i) of the Income Tax Act (Table 19). The distribution of the section 47 dividend from the Collective Investment Scheme in property (Table 20) to the individual investor is subject to section 10(1)(k)(i)(aa) of the Income Tax Act:

“There shall be exempt from tax – ...

(k)(i) dividends (other than foreign dividends) received by or accrued to or in favour of any person: Provided that this exemption shall not apply –

(aa) to dividends (other than those distributed out of profits of a capital nature and those received by or accrued to or in favour of any person who is neither a resident nor carrying on business in the Republic) distributed by a company the shares of which are “property shares” as defined in section 47 of the Collective Investment Schemes Control Act, 2002, on shares

included in a portfolio comprised in any collective investment scheme in property managed or carried on by any company registered as a manager under section 42 of that Act for purposes of Part V of that Acts”

As the dividend was derived from the rental profits of the property shares, it cannot be excluded from the provisions of the section on the basis that it is of a capital nature. Thus the dividend is subject to tax in the investor’s hands at the maximum marginal rate of 40% (Table 20).

The distribution of the section 47 dividend from either the Hedge Fund Trust or the Collective Investment Scheme in property to the Retirement Fund is considered to be receipt of rental income, and therefore taxable. This is based on the TORFA’s definition, in section 1, of rental income, part (c), which states:

“Rental income includes-

(c) any dividend (other than those distributed out of profits of a capital nature) distributed by a fixed property company as defined in section 1 of the Unit Trusts Control Act, 1981”

It is important to note that the TORFA defines the dividend as “rental income” solely on the basis that it emanates *from a fixed property company*. One can see from this definition that the TORFA has not been updated to reflect that the Unit Trusts Control Act has been replaced by the CISCA. The old Unit Trust Control Act referred to a “fixed property company” as defined in section 1, whereas the Income Tax Act refers to “property shares” as defined in section 47 of the CISCA. The absence of the phrase “on shares included in a portfolio comprised in any Collective Investment Scheme in property” found in section 10(1)(k)(i)(aa) of the Income Tax Act means that rental income includes dividends from property shares as defined in section 47 of the CISCA irrespective of the conduit through which the dividend passes. The effect of this phrase in section 10(1)(k)(i)(aa) of the Income Tax Act is that it discriminates between dividends from property shares, as alluded to in the TORFA definition of rental income, and such dividends which first passed through a Collective Investment Scheme in property as the conduit.

Table 19

Comparison of the overall effective tax rate on a distribution of a section 47 dividend from a Hedge Fund Trust (Table 18) to either an individual investor or a Retirement Fund

Investor	<i>Individual</i>	<i>Retirement Fund</i>
Dividend received	R100.00	R100.00
Tax	-	R9.00
<i>Effective tax rate</i>	<i>0%</i>	<i>9%</i>
<i>Effective tax rate overall</i>	<i>0%</i>	<i>9%</i>

Table 20

Comparison of the overall effective tax rate on a distribution of a section 47 dividend from a Collective Investment Scheme in property (Table 18) to either an individual investor or a Retirement Fund

Investor	<i>Individual</i>	<i>Retirement fund</i>
Dividend received	R100.00	R100.00
Tax	R40	R9.00
<i>Effective tax rate</i>	<i>40%</i>	<i>9%</i>
<i>Effective tax rate overall</i>	<i>40%</i>	<i>9%</i>

Comment on investment decision

For the individual investor, there is a tax advantage in holding property shares via a Hedge Fund Trust since dividends of a non-capital nature from such shares are exempt. The same dividend received from a Collective Investment Scheme in property is not exempt due to the wording of section 10(1)(k)(i)(aa) of the Income Tax Act, as discussed above.

For the Retirement Fund, there is no difference between the receipt of the dividend from the Hedge Fund in a Trust or from a Collective Investment Scheme in property because the TORFA definition of “rental income” merely includes dividends of a non-capital nature arising from property shares. As there is no reference to such property shares having to be held within a Collective Investment Scheme in property, all such dividends are considered to be rental income.

Capital dividend paid ex section 47 property shares

Section 10(1)(k)(i)(aa) of the Income Tax Act excludes from its ambit dividends declared out of capital profits in section 47 property shares. The consequence for the investor in the Collective Investment Scheme in property is that such dividends are exempt in the individual’s hands. The overall effective tax rate of a capital dividend paid to the investor is nil. Capital dividends from section 47 property shares are also exempt in the Retirement Fund by virtue of part (c) of the definition of “rental income” in section 1 of the TORFA, the relevant part of which reads:

“any dividend (other than those distributed out of profits of a capital nature) distributed by a fixed property company ...”

There would also be no tax payable on a capital dividend from section 47 property shares for either the individual or the Retirement Fund upon receipt from a Hedge Fund Trust, due to the section 10(1)(k) dividend exemption in the Income Tax Act.

Trading profits

The application of section 25B(1) of the Income Tax Act results in neither the Hedge Fund Trust nor the Collective Investment Scheme in property being taxed on profits, for example, from the short sale of shares, arising from trading activities within the fund (Table 21).

