THE IMPLICATION OF CAPITAL GAINS TAX ON DIFFERENT BUSINESS ENTITIES IN SOUTH AFRICA

by

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TABLE OF CONTENTS

CHAPTER 1

INTRODUCTION AND BACKGROUND

1. STRUCTURE AND OVERVIEW

On 1 October 2001 Capital Gains Tax legislation was incorporated as an integral part of the Income Tax Act. According to this, an Eighth Schedule has been inserted into the Income Tax Act, which caters for the determination of the amount of taxable gains and assessed capital losses. A new section 26A, which forms the link between the Income Tax Act and the Eighth Schedule has also been inserted in terms of which the taxable capital gain, as calculated in the Eighth Schedule, will be included in a taxpayer's taxable income. When reading these provisions, it is clear that the Eighth Schedule is not merely a mechanical aid to the calculation of tax liability, but that it also substantively creates liability.

A capital gain is the excess of the proceeds of an asset upon its disposal or, in the case of a deemed disposal, the market value over its base cost. In the event of the base cost exceeding the proceeds, a capital loss arises.

The first step in calculating a person's "taxable capital gain" or "assessed capital loss" is to determine the person's **capital gain** or **capital loss**. In doing this, the Eighth Schedule provides for four key definitions, which form the basic building blocks in determining such a capital gain or loss. These four definitions are **asset**, **disposal**, **proceeds** and **base cost**.

The event that triggers a possible Capital Gains Tax is, for example, the deemed **disposal** of an **asset**. Unless such a disposal occurs, no gain or loss arises.

STUDY PROGRAMME

This study will be compiled by doing a study of relevant literature. Emphasis will be placed on appropriate tax court cases and tax law, with the principles contained therein being applied to the relevant facts.

This study will examine the special implications of Capital Gains Tax for different entities contained within the South African tax system.

Chapter 1

The introduction incorporates structure and overview as well as the reasons for the introduction of Capital Gains Tax.

Chapter 2

The difference between Capital and Income with special relation to the relevant court cases will be discussed in this chapter.

Chapter 3

This chapter deals with the importance of valuations and base cost aspects and will be discussed with specific reference to the following:

- Market value;
- Eighth Schedule valuation regulations; and
- Calculation methods.

Chapter 4

The implication of Capital Gains Tax on the different business entities will be discussed in this chapter.

Chapter 5

The anti-avoidance measures will be discussed in this chapter.

Chapter 6

The findings of this study will be summarised in this chapter.

ASSETS

An asset is defined (Eighth Schedule) as widely as possible and includes any property of whatever nature and any interest therein. Capital Gains Tax applies to all assets disposed off on or after the 1st of October 2001, whether or not the asset was acquired before, on or after that date. However, only the gain accruing from 1 October 2001 will be subject to Capital Gains Tax. To decide whether an asset will be subject to Capital Gains Tax, it is important to establish if the person disposing of the asset is a South African resident or not. A natural person will be deemed to be resident in South Africa if he is "ordinarily" resident in South Africa. This means that South Africa must be the person's "home" or the place to which he will return to or he must be physically present in South Africa for a certain number of days. In the case of a company or trust, it will be deemed to be resident in South Africa if it was incorporated, established or formed in South Africa or if South Africa is the place where the effective management takes place.

As far as a South African resident is concerned, Capital Gains Tax will apply to all assets (i.e. property of whatever nature, whether moveable or immovable, corporeal or incorporeal) held by such a resident worldwide.

However, any currency other than any coin made mainly from gold or platinum will not be an asset for Capital Gains Tax purposes. The sale of such currency will therefore not be subject to Capital Gains Tax.

It should also be noted that any right or interest of whatever nature to or in such an asset would also be deemed to be an asset for Capital Gains Tax purposes.

DISPOSALS

As stated in paragraph 11 of the Eight Schedule, the concept of **disposal** covers any event, act, forbeance or operation of law, which results in a creation, variation, or extinction of an asset. It also includes certain events treated as disposals such as emigration, immigration and the change in the use of an asset. The following events qualify as "disposals" for Capital Gains Tax purposes:

- "... the sale, donation, expropriation, conversion, grant, cession, exchange or any other alienation or transfer of ownership of an asset;
- the forfeiture, termination, redemption, cancellation, surrender, discharge, relinquishment, release, variation, waiver, renunciation, expiry or abandonment of an asset;
- the scrapping, loss or destruction of an asset;
- the vesting of an interest in an asset of a trust in a beneficiary;
- the distribution of an asset by a company to a shareholder;
- the granting, renewal, extension or exercise of an option;
- the decrease in value of a person's interest in a company as a result of a value shifting arrangement;
- when non-trading stock assets of a person commence to be held as trading stock by that person. The person will be deemed to have disposed of the asset at market value;
- where assets that are held by a person as trading stock cease to be held as trading stock. The person will be treated as having disposed of those assets for a consideration equal to the market value of the asset. This market value will also be deemed to be the base cost of the asset;
- where a debt owed by a person to a creditor has been reduced or discharged by that creditor without full consideration for that reduction or discharge, the debtor will be treated as having acquired a claim on that portion of the debt that was reduced or discharged for no consideration, and thereafter disposed of that claim for an amount equal to the reduction or discharge. As the base cost of that claim is deemed to be R nil, the debtor will have a gain equal to the amount of the reduction or discharge;
- where "personal-use" assets cease to be held as such or where a non-personal-use asset commences to be used as a "personal-use" asset; or

- in the case of a non-resident, where an asset used by a permanent establishment of that person in South Africa ceases to be an asset of that permanent establishment otherwise than by way of a disposal or where an asset becomes an asset of such a permanent establishment other than by way of an acquisition ..." (SARS, 2002:31).

PROCEEDS

Once an asset is disposed of it gives rise to ***proceeds.*** Where an asset is disposed of, the amount which is received by or which accrues to the seller of the asset constitutes the proceeds from the disposal. This will also include the amount by which any debt owed by that person has been reduced or discharged. However, the amount of proceeds can be reduced under the following circumstances:

- Amounts already included or taken into account when the taxpayer's "gross income" was determined;
- Amounts that have been repaid to the person to whom that asset was disposed of; or
- A reduction due to the cancellation or termination of an agreement.

