



Taxation of Savings & Intermediary Delivery

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Keith Engel, Chief Director
(Legal Tax Design)



General Thoughts

Savings Instruments, Intermediaries
and the Role of Tax



General Savings Building Blocks

- Debt
 - Short-term
 - Long-term
- Company shares
 - Listed
 - Unlisted
- Real estate
 - Residential
 - Commercial
 - Industrial
- Derivatives
- Commodities
- Exotics (e.g. art, film)



Basic Savings Intermediaries

- Bank deposits
- Government (e.g. high-end and retail bonds)
- Collective Investment Schemes
 - Shares
 - Debt
 - Real estate (property unit trusts/also property loan stocks)
- Long-term insurers
 - Endowments
 - Guaranteed/living annuities
 - Retirement annuity funds
- Private equity
- Employer-provided retirement funds
 - Pension
 - Provident



Government's Tax Role

- Direct
 - Match profit potential and risk
 - Substance should govern rather than form
 - Tax and inflation
- Savings Intermediaries
 - Neutrality of intermediaries
 - Direct versus intermediary tax of the same product
 - Role of incentives (see next slide)



Tax as an Incentive: Can Tax Really Encourage Savings?

- Savings can only come from earnings exceeding consumption
 - Importance of culture
 - Options
 - Reduce tax on salary
 - Increase tax on consumption
 - Direct savings incentives
 - Administrative automatic withholding (compulsory versus voluntary)
- Long-term (e.g. retirement incentives)
 - Shift from short-term to long-term
 - Enhanced need for trust in the system



Taxation of Building Blocks

Debt, Equity and Real Estate



Taxation of Debt

- Taxation of interest income
 - Ordinary revenue (e.g. top 40% rate)
 - Incentives
 - Regular threshold
 - Elderly threshold
- Tax impact of interest payments
 - Deductible
 - Risk of artificial (or inflated) deductions



Taxation of Ordinary Shares: Yield

- Dividend yield – Shareholder
 - Current STC: Exempt
 - Future dividends tax: 10% charge
- Dividend Yield – Company payor
 - Not deductible
 - Current STC: 10% charge
 - Future dividends tax: No impact



Taxation of Shares: Sale Proceeds

- Passive investment (basic)
 - Maximum 10% capital gains
 - Incentive versus inflation relief
- Active investment (basic)
 - Ordinary revenue
- Special rules
 - Threshold gain/loss exemption
 - 3-year deemed capital gain/loss rule



The Preference Share Problem

- Tax arbitrage problem
 - 10% tax on yield versus 40% maximum
 - International tax divide
- Terms
 - Rate comparable to interest
 - Cumulative yield
 - Mandatory (or elective holder) redemption



Islamic Finance

- **Problem**
 - Shariah Law prohibits interest and other notional forms of income
 - Currently, the tax law follows form in the first instance with some overrides
 - Taxpayers are seeking substance in lieu of form
- **Product areas**
 - Mudarabah, Mubara, Musharakah, etc...
 - Goal is to achieve “profit” deposits, deferred-sale purchases, financial leases
- **Intermediaries**
 - Mainly banks
 - Some collective investment schemes
 - Insurance still very primitive



Investment Losses

- Instrument losses
 - Capital losses are ring-fenced against capital gains (e.g. cannot be used against salary)
 - Need for per investment vehicle ring-fencing (section 20A hobby losses)
- Debt used to acquire portfolio investment
 - No deduction against shares
 - Limited deduction against debt



High Risk (Employment Growing) Investment

- Call for savings investments to be channeled
 - Limited number of SA high risk investors
 - Incentives (e.g. film)
 - Deductions for negative business ventures (but see section 20A hobby loss ring-fencing)
- Need for incentive versus regulatory protection
 - Difficult to overcome information access and risk spreading concerns
 - 90% “listed” collective investment requirement



Delivery Vehicles

Collective Investment Schemes



CIS: Unit Trust-Based Form

- A CIS is typically:
 - a trust based scheme,
 - That comprises of a pool of assets,
 - managed by a section 42 CIS management company and
 - is governed by the CIS Control Act, 45 of 2002 (and regulated by the FSB through the Generic Trust Deed)
- CIS Control Act allows for the registration of a company (but this form is partly not utilised because other regulatory controls, such as the Generic Trust deed, only fit a Unit Trust format)



CIS Types

- CIS in Securities*:
 - mainly invested in shares (domestic and foreign) as well as other CIS schemes (domestic and foreign)
 - Bonds etc... are also permitted
 - These types of CIS, and includes all local and foreign funds registered constitutes the majority of CISs in SA.
- CIS in Participation Bonds:
 - mainly of participation bond instruments
- CIS in properties
 - Mainly invested in fixed properties
 - Known as “property unit trusts” (see REIT slides)
- Foreign CIS:
 - foreign schemes soliciting investments from South Africans and not registered with the FSB.
- Declared CIS:
 - a scheme declared by the Minister as a CIS.



