16 JULY 2020

TAX & EXCHANGE CONTROL **ALERT**

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Deferring tax on the transfer of listed shares to a collective investment scheme portfolio

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Deferral of tax through asset-for-share transaction

There is one possible way for Ms X to diversify her portfolio without any immediate tax consequences, namely, by undertaking an asset-for-share transaction that meets the requirements of section 42 of the Income Tax Act 58 of 1962 (Act). If Ms X transfers her shares in accordance with the requirements in section 42 of the Act to, say, an approved unit trust portfolio in exchange for units in the portfolio, the effect will be the following:

- She will incur no CGT when the shares are transferred to the portfolio. She will only incur CGT if and when she disposes of units in the portfolio in future;
- No securities transfer tax will arise on the transfer of the shares; and
- As the portfolio is exempt from CGT, the portfolio may be able to rebalance its investments subsequently thereby selling the shares free of CGT and utilising the proceeds to acquire different shares, provided the shares disposed of are still held on capital account. We discuss this issue in the next section of the article.

Asset-for-share transactions are regulated by section 42 of the Act. Under that provision, if a person disposes of a capital asset to a company that is resident in South Africa in exchange for equity shares issued by that company, then there is a deferral of tax. Notably, in this context, the term *"company"* includes a portfolio of a regulated collective investment scheme in securities (CIS), and the term *"equity share"* includes a participatory interest in such a portfolio (see section 41(1) of the Act).

Tax considerations applicable to a CIS

A number of requirements must be met before a person will qualify for the relief offered by section 42 of the Act. Notably, the market value of the asset being transferred must exceed the base cost of the asset and, if the transferor holds the asset as a capital asset, then the portfolio must also acquire the asset as a capital asset.

It is the latter requirement that has sometimes caused uncertainty in practice. The problem is that, if the manager of the portfolio intends selling the asset immediately after having acquired it from the transferor who held it as a capital asset, the question arises whether the portfolio itself also acquired the asset as a capital asset. In other words, given the short timeframe in which the portfolio acquires and then disposes of the asset, the issue that arises is that the asset may be converted from being a capital asset (in the hands of the transferor) to a revenue asset, that is, trading stock (in the hands of the portfolio).

In addition, under section 42 of the Act, certain anti-avoidance provisions apply if the transferee disposes of the assets it acquired within 18 months of acquisition.

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In 2018, National Treasury proposed amending the Act to state that any share sold by a CIS within less than 12 months of its acquisition, would automatically be considered to have been sold on revenue account.

Generally speaking, while a CIS portfolio is a taxpayer in its own right, it pays no CGT (paragraph 61(3) of the Eighth Schedule to the Act) and it only pays income tax on revenue receipts that it does not pay over to investors within 12 months of receipt (section 25BA of the Act). A CIS portfolio is effectively a conduit: investors pay CGT only when they dispose of units in the CIS portfolio, and they pay income tax on revenue distributions from CIS portfolios (typically, interest).

But, if it could be said that a CIS portfolio was selling certain shares on revenue account, and if it did not distribute the proceeds of the sale to its investors within 12 months, then the CIS portfolio could be liable itself for income tax on the proceeds. See in this regard our Tax & Exchange Control Alert of 22 February 2018.

In 2018, National Treasury proposed amending the Act to state that any share sold by a CIS within less than 12 months of its acquisition, would automatically be considered to have been sold on revenue account. Following numerous submissions by the public regarding the proposal, National Treasury decided in the same year not to proceed with that proposed amendment.

SARS' view previously expressed in relation to asset-for-share agreements involving a CIS portfolio

In 2016, there was a merger of a large local listed company with an international company. Shareholders in the local company were advised by some fund managers that, instead of selling their shares as part of the merger, they should transfer their shares to a CIS portfolio, thereby deferring their CGT and diversifying their portfolios.

At the time, SARS took a very dim view of the scheme, to the extent of releasing a press statement on 30 September 2016 warning against the scheme on the basis of the capital versus revenue issue above, and on the basis that the scheme may have amounted to impermissible tax avoidance – the statement is still available on the SARS website.

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The facts in the ruling were that a fund manager wished, on behalf of certain of its clients, to transfer the listed shares of the clients to a CIS portfolio in exchange for units issued by the portfolio.