BASE COST

The fourth building block in the calculation of a capital gain or capital loss is the base cost of an asset. The base cost of an asset in essence consists of three broad components, namely costs directly incurred in respect of the -

- Acquisition of the asset;
- Improvement of an asset; and
- Direct costs in respect of the acquisition and disposal of an asset.

The rules around base cost are quite complicated and are fully dealt with in Chapter 3.

The same principles apply in the calculation of a capital loss, in which case the base cost will exceed the proceeds.

CAPITAL GAIN AND LOSSES

A capital gain is determined for each asset disposed of during a year of assessment by deducting the base cost of the asset (paragraph 20) from the proceeds (paragraph 35) where the proceeds exceed the base cost, whilst, on the other hand, a capital loss is determined for each asset disposed of during a year of assessment by deducting the proceeds from the disposal of that asset (paragraph 35) from the base cost (paragraph 20) where the base cost exceeds the proceeds.

Aggregate capital gain or aggregate capital loss

It is important to note that a capital gain or capital loss is first determined separately in respect of each asset disposed of by a taxpayer during a year of assessment.

Once all individual gains and losses have been determined, they must be added together. An annual exclusion may be deducted in order to determine a person's aggregate capital gain or loss. It should be noted that this annual exclusion is only available to individuals (and special trusts). Companies, close corporations and other trusts do not qualify for the annual exclusion.

Net capital gain or assessed capital loss

Once a person's aggregate capital gain or loss has been determined, the person's assessed capital loss in respect of a previous year of assessment, if any, must be deducted from the aggregate capital gain or added to the aggregate capital loss to determine the net capital gain or assessed capital loss for the current year of assessment.

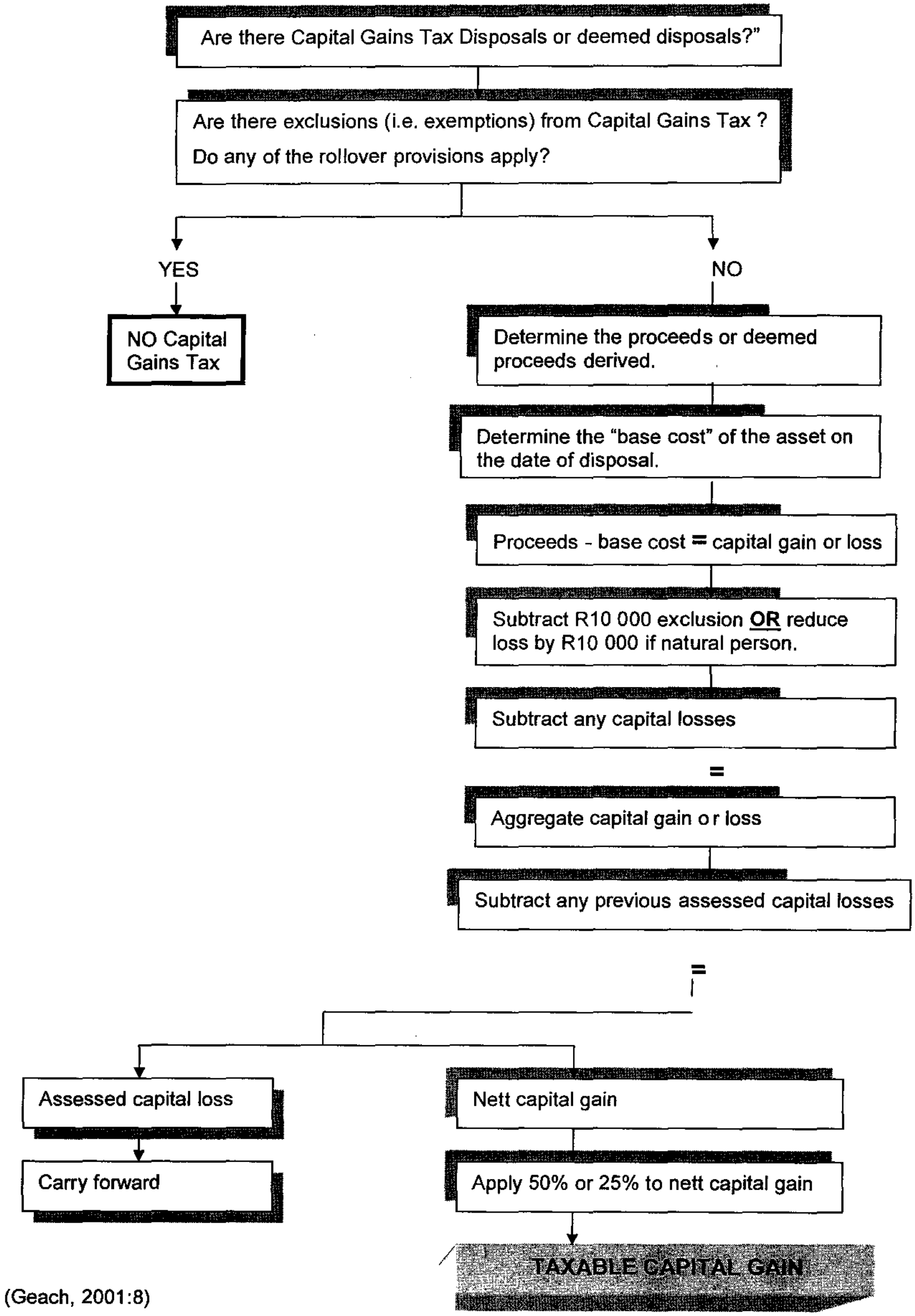
Taxable capital gain

Where a person has determined a net capital gain for the current year of assessment, such amount is multiplied by the inclusion rate to determine the person's taxable capital gain, which is to be included in that person's income for the year of assessment.

Inclusion of taxable capital gain in taxable income

Once a person's taxable capital gain has been determined, that taxable capital gain is included in the person's taxable income in terms of section 26A of the Income Tax Act. Thereafter, the ordinary rates of tax are applied to the person's taxable income to determine a person's normal income tax liability.