Table 21

Comparison of the overall effective tax rate on profits arising from trading activities within a Hedge Fund Trust and a Collective Investment Scheme in property

Entity	<i>Hedge Fund Trust</i>	<i>Collective Investment Scheme in property</i>
Trading profits	R100.00	R100.00
Tax at 40%	-	-
Distribution to beneficiaries	R100.00	R100.00
<i>Effective tax rate in fund</i>	<i>0%</i>	<i>0%</i>

Distribution of the trading profits by either the Hedge Fund Trust or the Collective Investment Scheme in property has identical tax consequences. This is because trading profits retain their nature in the hands of the recipients, in accordance with the “conduit pipe” principle of distributions made by a trust. Whereas trading profits constitute taxable income for the individual, such profits are not “income” as defined in section 3 of the TORFA and are thus not subject to tax within the Retirement Fund (Table 22).

Table 22

Comparison of the overall effective tax rate on a distribution of trading profits from a Hedge Fund in a Trust or Collective Investment Scheme in property (Table 21) to either an individual investor or a Retirement Fund

Investor	<i>Individual</i>	<i>Retirement fund</i>
Trading profits received	R100.00	R100.00
Tax	R40	-
<i>Effective tax rate</i>	<i>40.00%</i>	<i>0%</i>
<i>Effective tax rate overall</i>	<i>40.00%</i>	<i>0%</i>

Comment on investment decision:

The view that the Collective Investment Scheme enjoys favourable tax treatment compared with an investment in a Hedge Fund is less compelling when one compares a Collective Investment Scheme in property to a Hedge Fund Trust. As both are “trusts” for tax purposes, the taxation of the two entities is, in fact, the same, in many instances.

Foreign dividend income

A foreign dividend received and distributed by both the Hedge Fund Trust and the Collective Investment Scheme in property will be taxable in the hands of all recipient investors. Neither the Income Tax Act nor the TORFA discriminates between foreign dividends distributed by either entity. Whereas the individual investor is taxed in terms of section 10(1)(k)(i) of the Income Tax Act at 40%, the Retirement Fund is taxed in terms of section 3(e) of the TORFA at 9%.

Local dividend income from sources other than section 47 property shares

Local dividends received and distributed by both the Hedge Fund Trust and the Collective Investment Scheme in property are exempt for the individual investor in terms of section 10(1)(k)(i) of the Income Tax Act.

Local dividends received are not “income” as defined in section 3 of the TORFA and thus are not subject to tax within the Retirement Fund.

Capital gains

The taxation of a capital gain, which may arise through disposal of a long-term interest in property by the Hedge Fund Trust or a Collective Investment Scheme, is governed by paragraphs 80(2)(a) and (b) of the Eighth Schedule, which state:

“Subject to paragraphs 68, 69, 71 and 72, where a capital gain arises in a trust in a year of assessment during which a trust beneficiary who is a resident has a vested interest or acquires a vested interest (including an interest caused by the exercise of a discretion) in that capital gain but not in the asset, the disposal of which gave rise to the capital gain, the gain –

- (a) must be disregarded for the purpose of calculating the aggregate capital gain or aggregate capital loss of the trust; and*
- (b) must be taken into account for the purpose of calculating the aggregate capital gain or aggregate capital loss of the beneficiary in whom the gain vests.”*

The trust *per se* disregards the capital gain. Since capital gains, as determined in terms of the Eighth Schedule, are brought into the taxable income of an individual under section 26A of the Income Tax Act, the vested beneficiary accounts for such a gain when determining his or her aggregate capital gain or loss for the tax year. The capital gain is thus taxed at the individual’s inclusion rate for capital gains, in terms of paragraph 10(a) of the Eighth Schedule, at an effective rate of 10%.

The Retirement Fund is not taxable upon capital gains as these are not included in the income of the Fund in terms of section 3 of the TORFA.

Acquisition and disposal of an interest in the Hedge Fund Trust compared with that in a Collective Investment Scheme in property

Collective Investment Scheme in property

Paragraph 11(2)(c) of the Eighth Schedule specifically excludes the issue of an interest in a Collective Investment Scheme to a prospective investor from being a “disposal”, as defined in paragraph 11(1) of the Eighth Schedule. This paragraph refers to Collective Investment Schemes in general, and this would therefore include a Collective Investment Scheme in property. Paragraph 67A of the Eighth Schedule clearly states that the holder of a participatory interest in a Collective Investment Scheme must determine a capital gain or loss in respect of the disposal of that participatory interest by the holder.

Hedge Fund Trust

In terms of the Trust Deed, an investor would join the Hedge Fund Trust by making an initial capital contribution in the form of a donation of money to the Fund and by being appointed as a beneficiary. The question arises as to whether the introduction of a new beneficiary into the Hedge Fund Trust results in that Trust’s disposal of an asset for CGT purposes i.e. does the Trust “dispose of” a right to profits when an investor is appointed as a beneficiary? CGT is, with some exceptions, only triggered at the point when an *asset* is disposed of. In terms of the Trust Deed, the investor should have the right to the return of the capital invested on exiting the fund. It is submitted that such a right would fall within part (b) of the definition of an asset, which is defined in paragraph 1 of the Eighth Schedule as:

“(a) property of whatever nature, whether movable or immovable, corporeal or incorporeal, excluding any currency, but including any coin made mainly from gold or platinum; and

(b) a right or interest of whatever nature to or in such property.”