SARS adopted that view despite the fact that it had previously ruled that such a scheme would benefit from the roll-over relief and that "*[n]otwithstanding the short period that would have lapsed, the subsequent transfer of the participatory interest in the CIS to the third party will not change the character of the holding of the assets by the Applicant on the basis of it being held on capital account*": See SARS Binding Private Ruling 186 dated 12 February 2015 (BPR 186) and a discussion of the ruling in our Tax & Exchange Control Alert of 30 September 2016.

Binding Private Ruling 344

The type of transaction discussed under the previous heading was again the subject matter of the recent SARS Binding Private Ruling 344 dated 4 June 2020 (BPR 344). The facts in the ruling were that a fund manager wished, on behalf of certain of its clients, to transfer the listed shares of the clients to a CIS portfolio in exchange for units issued by the portfolio. After disposal of the shares by the clients, the CIS portfolios may have become obliged by their investment mandates to rebalance their portfolios by disposing of some of the shares acquired from the clients under the transaction. The disposals would have been undertaken in accordance with the normal investment authority and mandate of the relevant portfolio, and might have taken place within 18 months of the transaction thereby potentially triggering the relevant anti-avoidance provisions in section 42 of the Act.

SARS ruled that the transaction would meet the requirements for an asset-for-share transaction, and that the tax relief afforded by section 42 of the Act would apply. It ruled further that, while the 18-month anti-avoidance provision in section 42(7)(a) of the Act would apply to the subsequent disposal of the shares, in principle, the effect of its application will be nil. This is due to the application of paragraph 61(3) of the Eighth Schedule to the Act, the provision which exempts CIS portfolios from CGT.

SARS did provide the following warning, however: "*The relief available in terms of this ruling does not preclude the subsequent application, if appropriate, of any general anti-avoidance provisions to the proposed transaction.*"

Binding Private Ruling 339

SARS Binding Private Ruling 339 dated 21 February 2020 (BPR 339) also provides guidance. In that ruling, the trustees of a discretionary trust wished to transfer certain listed shares of the trust, together with the related investment management and administration functions, to a professionally managed and administered investment fund (that is, a CIS portfolio). In that case, SARS also ruled that the transaction would meet the requirements for an asset-for-share transaction, and that the tax relief afforded by section 42 of the Act would apply

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It is important to note that under the Tax Administration Act 28 of 2011 a binding private ruling is only binding on the taxpayers who applied for and are party to the ruling. In practice, such a ruling is indicative of SARS' view in respect of a certain set of facts and therefore another taxpayer (who is not a party to the ruling) can only place persuasive reliance on the rationale for a ruling, if it adopts a tax position based on that ruling. Importantly, SARS is not bound to apply what is stated in that ruling to anyone other than the specific taxpayer applicant.

Practically, it appears that the effect of the recent rulings is that, if an investor owns listed shares, and if the investor transfers the shares to a CIS portfolio in exchange for units issued by the portfolio, the relief afforded by section 42 of the Act could potentially apply in the following circumstances:

- The transaction must not be implemented to avoid tax impermissibly. In practice, this means that the transaction must not fall foul of the general anti-avoidance provisions in section 80A to 80L of the Act (GAAR) or constitute a sham or simulated transaction under the common law.
- If the portfolio disposes of the shares shortly after acquiring the shares, it should do so as part of a rebalancing of investments required by its investment policies. In other words, any disposals should be driven by commercial reasons. By its nature, a CIS is not a share trader even though it sells and buys assets on a daily basis. The mandate of a CIS, generally, is to realise capital growth over the medium to long term.
- The investor should be transferring its shares so as to move the management of the shares from itself to a professional fund manager for commercial reasons.

Conclusion

To return to the example at the beginning of the article, Ms X would need to exercise great caution if she wishes to diversify her portfolio through the asset-for-share arrangement. If her only desire is to diversify her investment pool, and if the CIS portfolio disposes of her shares shortly after acquiring the shares simply for the sake of diversifying her portfolio (and not because the portfolio is doing a "*rebalancing*" exercise pursuant to its investment policies), adverse tax consequences may still arise.

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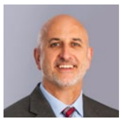

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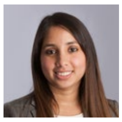

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Our BBBEE verification is one of several components of our transformation strategy and we continue to seek ways of improving it in a meaningful manner.

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