The following basic framework can be used when determining if Capital Gains Tax is applicable or not:


Are there Capital Gains Tax Disposals or deemed disposals?"
Are there exclusions (i.e. exemptions) from Capital Gains Tax ?
Do any of the rollover provisions apply?
YES
NO
NO Capital Gains Tax
Determine the proceeds or deemed proceeds derived.
Determine the "base cost" of the asset on the date of disposal.
Proceeds - base cost = capital gain or loss
Subtract R10 000 exclusion OR reduce loss by R10 000 if natural person.
Subtract any capital losses
=
Aggregate capital gain or loss
Subtract any previous assessed capital losses
=
Assessed capital loss
Carry forward
Nett capital gain
Apply 50% or 25% to nett capital gain
TAXABLE CAPITAL GAIN

(Geach, 2001:8)

2. REASONS FOR THE INTRODUCTION OF CAPITAL GAINS TAX

The idea of taxing capital gains is not new in South Africa. As early as 1969, the Franzsen Commission conducted an investigation and proposed a limited form of Capital Gains Tax on immovable property. However, in 1986 a report of the Margo Commission stated that capital gains should not be taxed. The Katz Commission was appointed to investigate the merits and demerits of a capital gains tax in South Africa, but in it's third report in 1995 declined to make any firm recommendation due to the complexity of it's administration and the lack of capacity of the Inland Revenue at that time. Further investigations and planning lead to the announcement in the Budget Speech on 23 February 2000 that Capital Gains Tax was to be introduced with effect from 1 April 2001. This date was later postponed to 1 October 2001.

The main reasons for the introduction of Capital Gains Tax can be summarised as follows:

- **International benchmarking:** Although in a more limited form, many of South Africa's trading partners have implemented Capital Gains Tax years ago.

- **Horizontal Equity:** Horizontal equity implies that similar economic circumstances should bear similar tax burdens, irrespective of the circumstances in which the income is received. In this context, the exclusion of capital gains from the income tax base fundamentally undermines the horizontal equity of the tax system.

- **Vertical Equity:** This requires that taxpayers with greater ability to pay taxes should bear a greater tax burden. Previous international surveys show that the biggest share of Capital Gains Tax revenues can be attributed to the wealthiest. Capital Gains Tax would also contribute to the progressivity of the income tax system to enable government to pursue other tax policies, widening tax bases and reducing standard tax rates.

- **Reduced the shift from income to capital:** With the implementation of Capital Gains Tax, taxpayers loose a large part of the incentive to disguise income as capital. The most classic example of this used to be the restraint of trade payments, which were little more than disguised remuneration.

- **Economic efficiency:** Because capital gains were untaxed in the past, taxpayers were encouraged to invest in assets that provide returns in the form of capital rather than income. Capital Gains Tax narrows the gap in the tax treatment of different assets.

- **Tax base broadening:** The idea of Capital Gains Tax was to broaden the tax base and thus enable government to bring more taxpayers into the net resulting in lower overall tax rates. (SARS, 2002:13)

3. THE EIGHTH SCHEDULE

The Eighth Schedule has been introduced as part of the Income Tax Act and sets out the Capital Gains Tax definitions, terminology and principles for the determination of taxable capital gains or losses.

Paragraph 1 consists of various definitions and is self-explanatory or refers to paragraphs where amounts are determined.

Paragraph 2 defines the scope of the legislation and prescribes who is subject to Capital Gains Tax and which assets are subject to Capital Gains Tax. Only disposals that took place after 1 October 2001 will be subject to Capital Gains Tax. Paragraph 2 also differentiates between a resident and a non-resident, where a resident is subject to Capital Gains Tax, whether in the Republic or outside, and where a non-resident is subject to Capital Gains Tax only on the disposal of:

- immovable property situated in SA;
- permanent assets through which a trade is carried on in SA.

Paragraph 13 is of great importance and sets out the dates (time rules) of disposals and whether the disposal falls within the Capital Gains Tax net. (SARS, 2001:24)

The following table is a summary of the Eighth schedule, which can be used for quick references: (Geach, 2001:13-16)

Part I: General

Paragraph 1	**Definitions**
	active business asset
	aggregate capital gain
	aggregate capital loss
	asset
	base cost
	boat
	capital gain
	capital loss
	disposal
	financial instrument
	foreign currency
	individual policyholder fund
	insurer
	net capital gain
	personal-use asset
	pre-valuation date asset
	primary residence
	proceeds
	recognised exchange
	residence
	taxable capital gain
	valuation date
	value-shifting arrangement

4. ROLLOVERS

If a person sustains an assessed capital loss for a tax year, that loss cannot be set off against the person's ordinary income of a revenue nature. An assessed capital loss, therefore, neither decreases a person's taxable income nor does it increase a person's assessed loss of a revenue nature. Such an assessed capital loss is, therefore, ring-fenced and can only be set off against capital gains arising during future years of assessment. Rollover relief is granted in three instances: involuntary, normal, and disposals to a spouse. The following rules determine in which tax year a capital gain or loss must be taken into account: (SARS, 2002:24)

4.1 Involuntary disposals

Many assets can be disposed of involuntarily. Where proceeds accrue to a taxpayer who involuntarily disposes of an asset by means of expropriation, damage, loss or destruction and the proceeds exceed the base cost of that asset, the capital gain that arises may be held over until the disposal of its replacement asset. However, to qualify for the holdover of the gain, the taxpayer must be able to prove that

i) an amount equal to the compensation received, will be expended in replacing that asset,
ii) the contract to replace the asset will be concluded within one year of the disposal,
iii) the replacement asset is brought into use within three years from the date of disposal, and
iv) non-residents will have to replace the asset with a South African-based asset.

The amount must be treated as a capital gain during the year that the replacement asset is disposed of. Where a taxpayer does not meet the above requirements, the gain that has been held over as well as interest are included at the end of the specified period.

4.2 Voluntary (normal) disposals

When an asset (qualifying for the sections 11(e), 128, 12C, 14 or 14 *bis capital* allowances) is disposed of in normal circumstances (i.e. voluntary) and the proceeds exceed the base cost of the asset, the resultant capital gain may be phased in over a period of 5 years if

(i) an amount equal to the proceeds derived on disposal will be expended in replacing the asset,

(ii) the person has, by the end of the year of assessment during which the asset had been disposed of, concluded a contract to replace that asset with another asset which will qualify for similar allowances,

(iii) the replacement asset is brought into use within one year from the date of disposal of the original asset, and

(iv) non-residents will have to replace the asset with a South African-based asset.