One may apply the logic of the *obiter dictum* uttered in the case CIR v Genn & Co (Pty) Ltd (20 SATC 113) to this scenario, wherein Schreiner JA stated that “borrowed money is not received, nor does it accrue within the meaning either of the definition of ‘gross income’ or of section 12(f).” Since, in a vested trust, the investor always has the right to the return of the initial capital in terms of the Trust Deed, it can never said to be “received” or constitute an “asset” in the

hands of the Trust. Thus, the creation of a new beneficiary in the trust may be more accurately described as that the beneficiary has created a right to profits of the trust, rather than that the trust itself has “disposed of” such a right.

Comparison

The data regarding the tax consequences of the disposal of an interest in a Collective Investment Scheme presented in Table 16 is applicable to all Collective Investment Schemes and thus the Collective Investment Scheme in property would be subject to the same provisions as the Collective Investment Scheme in securities.

Comment on investment decision

The taxation of the capital gain or loss on the disposal of the interest in the Hedge Fund Trust would be identical to the disposal of the investment in the private Hedge Fund Company, illustrated in Table 16. This is because the vested interest held by the beneficiary constitutes neither shares listed on a recognized stock exchange, nor a participatory interest in a collective investment scheme, nor could it be described as being held “wholly and exclusively for business purposes”.⁷⁷ Paragraph 20(2) of the Eighth Schedule precludes the base cost of an asset, which would include a vested interest in the Hedge Fund Trust, from the inclusion of any borrowing costs. Thus the disposal of the interest in a Collective Investment Scheme is more advantageous, for tax purposes, than the disposal of the interest in the Trust (or the private Hedge Fund Company), in instances where borrowing costs have been incurred.

4.3 Taxation of a Hedge Fund housed in a Partnership

A limited liability partnership is the most commonly encountered entity in which Hedge Funds are housed in South Africa today.⁷⁸ A Hedge Fund Partnership has, however, no counterpart for tax purposes, in any form of Collective Investment Scheme i.e. no Collective Investment Scheme is treated as a partnership for tax purposes. This thesis will therefore discuss the taxation of a Hedge Fund Partnership without comparing this to Collective Investment Schemes.

⁷⁷ Refer to discussion on pages 71-72

⁷⁸ p14 of the paper referred to in footnote 14

Partnerships in South Africa fall under the jurisdiction of the common law. Generally, no formalities are required to establish a partnership, although a written partnership agreement is usually advisable. A partnership is restricted to a maximum of twenty persons. Under the common law, any change in the composition of the partners triggers the termination of that partnership.⁷⁹

There are two types of partnerships; ordinary partnerships, where all the partners are jointly and severally liable for the debts of the partnership,⁸⁰ and a limited liability partnership, also known as an *en commandite* partnership.⁷⁹ In this latter type of partnership, there are two types of partners. A “disclosed” partner actively participates in running the business and is jointly and severally liable, along with other disclosed partners, to third parties for all obligations incurred by any partner acting within his powers in conducting the partnership business. A business is often carried on in the name of one disclosed partner only. The second type of partner is an “undisclosed” partner, also referred to as an *en commandite* partner. Undisclosed partners contribute money to, and share in the profits of, the venture. Their liability to the partnership is limited to the amount of their contributions. A limited partner may deduct any losses incurred, to a maximum of the sum of his contribution to the partnership and any profits he has earned from the business. Undisclosed partners have no right to actively participate in the conduct of the partnership business. Neither may they possess the assets of the partnership, nor are they liable to creditors. They are only liable to their co-partners. They may also not claim repayment of capital contributed or their share of profits in competition with creditors of the partnership i.e. creditors would be paid out first in the case of a liquidation of the partnership.

Hedge Funds are, virtually without exception, run in the form of limited liability partnerships. The disclosed partner would be the hedge fund manager who would actively run the investment business for the benefit of the undisclosed partners, who would contribute capital. If the Hedge Fund manager is a company, and invariably this is the case, the undisclosed partners would also enjoy the protection of limited liability, by virtue of the law of partnerships. In terms of the common law principle of partnerships, it is only the active partner, who is usually the only

⁷⁹South African Business Entities A Practical Guide”, third edition, by JL van Dorsten, published by Obiter Publishers CC

⁸⁰Starting and running your own business, KPMG publication, 2001

disclosed partner, who is liable for the partnership losses. Thus, even if the Hedge Fund participates in a trade which causes significant financial loss, it is only the company which would be liquidated. The personal assets of the undisclosed partners could not be attached. This is important when one considers the potential downside of short selling and leverage (see Table 1 and the discussion in Chapter 1). The maximum loss that a long-only held security could incur would be the initial cost of the share. With a short-sold security, however, should the price rise instead of fall, the potential loss incurred is not capped.

Taxation of a hedge fund partnership

A partnership is not a separate legal entity and therefore cannot be levied with tax, as only persons are taxed.⁸¹ Section 66(15) of the Income Tax Act requires, however, that:

“Persons carrying on any business in partnership shall make a joint return as partners in respect of such business, together with such particulars as may, from time to time, be prescribed, and each partner shall be separately and individually liable for the rendering of the joint return.”