FSB Requirements: CIS Distributions

- Distributions must be made at least once a year, as per the FSB Generic Title Deed;
- Distributions are typically made
 - Per month;
 - 3 monthly basis;
 - 6 monthly basis; or
 - Annual
- Distributions consist of interest and dividends received by the CIS (capital profits need not be distributed)



Straight Flow-Through

- All non-CGT distributions from a CIS follow a simple conduit/ flow-through principle
- Thus:
 - All income declared by CIS will retain its nature in the CIS member's hands (i.e. interest and dividends retain their interest/dividend character); frequent distributions prevent prolonged deferral
 - But note that CGT exists only when an investor sells CIS units (not when the CIS sells underlying equity/debt)



Management Fee Problem

- Facts:
 - CIS earns R10 million in dividends. CIS incurs R500 000 of management fees. CIS then distributes the remaining R9.5 million to investors
- Result?
 - The prevailing practice is to treat the CIS as having no net income (or to say that the fees are offsetting interest income if interest exists)
 - Query whether management deductions should effectively be allowed against shares?
 - Note however that the investors only benefit by R9.5 million (and the R500 000 is taxed in the hands of the management company)



Preference Share CIS: Background

- Preference CIS schemes:
 - Dividend yield linked to money market rates (but slightly lower)
 - Underlying structures
 - Left-over debt/equity swaps
 - Preference shares collateralised by debt
 - Hidden “magic” box (deductible-interest paying debt is transformed somehow into shares with tax-free dividends)
- Tax Benefit for the Investor:
 - Interest taxable at top marginal rates is turned into tax-free receipts of dividends (subject to 10% STC)



Preference Share CIS: Issues

- Debt versus equity
 - Applies to all preference share schemes (not just CIS structures)
 - Risks exist for substance over form approach (because deemed debt would be deductible for the payor)
 - Need for preference shares in BEE structures (because interest cannot be deducted when using funds to acquire shares)
- “Magic Box”
 - How does debt payments become transformed into dividends? (offshore leg concern)



Note on REITS

- Property CIS structures are split into:
 - Property unit trusts (regulated)
 - Property loan stocks (unregulated)
- Proposed merger:
 - Under consideration is whether both structures will fall into a unified real estate investment trust (REIT) structure
 - Taxpayers are seeking to remove the tax impact of transition
- Can real estate investment really be treated as a flow-through?
 - Positive: Enhance property investment monetisation and international conformity
 - Negative: Change could be perceived as unfair to other real estate investment businesses
 - Can one really apply flow-through principles to entities that are essentially active operational businesses (as opposed to a traditional CIS that merely passively manages shares/debts)



Delivery Vehicles

Long-Term Insurers



CIS Versus Long-Term Insurance Products

- **Basic CIS Unit Taxation:**
 - After-tax contribution
 - Growth
 - Internal capital gains exempt (allows for tax-free switching of investment)
 - Other revenue at top marginal rates (possibly small delay)
 - Capital gains withdrawal (can withdraw anytime)
- **Basic Endowment Policy Taxation:**
 - After-tax contribution
 - Growth in the four funds
 - Capital gains 7,5% (but internal mechanisms often allow for tax-free switching)
 - Other revenue 30%
 - Exempt capital gains withdrawal (with 5-year holding period)



Four Funds

- The boxes
 - Individual policyholder fund (30%)
 - Corporate policyholder fund (28%)
 - Exempt policyholder fund (0%)
 - Shareholder fund (28%)
- Tracking
 - Accounting versus tax
 - Notional allocation of assets
 - Shifting between boxes



Deduction Formula

- The calculation
 - Direct allocation of expenses
 - Indirect (e.g. selling and administration) allocation of expenses
 - Interest + rent + foreign dividends
Interest + (2.5)rent + (4.75)total dividends
- Specific items
 - SARS has raised concerns that the premiums should theoretically be income for the insurer
 - Taxpayers argue that the formula causes distortions (e.g. unbundlings)
 - Impact of new Dividends Tax will require another formula adjustment



Other Considerations

- Holding of CISs through the insurance company (impact?)
- Mixed products
 - Life/disability insurance versus investment
 - Combined products (smooth bonus)
 - Can investment products really be taxed the same as risk products?
- Cross-border problems



Taxation of Pensions

What's Left to do?



Basics: The Three Legs

- Deductible contributions
- Exempt growth
- Taxable payouts
 - Retirement/retrenchment formula (e.g. R300 000)
 - Non-retrenchment pre-retirement formula (e.g. R22 500)
- Side note: Employer-provided retrenchment packages will be treated the same as pension retrenchment packages



Semi-Regulatory

- Pension/provident fund withdrawals
 - Should any difference exist between allowable pension lump sums ($1/3^{\text{rd}}$) versus provident lump sums (all)?
 - Should pre-retirement withdrawals be limited (e.g. to a percentage of historic salary)?
 - What about home loan guarantees?
- CIS versus insurance participation
 - Are retirement annuity fund (defined contribution) plans really the sole preserve of life insurers?
 - Is a living annuity really the sole preserve of life insurers?



Deductible Contributions

- Employer-fund contributions
 - Disparity between pension and provident fund contribution limits?
 - Should a ceiling be imposed on deductible contributions?
 - How does one allow for arrear catch-ups without undermining the limits?
- Individual retirement annuity funds
 - Limits
 - Mixing of limits with employer-fund contribution limits



The End

Thank You!