In terms of the phasing-in provisions, 20% of the capital gain must be recognised in the year in which the replacement asset is brought into use and in each of the four succeeding years of assessment (i.e. in 5 equal instalments).

Where a taxpayer failed to meet the above requirements, the gain that has been held over as well as interest are recognised at the end of the specified period. This additional amount compensates the fiscus for the deferral in the taxation of the gain and creates the need to re-open past assessments.

4.3 Transfer of assets between spouses

This rule provides for a deferral ("rollover") of a capital gain or loss when an asset is transferred between spouses and will be treated as a disposal at base cost. The commissioner will allow the roll-over if the asset is transferred to a spouse

- during the lifetime of that person, or
- as a result of that person's death, or
- in consequence of a divorce order, or
- in the case of the termination of a permanent marital-like union, or
- in consequence of an agreement of division of assets that have been made on order of court.

5. EXCLUSIONS

Certain capital gains or losses must be disregarded or are limited for purposes of determining a capital gain or loss, for example, any capital gain or loss which is derived on the disposal of an asset that was used solely to produce amounts that were exempt from income tax (**other than** shares from which dividends are received).

Although gains or losses in respect of most personal use assets are excluded from the Capital Gains Tax system, an annual exclusion of R10 000, which applies for gain and losses for any transaction made by an individual, is granted. A natural person (and special trust) is also entitled to have a deduction of one million rand of the gain or loss made on the sale of their primary residence. In other words, where a capital gain or loss exceeds R1 million, only the excess would be subject to Capital Gains Tax .

A primary residence means a residence in which a natural person (or his/her spouse) holds an interest in, and which that person ordinarily resides in as his/her main residence and uses it for domestic purposes.

The above means that a company, close corporation or trust owning a residence used as a primary residence of a shareholder, member or beneficiary would not qualify for the exclusion.

Where a person holds more than one residence, only one will qualify as a primary residence. The maximum size of the property qualifying for the

R1 million exclusion is set at 2 hectares. However, the exclusion may be apportioned should the property exceed two hectares and the land is used mainly for domestic and private purposes.

6. SUMMARY

Because of the complexity and diversity of Capital Gains Tax the biggest problems that the SA taxpayer experience is the distinction between different entities when acquiring a new asset.

Further implications comprise of whether or not the proceeds on the disposed assets will be included in "taxable income". The result is that while "gross income" as defined in section 1 of the Income Tax Act remains unchanged, "taxable income" is increased by the "taxable capital gain". Various issues arise from this such as the importance to distinguish between "income" and "capital", cash flow, roll-over issues, the interface with provisional tax, the "start-of tax shelter", base costs and valuation of assets. This all leads to the need for in-depth planning.

Because taxable capital gains are added directly to "taxable income", the deductions and set-offs allowed in terms of the relevant provisions of the Act may not reduce the amount of these gains. The only deductions and set-offs that may be taken into account are those allowed expressly in terms of the Eighth Schedule. Since there is no clear demarcation in the legislation between "income" and "capital", the Income Tax Act in general and the Eighth Schedule offer no assistance in distinguishing an "income" receipt from one representing a realisation of "capital". To prevent "overlaps", the Eighth Schedule applies to all assets, with a specific provision that exclude gains included in gross income or have been taken into account in the calculation of "taxable income" for normal tax purposes. However, this does not remove the inquiry as to the capital or revenue nature of the proceeds on disposal of an asset. It is clear that this distinction is critical to the decision as to whether the proceeds are to be included in "gross income" or "taxable income". This issue will be discussed in detail in Chapter 2. Further issues that will require careful consideration is the application of Capital Gains Tax on different types of entities as well as valuation of the base cost of assets acquired before October 1, 2001.

CHAPTER 2

INCOME AND CAPITAL

1. INTRODUCTION

Long before the introduction of Capital Gains Tax on 1 October 2001 many taxpayers experienced difficulties in distinguishing between "income" and "capital". With the introduction of Capital Gains Tax, the "taxable income" of a taxpayer is increased by the "taxable capital gain".

In establishing whether an asset as defined by the Act will be subject to Capital Gains Tax, it will furthermore be important to establish whether the person disposing of the asset is a South African resident or not. As far as a natural person is concerned, such a person will be deemed to be resident in South Africa if he or she is "ordinarily resident" in South Africa. South Africa must be the person's "home" (Kuttle), or the place to which the person will return to after his or her wandering or the person must be physically present in South Africa (a 1) for a certain number of days.

As far as a company or trust is concerned, it will be deemed to be resident in South Africa if it was incorporated, established or formed in South Africa or if it has its place of effective management in South Africa.

As far as a South African resident is concerned, Capital Gains Tax will apply to all assets held by such a resident worldwide.

However, any currency other than any coin made mainly from gold or platinum will not be an asset for Capital Gains Tax purposes. The sale of such currency will therefore not be subject to Capital Gains Tax.

Any right or interest of whatever nature to or in such an asset will also be deemed to be an asset for Capital Gains Tax purposes.

As far as non-residents are concerned, only the following assets will be affected;

- immovable property situated in South Africa, and
- any asset of a permanent establishment of that person in South Africa through which a trade is carried on.

A "permanent establishment" is, effectively, any fixed place of business through which the business of an enterprise is wholly or partly carried on in South Africa and includes a place of management, a branch, office, a factory, a workshop, etc.

A capital asset is defined by the Act as a non-trading asset held either as a fixed asset or as an investment asset. There are two ways of classifying capital assets:

- Based on activity i.e. income or profitability, or
- Based on tangibility i.e. physical existence.