In practice, the rendering of the joint return would require the partners to submit a statement of account for the partnership business as a whole, together with their individual tax returns. Although current legislation does not require books of account to be kept by a partnership (as is the case with companies), common law requires the controlling partner to render annual accounts.⁷⁹ The individual’s tax return requires the taxpayer to state whether he is a member of a partnership or not.

Section 77(7) of the Income Tax Act then states:

“Separate assessments shall, notwithstanding the provisions of subsection 15 of section 66, be made upon the partners”

Thus, the income of the partnership business is apportioned among the partners in accordance with the profit-sharing ratio, with each partner being taxed on his/her share. The taxation of a Hedge Fund Partnership will therefore proceed entirely in accordance with the taxation of

⁸¹ The principle that registration for tax is restricted to *persons* was confirmed in *The Phillip Frame Will Trust (1990)* 53 SATC 166

receipts and accruals in the hands of the recipient investors described previously. The interposition of the partnership as the means of earning that income has no further tax implication for the investor. The tax consequences of the receipt of each type of income, namely, local dividends, foreign dividends, section 47 dividends, trading profits and capital gains, would be treated exactly as discussed previously both for an individual investor and a Retirement Fund.

For the Hedge Fund housed in an *en commandite* partnership, the provisions of section 24H govern the taxation of persons carrying on trade in such a partnership. This section provides as follows:

- A “limited partner” refers to any member who’s liability towards partnership creditors is limited to the amount of his/her contribution (section 24H(1) of the Income Tax Act)
- The Income Tax Act deems each partner to be carrying on the partnership business, irrespective of a limitation of liability (section 24H(2) of the Income Tax Act)
- Limited partners may not deduct, for tax purposes, an amount in excess of his/her contribution, plus any profit earned from the partnership, in the determination of taxable income (section 24H(3) of the Income Tax Act)
- Amounts disallowed in terms of the above section may be carried forward to the next year of assessment (section 24H(4) of the Income Tax Act)
- Income (and any deductions thereto) accrued to the partnership on any given day shall be deemed to have accrued, in the relevant profit sharing ratio, to each partner on the same day (section 24H(5) of the Income Tax Act)

The above provisions mean that the trading profits or losses of the Hedge Fund Partnership would accrue to each partner as and when they arise on a day-to-day basis. Since tax is assessed annually, one need only determine the nett profit or loss of the partnership at the end of the tax period. To quote Botha JA:⁸²

⁸² *Botha JA in Caltex Oil (SA) Ltd v SIR (1975) 37 SATC 1*

“It is only at the end of the year of assessment that it is possible, and then it is imperative, to determine the amounts received or accrued on the one hand and the expenditure actually incurred on the other during the year of assessment.”

Paragraph 36 of the Eighth Schedule is the counterpart provision to section 24H of the Income Tax Act in respect of the accrual of capital gains to a partnership. When capital assets are disposed of by the partnership, paragraph 36 provides that proceeds from the disposal must be treated as having accrued to each partner at the time of that disposal. The capital gain (or loss) would be attributed among the partners in accordance with the asset-sharing ratio (if different from the profit-sharing ratio).⁸³

Normally, the nett trading profit of the Hedge Fund Partnership would be determined for the year of assessment, and this would be attributed to the partners in their profit-sharing ratio. The only exception to this practice would be in the event that the composition of the partnership changed during the course of the year of assessment. This would cause the termination of that partnership in terms of the common law, and accounts would need to be drawn up as at the date of the termination. Dissolution of a partnership would trigger a disposal, for capital gains tax purposes, of each partner’s interest.

The Comprehensive Guide to CGT (“the Guide”), published by the South African Revenue Service (SARS), states that, for practical reasons, it is not intended that the strict legal approach, described above, be followed. Instead, each partner must be regarded as having a fractional interest in each of the partnership assets.⁸⁴

The Guide suggests a framework to be applied when a new partner joins a partnership:

“When a new partner joins, the existing partners must be treated as having disposed of a part of their share in the partnership assets and a capital gain or loss must be determined in respect of the part disposed of. The base cost of the part disposed of must be determined in accordance with paragraph 33 of the Eighth Schedule.”

Thus the departure from the strict legal approach based on the common law means that each partner does *not* have a complete disposal of his interest in the partnership. Instead, the Guide

⁸³ Comprehensive Guide to CGT, Second draft, SARS, 2005

advocates that only a part-disposal should be recognised for CGT purposes, e.g. if a fifth person joins as an equal partner to a four-person partnership, this will not result in the existing partners each disposing of their 25% share in return for the acquisition of a 20% share. Rather, each one will be considered to have made a part-disposal of 5% of their existing share of the assets.

The Guide also suggests a framework to be applied when a partner leaves a partnership:

“A partner leaving the partnership will have disposed of his or her interest and a capital gain or loss must be determined. The remaining partners who acquire that partner’s interest will reflect an increase in the base cost of their investment.”

The departure from the common law is again noted in the Guide’s interpretation of a partner’s departure from a partnership. Instead of this resulting in a disposal of *each* partner’s interest in the partnership, to be replaced by the acquisition of an interest in a new partnership, only the departing partner has a disposal of his/her interest. The acquiring partner/s will have an addition to their existing base cost/s, to the extent of their contribution to the consideration paid to the departing partner.

