STANLIB Multi-Manager

The Educator

CGT and the impact of switching

In The Educator, we address a number of topics with the ultimate goal of providing a better understanding of investing clients' money.

Collective Investment Schemes - Capital Gains Tax and the impact of frequent switching

Background

Capital Gains Tax (CGT) was introduced into the South African Income Tax Act from 1 October 2001. In this issue of Educator we provide a short overview of the CGT implications for a South African Collective Investment Scheme (CIS).

When is a CGT event triggered?

Capital gains are only triggered when you sell units from your CIS[1] (deemed disposal). You are not liable to pay CGT simply because your investments increased in value during a specific tax year. Thus, you as an investor determine when you become liable for CGT.

How to determine your capital gain or loss

Your service provider presents you with an IT3 C tax certificate at the end of each tax year if you have made a capital gain or loss on your investment. The capital gain is determined by calculating the difference between the base cost[2] (the value of your investment when first purchased) and the market value of the units at the date of sale.

What CGT does the unit holder have to pay?

As a unit holder, you enjoy an annual exclusion of R40 000 per year on your total capital gain. The current inclusion rate for CGT is 40%. This means that 40% of the capital gain must be added to your income. For example, if you are taxed at a marginal tax rate of 41% then the capital gains tax will be 16.4% (41% x 40%).

Example: an investor purchases units in a CIS on 1 January 2005 for R100 000. On 20 September 2016, the investment value was R200 000 and the investor sold out of the investment.

Impact of deferring your CGT

Capital gain	R100 000 (R200 000 – R100 000) IT3 C certificate
CGT payable	R100 000 - R40 000 (annual exclusion) R60 000 (x 16.4%*) R9 840 *Assumes the investor's marginal tax rate is 40% (40% x 41%)

By deferring CGT you can noticeably improve your tax efficiency.

Example: Investor 1 invests R1 million and only sells out after 10 years (portfolio 1), whereas investor 2 makes five switches over the same 10-year period.

By deferring the CGT, investor 1 significantly improved the tax efficiency of portfolio 1 versus portfolio 2.

Initial investment of R1 million	Before tax return	Portfolio 1 After tax, no switches	Portfolio 2 After tax, five switches
After 10 years	R3.3 million	R2.9 million	R2.4 million
Tax efficiency ratio*		89%	74%

*Equals after tax return divided by before tax return

Assumptions:

- Full 12% return is earned consistently in the form of capital gains only
- Effective CGT rate: your marginal tax rate of 16.4% (40% x 41%)
- Annual exclusion of R40 000
- Five switches over 10 years (in years 2, 4, 6, 8 and 10)

Conclusion

This issue of Educator aims to inform you about how CGT may affect your CIS proceeds when you sell out of the investment and how it may influence your choices.

It is important to plan your investment properly and understand the CGT implications. Although we have outlined key things to consider in CGT, we are not tax professionals. Please seek the appropriate assistance/advice from a qualified financial or tax adviser.

[1] Excludes Money Market CISs. The unit price is static and you do thus not realise any capital gains when you sell your units.

[2] Specific expenditure may be included in the base cost such as initial adviser fees.

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