For capital gains tax purposes, SARS classifies assets as per the following table:

i) Fixed/immovable property
    - Land
    - Buildings
    - Mineral rights

ii) Primary residence
    - House
    - Townhouse
    - Flat
    - Motorhouse
    - Caravan

iii) Financial instruments - listed
    - Shares
    - Unit trusts
    - Bonds
    - Futures
    - Options

iv) Financial instruments - unlisted

- Shares
- Debentures
- Promissory notes
- Bonds
- Options
- Forward contracts
- Swaps
- Debt

v) Intangible assets

- Goodwill
- Trade marks
- Patents
- Copyrights
- Franchises
- Licenses
- Fiduciary interest
- Usufructory interest

vi) Foreign currency

vii) Plant and machinery

viii) Other moveable property used for business purposes

- Aircraft
- Boats
- Motor vehicles
- Office furniture and equipment

ix) Other moveable property not used for business purposes (excluding personal use assets)

- Krugerrands
- Personal use boat > Ten meters
- Personal use aircraft > Four hundred and fifty kilograms

Because the Act provides no definition of receipts or accruals of a "capital nature" we have to study case law to determine the definition of receipts or accruals of capital nature. However, as will be seen from the study of certain cases, there is no fixed rule to determine whether an amount is of a capital nature or not.

2. INCOME OR CAPITAL: CASE STUDIES (UNISA, 1998)

2.1 Introduction

As will be seen from the following case studies, it is clear that, normally, it is not possible to have one amount of income that is partly capital and partly revenue.

In TUCK v CIR, 1988 (3) SA 819 (A) (Williams, 1996:195) the nature of the amount paid to an employee had to be determined by establishing the reason for the amount being received. Equally important is the intention of the taxpayer in determining the taxability of a transaction.

2.2 Case studies

As indicated by Davis, A.J.A (PYOTT LTD V CIR, 1945 AD 128, 13 SATC 121) (UNISA, 1998:2) it was argued that the receipt of a deposit was neither income nor capital. What is clear is the fact that **normally** it is not possible to have one amount that is partly income and partly capital. However, in TUCK v CIR, 1988 (3) SA 819 (A), 50 SATC 98, it was stated that the nature of an amount paid to an employee had to be determined by establishing the reason for the amount being received. The reason for the receipt was actually found to be a mixture of a restraint payment and a payment for services rendered. This case introduced a new principal into the existing law, namely the apportionment of a single amount into capital and revenue. Amounts received for the use of assets, without any change in ownership, can create problems. A receipt may be of a capital nature in the hands of one taxpayer, for example, the sale of his private dwelling house, but be of an income nature in the hand of another, for example, if the taxpayer's business is to buy and sell houses. " ... In R KOSTER & SON (PTY) LTD V CIR, 47 SATC 23, 1985 (2) SA 834 (A) the proceeds on the disposal of breeding livestock was included in income, although the livestock was not acquired for resale at a profit or to be used as trading stock. If a taxpayer inherited shares in a private company which he later sold, the court in ITC 1451, S1 SATC 93, decided that an inheritance is generally in the nature of capital. In the absence of any scheme of profit making, the realisation at an enhanced value of an asset which was inherited as capital will be profit of a capital nature. Although the onus is on the taxpayer to prove that a receipt is of a capital nature (section 82), it does not, however, mean that all receipts must prima facie be regarded as income. Whether an amount is of a capital or income nature is a question of law, which has to be decided upon the facts of each case. The courts have consistently recognised that in certain instances, the nature of a receipt is determined by objective rather than subjective considerations ..."

" ... In COT v REZENDE GOLD AND SILVER MINES (PVT) LTD, 37 SATC 39, 1975(1) SA 968(RAD) (UNISA, 1998:6), Wessels J, applied the test postulated in CIR V BOOYSENS ESTATE LTD, 1918 AD 576, 32 SATC 10, namely that the receipt is income where it is capital productively employed, from which income derives without a change in the ownership of the asset.

The respondent company (REZENDE) decided to dispose of a mine and entered into an agreement with the 'I' mining company. Under the terms of this agreement the 'I' company was given an option for the purchase of the mine and its equipment for a period of two and a half years subject to a monthly payment during the continuance of the option. Thereby the option holder also acquired the right to explore and work the mine for its own benefit, subject to a tribute payment each month of 5 percent of its gross earnings. Should the mine be purchased by the option holder, the purchase price was to be reduced by the option and tribute payments. The option holder purchased the mine and the above mentioned set-off took place.

The respondent claimed that the tribute payments so received constituted a receipt of a capital nature and the Special Court upheld the appeal by referring to the STRUBEN MINERALS case where the payments had been made to obtain rights which were merely subsidiary to the main purpose of purchasing the mine and consequently were to be regarded as part of the cost of acquiring the mine as a capital asset. On appeal by the Commissioner the court held that a distinction had to be drawn between the exploratory rights paid for in the STRUBEN case and the rights to mine for its own benefit for which the option holder had paid while it was deciding whether it should exercise the option. The character of a receipt had to be determined at the date of receipt and could not be affected by its allocation at a later date to a purpose which, though possible, had not been determined at the date of receipt. The court thus held that as the percentages had been received as a rental for the use of the mine they constituted receipts of income and were taxable ..."

Compare REZENDE's case to SIR v STRUBEN MINERALS (PTY) LTD, 1966 (4) SA 582 (A), 28 SATC 248 (Williams page 297), where option monies paid during the prospecting period prior to the sale of a capital asset were held to be of a capital nature. In REZENDE's case, the payments received by the taxpayer were not option monies but rentals.

" ... In MODDERFONTEIN B GOLD MINING CO LTD v CIR, 32 SATC 202, 1923 AD 34, the appellant company was the registered owner of a certain Bewaarplaats on a proclaimed mining area in the Transvaal. Under the laws of the Transvaal Republic no mining had been permitted under Bewaarplaatsen, but by the provisions of the Transvaal Gold Law of 1908 the right to mine under such areas was vested in the Crown and the Government was authorized to lease or otherwise dispose of such rights, and by the Bewaarplaats Moneys Application Act, No. 24 of 1917, provision was made for the sharing of the consideration received for such rights between the State and the owner. As a result of such an agreement the company became entitled to a portion of the Bewaarplaats rentals receivable by the State from a company undertaking mining in these areas.

The appellant contended that the receipt of this portion of rentals was either of a capital nature, or, if not, constituted mining income rather than rental income. The relevance of the second contention was that, if the rentals constituted a share of mining income, they would have been exempt from tax in terms of the statutory provisions under which the lease of the area had been granted to the mining company.