These principles are illustrated for the following scenario, with the CGT effects on the base costs of the partners’ interests shown in Tables 23 to 25.

Four individuals, A, B C & D, form a Hedge Fund Partnership on 1 January 2002, each contributing R100. The Hedge Fund Partnership was valued on 31 December 2002 at R1200. A fifth partner, E, joins as an equal partner on 1 January 2003. The Hedge Fund Partnership was valued at R 2400 on 1 January 2006, at which point D withdrew. In terms of the Guide, partners A to D had a part-disposal of their interest in the partnership when E was admitted as a new partner. Paragraph 33(1)(a) of the Eighth Schedule indicates the method whereby the base cost of an asset, which is part-disposed of, may be determined. This may be calculated as: the partner’s base cost multiplied by the proportion of the market value of the part disposed of as bears to the market value of the entire asset before the disposal. Thus, each partner disposes of R20 of the original base cost of their interest (Table 25).

⁸⁴ Ibid, page 231

The proceeds received by each partner on the part-disposal of their partnership interest would be determined in terms of paragraph 38 of the Eighth Schedule. This is because partners are defined as connected persons in relation to each other in the definition of a “connected person” in section 1 of the Income Tax Act. Paragraph 38 of the Eighth Schedule provides that transactions between connected persons must be treated as taking place at market value. In the example, E is purchasing a 20% interest in the partnership for a consideration equal to one-fifth of the market value of the partnership at that date (R1 200/5). The base cost of partner E’s interest would therefore be R240 (Table 25).

On withdrawing from the partnership, D is paid out his share of the market value of the partnership at that date i.e. one-fifth of R2 400, or R480. This consideration includes his share of both realized and unrealized partnership profits. It is important to note that realized profits, which were not physically paid out prior to D’s withdrawal, have already accrued to D for tax purposes. This would not therefore constitute an amount received by him for tax purposes at the point of his withdrawal. It was assumed (Table 24) that R120 of the credits to D’s capital account comprised realized profits. Unrealised profits, assumed to be R280 (Table 24), may arise from the market valuation of equities within the fund (whether held on a short or long-term basis) and the market valuation of the open trading positions within the fund, which may be assets or liabilities at the date of his withdrawal. The unrealised profit, less the base cost of the partnership interest of R80 (Table 25), gives rise to D’s capital gain of R280 on withdrawal from the partnership (Table 25).

Partners A, B, C and E were assumed to contribute equally to the buy-out of D’s interest and accordingly, the base costs of each of their interests increased by an amount equal to one-quarter of the consideration paid of R480 (i.e. R120 – Table 25, second page).

From this simplistic example, one of the practical problems with Hedge Fund investments may be noted, in that, although D was to be paid out R480 for his share, there is only R300 cash in the bank at that point (Table 23, at 1 January 2006). In order to be able to pay D his share, it would be necessary to liquidate part of the R800 open trading positions, which may not be opportune for the investment strategy of the Fund as a whole. Alternately, D will have to wait until more cash becomes available in due course, leading to the problems of illiquidity and pricing infrequency which were discussed near the end of Chapter 1.

Table 23

Balance sheet of a Hedge Fund Partnership, illustrating the market value of the partnership at various times. The capital accounts attributable to each partner are shown in Table 24

Date	1 Jan 2002	31 Dec 2002	1 Jan 2003	1 Jan 2006
<i>Event:</i>	<i>4 members: A, B, C & D join</i>		<i>E joins</i>	<i>D withdraws</i>
Non-current assets (equity)	-	R500	R500	R1 000
Current assets	R400	R800	R1 040	R1 500
Equity	-	R300	R300	R400
Bank	R400	R100	R340	R300
Open trading positions (+ve)	-	R400	R400	R800
Current liability	-	R100	R100	R100
Open trading positions (-ve)	-	R100	R100	R100
<i>Market value of partnership</i>	<i>R400</i>	<i>R1 200</i>	<i>R1 440</i>	<i>R2 400</i>

Table 24

Capital accounts attributable to each partner of the Hedge Fund Partnership at various times (Table 23)

Date	1 Jan 2002	31 Dec 2002	1 Jan 2003	1 Jan 2006
<i>Event:</i>	<i>4 members: A, B, C & D join</i>		<i>E joins</i>	<i>D withdraws</i>
Capital account total	R400	R1 200	R1 440	R2 400
Capital account A	R100	R300	R300	R480
Capital account B	R100	R300	R300	R480
Capital account C	R100	R300	R300	R480
Capital account D	R100	R300	R300	-
Capital account E	-		R240	R480
D – R480 consideration paid out, comprising of:			<i>Realised profits</i>	<i>R120</i>
			<i>Unrealised profits</i>	<i>R280</i>
			<i>Base cost</i>	<i>R80</i>

Table 25

Illustration of the Guide's interpretation⁷⁵ to the addition to the base cost of each partner at various times

