Does the regulation of a hedge fund as a collective investment scheme result in different tax implications?

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Before 1 April 2015, hedge funds were unregulated and were constituted (broadly speaking) as limited liability partnerships or trusts. For tax purposes, these structures functioned as flow-through entities with investors being responsible for the disclosure and payment of tax resulting from investment activities. As such, fund managers were not typically involved in the disclosure of and accounting for the tax resulting from investment activities.

However, on 1 April 2015, this changed when a hedge fund was declared to be a portfolio of a collective investment scheme. The impact of this declaration was that an unregulated portfolio of a hedge fund was required to transition to a regulated portfolio of a hedge fund collective investment scheme (**hedge fund CIS**).

By now, most unregulated hedge funds would have transitioned or will soon transition to a hedge fund CIS, raising the question whether the tax implications of the hedge fund, the investors and manager will differ subsequent to the

transition.

After the transition, the investor would hold a participatory interest in a hedge fund CIS. This is a different asset than the one the investor held prior to the transition and it will have different tax implications, which we summarise below. In addition, the hedge fund CIS constitutes a person for tax purposes and is liable for the disclosure and payment of taxes in its own name whereas an unregulated fund constituted as a limited liability partnership or vesting trust would effectively have been transparent for tax purposes.

After the transition, the differences in tax treatment are as follows:

- From the investors perspective, it would be taxed only on amounts distributed by the hedge fund CIS and its proceeds when it disposes of its participatory interest in the hedge fund CIS. To the extent that the distributions by the hedge fund CIS constitute interest and dividends, the tax implications for the investor should not differ from the unregulated structure. However, if realised gains are not on-distributed to the investor, the investor would not disclose or pay tax on such realised gains since these would be accounted for in the hedge fund CIS. Gains made on the sale of the participatory interest by the investor would be deemed to be of a capital nature if the participatory interest was held for a period of at least three years.
- From the perspective of the hedge fund CIS, seeing that it constitutes a person for tax purposes, it is required to submit tax returns and to account for tax in respect of all amounts that it did not on-distribute or which are not subject to a specific exemption. The hedge fund CIS is further required to submit certain third party returns to the South African Revenue Service. The hedge fund CIS therefore picks up tax risk, in that it is required to disclose and account for gains that are not

on-distributed to its investors. Incorrect disclosure or payment of tax may result in the hedge fund CIS being liable for interest, penalties and/or criminal liability in certain instances (please see last point below).

- From the managers perspective, its own tax implications in respect of the management fees would not change, but as it is responsible for the financial affairs of an entity that is a taxpayer in its own right, being the hedge fund CIS, it may potentially pick up secondary tax liability. For example, the Tax Administration Act, 2011 contains withholding agents and third party liability provisions which may, in certain instances, apply to the manager.
- Furthermore, the Tax Administration Act contains provisions that make certain acts or omission criminal offences. The impact of these provisions should be carefully considered by the hedge fund CIS, the trustees and the manager to determine the risks and impact of these provisions, particularly to the extent that these provisions relate to the compliance obligations of the hedge fund CIS for which the manager would typically be responsible.

On the basis set out above, the tax implication or compliance requirements post-transition may be very different for the hedge fund, the investors and the manager when compared with the situation before the transition.

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This article was first published by ENSafrica (www.ENSafrica.com) on 22 February 2017.

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