Regarding the first contention, the court held that the receipts were not of a capital nature due to

(1) their annual nature and
(2) their closeness in character to rental payments.

Regarding the second contention, it was held that the receipts did not constitute mining income as the amounts received by the State did not constitute mining income as the relationship between the parties was one of lessee and lessor rather than of partnership.

The appellant in ITC 740, 18 SATC 219, carried on farming operations and received an amount from the South African Railways and Harbours for water taken under certain servitudes over his farm. The servitudes were acquired by expropriation and conferred upon the Railway Administration the right, inter alia, to enter upon the farm and sink boreholes and to take water therefrom for which the Administration bound itself to make payment on a specified basis.

The CIR included the amount so received in the appellant's taxable income and objection was brought against the assessment on the grounds that the amount in question represented a capital accrual. The court held that the transaction approximated to one of sale (albeit under compulsion) of the water produced by and derived from the appellant's farm and that the payments received were not a quid pro quo for a capital asset but periodical payments for a product of the farm and as such constituted income."

This case should be distinguished from ITC 1471, 52 SATC 96, where a farmer argued that the proceeds on the sale of building sand were of a capital nature. It is common cause that the farm itself was held as a capital asset. The reasoning of the court was along the following lines:

- The building sand was a wasting asset which could not be regarded as fructus of the farm;
- The building sand was a non-renewable resource and thus the removal resulted in a permanent diminution of the value of the land;
- The farmer had granted a right to remove this sand to the purchasers thereof and this was akin to the sale of portion of the land or to a lease of mineral rights; and
- Thus, the farmer was not trading in sand and that the proceeds were of a capital nature.

In ESTATE A G BOURKE v CIR, 53 SATC 86, 1991 (1) SA 661(A) (UNISA, 1998:11), the taxpayer received compensation for the destruction of pine trees in a plantation caused by fire. Held - what was destroyed was the crop. There was no sterilisation of the capital asset, that is, the property, could have been replanted to pine trees to produce further "crops" or "fruits". Therefore the compensation was regarded as revenue income. Another case was ITC 652, 15 ATC 373, where the appellant company was the owner of a gold mine in respect of which it entered into a tribute agreement with another company (referred to in the agreement as the Tributors) in terms of which the appellant company, as owner, granted to the Tributors the right to prospect and sample the mining property and thereafter, within a specified time, to take the property on tribute for a period of four years with the right to mine the property with a view to winning gold or other metals for their own account or benefit, and to purchase the property from the owner. In consideration of the rights so granted it was stipulated that there should be paid a "royalty or rental", being a percentage of the gross proceeds of the gold won, subject to a minimum payment in each period of four months during the time of the agreement. The Tributors were further granted the right at any time during the time of the agreement to purchase the property and if the option was exercised, all sums paid as royalty or rental should be and form portion of and be deemed to have been paid on account of and in reduction of the purchase price. If the option was not exercised, all payments should remain and be considered as rent or royalty. It was further provided that the Tributors should not be entitled to terminate the agreement otherwise than by the exercise of their right of purchase until the payments of royalty or rental for the first period of twelve months of the agreement should total £3,000, after which the tributors were to have the right to cancel the agreement on three months' written notice.

The amount received was included in the taxable income of the company by the CIR but the appellant objected to this on the grounds that the amount in question was a capital receipt as against the sale of the mine. The court held that the stipulation in the agreement entitling the tributors to terminate the agreement at any time after £3,000 had been paid in respect of the first period of twelve months, was conclusive in determining the nature of the agreement as one of lease with an option to purchase, rather than a sale subject to a suspensive condition regarding the passing of ownership. Thus, the amounts received could not be held to be receipts on account of the purchase price of the property and so capital, but represented income ..."

From the decisions of the cases dealt with in the preceding paragraphs, it is clear that if the nature of the receipt is inherently income, then it is not necessary to enquire as to the intention of the taxpayer. It is imperative, therefore, when drafting an agreement for the sale of a capital item, to ensure that the nature of the receipt will not be inherently income.

NATURE OF THE ASSET SOLD

Certain assets are likely to have the appearance of a fixed asset, while others appear to be of a trading nature. The nature of an asset may therefore be an important issue as can be seen in the following extract from an English court case: Marson v Mortin (1986) 1 WLR 1343.

"... The nature of the subject matter may be a valuable pointer. Was the transaction in a commodity of a kind which is normally the subject matter of trade and which can only be turned to advantage by realisation, such as referred to in the passage that the chairman of the Commissioners quoted from *Inland Revenue Commissioners v Reinhold* 1953 SC 49?

(What the chairman said in that passage was that if the subject was "normally used for investment – land, houses, stocks and shares – the inference is not so readily to be drawn from an admitted intention in regard to a single transaction to sell on the arrival of a suitable pre-selected time or circumstance and does not warrant the same definite conclusion as regards trading or even that the transaction is in the nature of trade".) For example, a large bulk of whisky or toilet paper is essentially a subject matter of trade, not of enjoyment ..."

" ... In CIR v GEORGE FOREST TIMBER COMPANY 1 SATC 20, 1924 AD 516 (Williams, 1996: 156, 174, 374 and 377), the principle arising from the above-mentioned case and from ITC 740 is that as soon as the fruit of the land is severed and sold, the proceeds constitute income, provided that the fruits are not wasting assets ... "

REASON FOR THE RECEIPT

Amounts received by a taxpayer for services rendered are considered to be income even if such amount is disguised in the form of an inheritance, gift or donation. (UNISA, 1998:13).

" ... In CIR v BROOKS, 26 SATC 91, 1964(2) SA 566 (A) (UNISA, 1998:13), however, the respondent, who under the will of her deceased husband was appointed the sole and universal heiress of his estate, received after the confirmation of the administration and liquidation account an amount which represented the available balance of the estate. The greater part of the estate was made up of sums payable to the estate by a company of which the deceased had been managing director in terms of the contract under which he had been employed. In terms of that contract the deceased had been entitled for a period of five years from 1st July 1957, to a salary of £6,000 per annum, plus a bonus calculated on the annual net profits of the company. The contract further provided that in the event of his death during the term of the agreement, the company would continue to pay his salary and bonus to his estate or heirs for a period of two years or to the end of the contract period, whichever was the lesser period. It was a further provision of the contract that in the event of his death, before attaining the age of 70 years, the amount standing to his credit in a special pension fund would become payable to his estate or heirs. The respondent's husband died on 12th March 1958 at the age of 66.