<i>Event</i>	<i>Market value of partnership</i>	<i>A</i>	<i>B</i>	<i>C</i>	<i>D</i>	<i>E</i>
A to D join – initial capital paid in	R400	R100	R100	R100	R100	-
E joins – initial capital paid in (R1 200 / 5)	R1 200	-	-	-	-	R240
Each partner receives proceeds (R240 / 4)	R1 440	R60	R60	R60	R60	-
Less: part-disposal of base cost [R60 / (R1 200/4)] X R100		R20	R20	R20	R20	-
Capital gain		R40	R40	R40	R40	-
Revised base cost (R100-R20)		R80	R80	R80	R80	R240
D withdraws – disposal by D:	R2 400					
Consideration paid to D (R2 400/5)		-	-	-	R480	-
Less: realized profits		-	-	-	R120	-
Proceeds		-	-	-	R360	-
Less: base cost		-	-	-	R80	-
Capital gain		-	-	-	R280	-

D withdraws – acquisition by A, B, C & E:	R2 400					
Paid to D (R480/4)		R120	R120	R120	-	R120
Plus: existing base cost		R80	R80	R80	-	R240
Revised base cost		R200	R200	R200		R360

5 Consideration of tax efficiency of Hedge Fund entities and a proposal for a tax-neutral structure

This section proposes an alternate Hedge Fund structure which draws from the Hedge Fund entities previously discussed and attempts to optimise taxation for the investor.

5.1 Linked unit hedge fund

In Tables 3 and 4 (Chapter 4), taxation of the trading profit and capital gains in a linked unit Hedge Fund structure was considered. A linked unit Hedge Fund entailed housing the Hedge Fund in a company where investors hold an equal number of shares and debentures in that company. The investor is therefore potentially able to receive profits earned in the Hedge Fund in two forms: dividends, by virtue of the shares held, and interest income, by virtue of the debentures held.

Table 3 illustrated that if investment returns were paid as interest on debentures to investors, the interest should constitute deductible expenditure for the Hedge Fund in terms of section 24J(2) of the Act. The deductible interest expense was set off against trading profit, thereby resulting in a nett nil amount of taxable income in the Hedge Fund. However, the interest income received by the investors constituted taxable income and was subject to taxation at the 40% maximum marginal rate for the individual and at 9% for the Retirement Fund, assuming such interest was earned after 1 March 2006 (Table 3a). It is therefore advantageous for the individual to receive trading profits in the form of dividend income from the Hedge Fund, as the effective tax rate on the dividend paid by the company of 37.875% compares favourably to that of 40% on interest received (Table 3b). The problem with receiving the return in the form of dividends is that, although the dividend is tax-free in the hands of the investor, this income is still subject to an overall effective tax rate of 37.875%, due to taxes within the Hedge Fund Company. The question arises as to whether these taxes on the payment of the dividend by the company can be avoided.

On the disposal of a long-term interest in property by the Hedge Fund, the individual would elect to receive the capital gain in the form of a dividend, upon which an overall effective tax rate of 25.188% would apply (refer to Table 15 and the discussion on page 68). However, if it

were possible for the capital gain to accrue to the individual directly, for tax purposes, and not first to the Hedge Fund Company itself, an overall effective tax rate of only 10% would apply. The Retirement Fund would elect to receive any capital gain as interest income, on or after 1 March 2006, thus being subject to an overall effective tax rate of 22.195% (Table 4a). by way of contrast, were the capital gain able to accrue directly to the Retirement Fund, without first being subject to CGT within the Hedge Fund Company, the overall effective tax rate on the income accrual would be nil. Tax on the capital gain within the linked unit Hedge Fund is thus an additional tax burden and the question arises as to whether this can be avoided altogether. The disadvantage of the linked unit structure for the Retirement Fund is that trading profits and capital gains do not constitute taxable forms of income to the Retirement Fund itself. However, payment of such trading profits or capital gains to the Retirement Fund in the form of interest constitutes taxable income in the Retirement Fund. Furthermore, if the Retirement Fund were to elect to receive trading profits and capital gains in the form of dividends, income tax is payable in the company at 29% on the trading profits and at an effective rate of 14.5% on the capital gains. The dividend is then still subject to STC. If, however, the trading profits and capital gains could accrue to the Retirement Fund directly, the overall effective tax rate on these income accruals would be nil. The question thus arises as to whether the conversion of non-taxable income to taxable income can be avoided.

5.2 Hedge Fund Trust or Partnership

These entities are treated identically for tax purposes, insofar as the discussion below extends.

Trading profits earned in the Hedge Fund Trust are not subjected to taxation within the Trust, since this was argued to be a vesting Trust in Chapter 4.2 (refer to discussion on pages 80-81). The income directly accrues to the beneficiaries for taxation purposes in terms of section 25B(1) of the Income Tax Act (Table 21). Such income for the individual will be subject to the maximum marginal tax rate of 40%. In contrast, such income for the Retirement Fund investor retains its nature as trading profits, in accordance with the conduit pipe principle, and is thus subject to a nil overall effective tax rate, because trading profits are not classified as taxable income in terms of section 3 of the TORFA (Table 22).

Capital gains, earned by the Hedge Fund Trust through its disposal of a long-term interest in property, accrue directly to the beneficiaries. The gain for the individual would be subject to an overall effective tax rate of 10%. This compares favourably to the overall effective tax rate of 25.188% on capital gains earned by the Hedge Fund Company and distributed to the individual in the form of dividends (Table 15). A favourable overall effective tax rate is seen for capital gains which are able to accrue directly to the Retirement Fund. Capital gains are not included in the income of the Retirement Fund in terms of section 3 of the TORFA. On being earned by the Hedge Fund Trust and directly accruing to the Retirement Fund for tax purposes, the overall effective tax rate on the capital gain is nil.