The company thus paid into his estate during the year of assessment ended 30th June 1958, the amount which stood to his credit in the pension fund and the salary and bonus attributable to the period since his death and during the year of assessment ended 30th June 1959, further additional payments in respect of salary and bonus. After the estate account had been closed the remaining amounts due as salary and bonus were paid direct to the respondent as heiress. The CIR raised additional assessments upon her in her personal capacity for the two years of assessment ended 30th June 1958 and 1959, in respect of the amounts which had been paid by the company to her husband's estate during those years of assessment, on the grounds that they had retained their character of income and, as such, were taxable in the hands of the ultimate beneficiary.

The respondent appealed against these assessments to the Special Court who upheld her appeal on the ground that whatever had accrued to her as the residue of the estate was an accrual of a capital nature. On appeal from the Commissioner, the court held that notwithstanding the income nature of the amounts received by the estate, the residue of the estate, as received by the respondent as her inheritance, was a capital receipt and not a receipt in the nature of income ... "

Beyers, J.A. said: "I agree that that which accrues to a residuary heir is in no sense of the word income. An inheritance is, after all, a gift, and unless it can in some way be related to reward for services rendered by the beneficiary to the testator, it is under ordinary circumstances a capital receipt."

3. THE GOLDEN RULE: INTENTION

Silke (2003:21) states that " ... the most important test employed by the courts in deciding whether the proceeds arising upon the disposal of an asset are in the nature of income or capital is the test of 'intention':
with what intention did the taxpayer acquire and hold the asset? ... "

Corbett, J.A, in his judgement in Elandsheuwel farming (Edms) Bpk v SBI (1978A) (at 101) (Silke, 2003:20), summarised the question of what is capital and what is income as follows:

" ... Where a taxpayer sells property, the question as to whether the profits derived from the sale are taxable in his hands by reason of the proceeds constituting gross income or are not subject to tax because the proceeds constitute receipts or accruals of a capital nature, turns on the further enquiry as to whether the sale amounted to the **realisation of a capital asset** or whether it was the sale of an asset in the **course of carrying on a business** or in pursuance of **a profit-making scheme**. Where a single transaction is involved it is usually more appropriate to limit the inquiry to the simple alternatives of a capital realisation or a profit-making scheme. In its normal and most straightforward form, the latter connotes the acquisition of an asset for the purpose of reselling it at a profit. This profit is then the result of the productive turnover of the capital represented by the asset and consequently falls into the category of income. The asset constitutes in effect the taxpayer's **stock-in-trade** or **floating capital**. In contrast to this the sale of an asset acquired with a view to holding it, either in a non-productive state or in order to derive income from the productive use thereof, and in fact so held, constitutes a **realisation of fixed capital** and the proceeds an accrual of a capital nature. In the determination of the question into which of these two classes a particular transaction falls, the **intention** of the taxpayer, both at the time of acquiring the asset and at the time of its sale, is of great, and sometimes decisive, importance. Other significant factors include, inter alia, the actual **activities** of the taxpayer in relation to the asset in question, the **manner** of its realisation, the taxpayer's **other business operations** (if any) and, in the case of a **company**, its objects as laid down in its memorandum of association.

While the normal type of profit-making scheme, relating to the acquisition and subsequent sale of an asset, contemplates a continuing and unchanging purpose from acquisition to sale, the courts have recognised the possibility of an intervening **change of purpose or intention**. Thus, an asset may have been acquired with the intention of reselling it at a profit but thereafter the owner's intention may change and he may decide to hold it as an income-producing capital asset or investment. If, while this latter purpose persists, the asset is realised, this change of intention would be a strong indication that it was a capital realisation and that the proceeds would be non-taxable. Conversely, an asset originally acquired to be held as an income-producing investment may by reason of a subsequent change of purpose or intention on the part of the owner become the subject-matter of a profit-making scheme so that the proceeds of an ultimate realisation constitute gross income.

In conjunction with what has been stated in regard to change of intention, particularly the kind of change which converts a capital asset into stock-in-trade, must be read the principle that where a taxpayer wishes to **realise a capital** asset he may do so to **best advantage** and the fact that he does just this cannot of itself convert what is a capital realisation into a business or a profit-making scheme. There are, however, limits to what a taxpayer may do in order to realise to best advantage. The manner of realisation may be such that it can be said that the taxpayer has in reality gone over to the running of a business or embarked upon a profit-making scheme. The test is one of degree ..."

It is clear that we must not only investigate the taxpayer's intention at the time of acquiring the asset, but the whole period in which he possesses the asset. The onus is still on the taxpayer to prove that the asset was acquired for investment purposes and not for resale at a profit, if the proceeds are to be regarded as of a capital nature. On the other hand, if a loss was incurred on the sale of an asset, the taxpayer must prove that the asset was not acquired for the purpose of investment but rather to make a profit.

CHANGE OF INTENTION

The tax consequences change if the taxpayer's intention changes during the period in which the asset is held. However, it does not mean that a decision to sell a capital asset rather to hold it will change the nature of the asset. This will result in a change in form - for example, from fixed property to cash. In CIR V RILE INVESTMENTS (PTY) LTD, 40 SATC 135, 1978(3) SA 732(A) (Williams, 1996:240), it was stated that a mere change of intention from revenue to capital was insufficient proof that he meant to cease trading in the asset and hold it on a long-term basis as capital.

4. CONCLUSION

"The hardest thing in the world to understand is income tax" - Albert Einstein.

This is certainly not far from the truth when we look at the distinction between "income" and "capital". By statute and common law, income and capital are mutually exclusive categories. However, a single amount can consist of both and be capable of apportionment as partly income and partly capital. In our tax system the most fundamental distinction is that between income and capital and in saying this, the Act still does not define either "income" nor "capital". By defining "gross income" as the total amount received by or accrued to the taxpayer, amounts of capital nature are excluded. There is also a third, innominate category which is neither income nor capital. If a "once-off" gift is made to a taxpayer, the amount is certainly not of income nor of capital nature. However in Payott Ltd v CIR, Davis AJA said that it is not possible to have an amount which is neither income nor capital.