Local dividend income distributed by a Hedge Fund Trust accrues directly, either to the individual or the Retirement Fund, and no tax is payable on the distribution.

From a tax perspective, the Hedge Fund Trust or Partnership is, generally speaking, for the individual, and in all respects, for the Retirement Fund, a more favourable structure, from a tax perspective, than the Hedge Fund Company.

5.3 An alternative Hedge Fund structure

The discussion above suggests that the ideal structure for the investor is the flexibility of the linked unit Hedge Fund structure combined with the favourable tax implications of the Hedge Fund Trust or Partnership.

This may be envisaged in the following structure: the Hedge Fund activities are housed within a Hedge Fund Trust. A Linked Unit Company, in which investors may hold both shares and debentures, funds the Hedge Fund activities through interest-bearing loans extended by itself to the Trust. The investors in the Hedge Fund become both beneficiaries of the Hedge Fund Trust and holders of linked units in the Company. This is illustrated diagrammatically in Figure 1. In this structure, it is proposed that capital gains, net local dividend income and trading profits earned within the Hedge Fund Trust are paid directly to the investors in their capacity as beneficiaries of the Hedge Fund Trust. An individual investor may alternatively elect that, specifically, trading profits earned in the Hedge Fund Trust are distributed as interest payments on the loans extended by the Company to the Trust. The individual investor would then further

elect that the Company should declare the interest income it received from the Trust as a dividend. An overall effective tax rate of 37.875% would apply to such receipts, as opposed to 40%, were the Trust to distribute the profits directly to the individual beneficiary. A summary of the overall effective tax rates applicable is shown in Table 26.

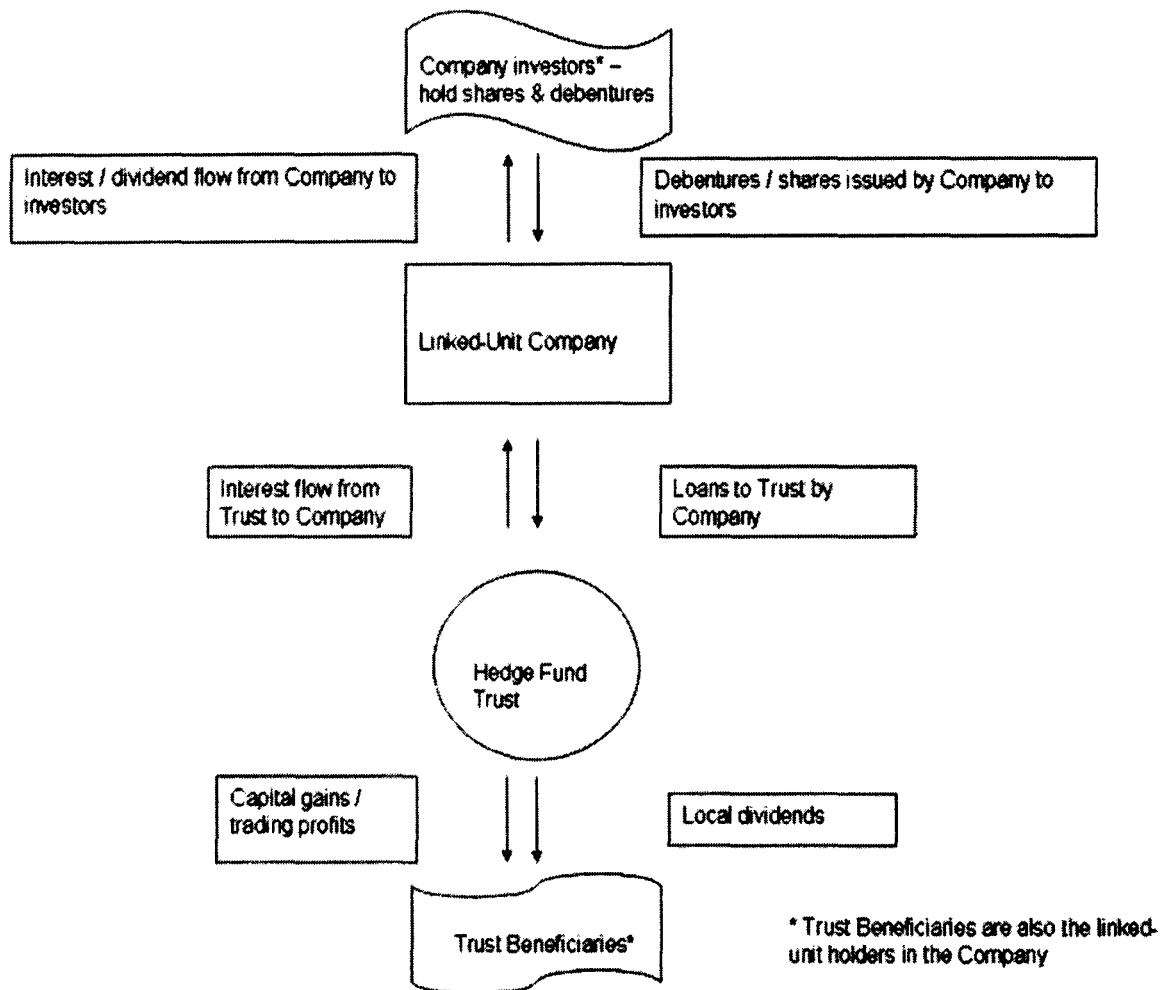
Table 26

Effective tax rates on various investment returns arising to the individual and Retirement Fund investors in a Hedge Fund Trust funded by a linked unit Company

<i>Investment return in Hedge Fund Trust</i>	<i>Trust pays:</i>	<i>Company pays:</i>	<i>Individual</i>	<i>Retirement Fund (after 1.3.2006)</i>
Trading profits	Interest on trust debentures to company	Dividends to individual	37.875%	Not elect
Trading profits	Distribution to trust beneficiary	-	Not elect	0%
Capital gains	Distribution to trust beneficiary	-	10%	0%
Local dividends	Distribution to trust beneficiary	-	0%	0%

Figure 1⁸⁵

Possible flow of investment returns arising in a Hedge Fund Trust funded by a linked unit company



⁸⁵ Discussions held with J Gillmer, Deneys Reitz, June 2005, in regard to tax efficient hedge fund structuring are acknowledged, with respect to the structure in Figure 1

5.4 Conclusion

The above structure achieves maximum tax neutrality. This structure is particularly favourable for the Retirement Fund investor, as non-taxable returns in its hands, i.e. capital gains and trading profits, may accrue directly to the Retirement Fund in its capacity as a beneficiary of the Hedge Fund Trust, thus being subject to a nil overall effective tax rate. The conversion from non-taxable to taxable income forms, as occurs in the case of the Hedge Fund Company, is thus avoided.

The individual investor benefits from the flexibility of this structure in that an alternative is available for the distribution of trading profits, other than as a distribution to the investor in his capacity as a Trust beneficiary. Although the individual would opt for capital gains to be distributed to him in his capacity as a beneficiary of the Trust, he would elect for a dividend distribution via the Company in respect of trading profits earned within the Hedge Fund.

6 Conclusion of thesis

This thesis demonstrates that the nature of the investment return, the nature of the Hedge Fund entity and the identity of the investor all influence the effective overall tax rate of investment returns. Summaries of the effective overall tax rate on investment returns from a Hedge Fund Company versus a Collective Investment Scheme in securities (Table 27) and from a Hedge Fund Trust versus a Collective Investment Scheme in property (Table 28), for the individual investor and the Retirement Fund, are shown below.

Refer to Table 27: apart from capital gains, the individual investor is subject to a lesser overall effective tax rate on investment returns by the investment in a Hedge Fund Company compared with the same investment in a Collective Investment Scheme in securities. “Capital gains” refer to gains earned within the Funds (as opposed to gains made by the investor on disposing of the investment). Should Hedge Funds continue to target wealthy individual investors, there is no incentive for these Funds to be brought into the regulatory net if they would then become subject to the same tax provisions as Collective Investment Schemes in securities (Table 27).

The linked unit Company structure provides further flexibility for the investor in a Hedge Fund in that, in theory, the investor can elect as to whether investment returns are to be received as interest or as dividends. It was illustrated in Chapter 4 that the individual investor would prefer to receive dividends.

Retirement Funds, on the other hand, have no incentive, from a tax perspective, to invest in a Hedge Fund Company as compared to a Collective Investment Schemes in securities, since all returns, other than local dividends, become subject to taxation not otherwise incurred for the same returns received from the Collective Investment Schemes in securities (Table 27). On the other hand, a Hedge Fund Trust which is financed by a linked-unit Company i.e. the alternate Hedge Fund structure discussed in Chapter 5, offers a tax-neutral means of investment in a Hedge Fund for a Retirement Fund.

Table 28

Summary of effective overall tax rate on investment returns from a Hedge Fund Trust versus a Collective Investment Scheme in property

Investor:	<i>Individual</i>		<i>Retirement Fund</i>			
Investment return	Hedge Trust	Fund	Collective Investment Scheme in property	Hedge Trust	Fund	Collective Investment Scheme in property
Section 47 rental dividend	0%		40%	9%		9%
Section 47 capital dividend	0%		0%	0%		0%
Taxable income	40%		40%	0%		0%
Foreign dividends	40%		40%	9%		9%
Local dividends	0%		0%	0%		0%
Capital gains	10%		10%	0%		0%

The taxation of the return on the disposal of an investment in either a Hedge Fund or a Collective Investment Scheme follows similar principles. One-third of finance charges incurred on money borrowed to make the investment can be added to the base cost of listed company shares and participatory interests held in any Collective Investment Scheme, whereas these costs cannot contribute to the base cost of shares in a privately-held company or to the base cost of a

vested interest in a trust, unless the investment can be said to be held exclusively for business purposes.

The taxation of the disposal of partnership interests has been simplified in terms of the Comprehensive Guide to CGT from the position in terms of the common law principles.

It now remains to be seen what comes of the proposed regulation of the Hedge Fund industry.

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