"... This is a half-way house of which I have no knowledge ..."

In CIR v General Motors SA (Pty) Ltd 1982 SA 196 (T), 43 SATC 249 at 245, the courts still have not acknowledged this third category, but accepts that "in the hands of a borrower, a loan is colourless" - being neither income nor capital. (Williams, 1996:186).

The question whether an amount is of a capital or income nature is still a question of law and the onus is on the taxpayer to prove the nature of a receipt or accrual.

CHAPTER 3
BASE COST AND VALUATIONS

1. INTRODUCTION

With the introduction of Capital Gains Tax, government and specifically the South African Revenue Service have a bigger interest in measuring wealth and the growth of wealth regarding disclosed and undisclosed revenue and assets and the taxation of the revenue. Because the base cost is an important variable in the Capital Gains Tax equation, it is necessary to take a closer look at valuation permutations when a valuation is made. It is important that there is a clear understanding of what is being valued; the enterprise as a whole or only a specific asset. Dr. John Hendrikse and Advocate Leigh Hendrikse summarised some of the permutations as follows: (Hendrikse & Hendrikse, 2002:44)

"... (a) **Gross value** (gross asset value)

Where one is valuing an entire entity (e.g. a commercial business enterprise or real estate investment enterprise), then in the first instance the valuation to be done is of the gross value of the entity, i.e. the gross value of all the principal assets of the subject.

Similarly if one is valuing a part of the business (e.g. business units), one would only value that part or division's *applicable gross assets.*

(b) **Specified net value** (net asset value)

Frequently the parties agree as part of the purchase negotiation and the concluded transaction, that the purchaser is to take over all or some of the liabilities, such as creditors and loans. All that this means is that the value for the purpose of the transaction is the gross value less agreed liabilities.

(c) **Share equity value** (net worth)

Where one is valuing a share or interest in an incorporated entity, whether listed or unlisted, this represents the net asset value or equity value, i.e. the total gross assets less total liabilities. This value is the same as the net value described above. This is particularly relevant to the value of listed shares, or new listings.

In relation to unlisted public or private companies, or close corporations, the shareholder or member loans are treated as part of the liabilities ..."

One of the most complicated issues regarding Capital Gains Tax is the determination of the base cost of an asset. The 1st October 2001 is the valuation or benchmark date, which represents the starting date from which all capital gains, or losses are measured. Different rules apply for assets acquired before 1 October 2001 and those acquired on or after this date. For pre-1 October 2001 assets, only the part of the gain arising after 1 October 2001 will be subject to Capital Gains Tax. A capital gain will be equal to proceeds on disposal less base cost. In paragraphs 25 to 28 of the Act, the base cost of a pre- 1 October 2001 asset can be determined as either:

- it' s market value on 1 October 2001; or
- 20% of disposal proceeds; or
- an amount determined on a time-apportionment basis, and

the base cost valuation option of an asset acquired on or after 1 October 2001 will be determined as either:

- actual cost; or
- time-apportionment basis; or
- 0 % of proceeds.

The election of any of the above methods will require careful consideration, particularly as the time-apportionment basis may only be applied once the asset is disposed of, which could be many years after 1 October 2001. On the other hand, market value may only be adopted as base cost if the valuation of the asset was done as at 1 October 2001. In order to maximise the base cost and minimise the capital gain, the decision of the base cost option can only be objectively made at the disposal date of the asset. It is therefore very important to ensure that all previously owned assets were valued at 1 October 2001. Because of the complexity of the topic, the valuation procedures are discussed in paragraph 5.

Diagrams for quick reference at the end of this chapter illustrate how "valuation" interface with various capital gain scenarios and base cost options.

2. BASE COST - OTHER IMPORTANT ASPECTS

As previously stated, the gain or loss on the disposal of a capital asset is the difference between the proceeds of the Capital Gains Tax event and the cost of acquisition. However, because of the endless variety of commercial transactions, it is necessary to define the acquisition "base cost" in extremely detailed terms with both inclusion and exclusions – not only for clarity, but also to effect anti-tax avoidance mechanisms.

The Capital Gains Tax legislation contains various rules for determining the base cost of specified assets. These rules are as follows:

Base cost of identical assets (Paragraph 32)

When an asset that forms part of a group of similar assets is sold (a so-called "fungible asset"), it may not be possible to physically identify the particular asset that is being disposed of. Examples of such assets are Kruger Rands, units in a unit trust and shares. This results in problems, since when the same assets are purchased at different "base costs", which one is sold?

In order to identify such assets for Capital Gains Tax purposes, a dual test has been devised. (Paragraph 32 (2)). First, if anyone of the assets in a particular holding were to be sold, it would realise the same amount as anyone of the other assets in the holding. Secondly, all the assets in the group must share the same characteristics.

Where any such assets have unique identifying numbers, for example, share certificate numbers, that fact is ignored for the purposes of determining whether an asset is part of a holding of identical assets.

Taxpayers are permitted to adopt one of three alternative methods to determine the base cost of assets that form part of a group of similar assets. These methods are:

Method 1: Specific identification

Under this method, the cost of each asset disposed of is discretely identified. (For example, by reference to share certificate numbers).

Method 2: First-in-first-out (FIFO)

Under this method, it is assumed the oldest asset is sold first.

Method 3: Weighted average method

This method implies that an average unit cost must be computed after each acquisition of an asset by adding the cost of the newly acquired assets to the cost of the existing assets on hand and dividing this figure by the new total number of assets.

It should be noted that the weighted average cost method may not be used where the base cost of an asset is determined using the time-based apportionment method. This is due to the fact that under time-based apportionment, it is necessary to know the date of acquisition of each asset. Where assets are pooled, this will not be easily accomplished.

Once a method has been adopted in respect of a holding of assets, that method must be used until all the assets in the particular class have been disposed of. The above methods are best explained by means of examples:

Example: 1

Mr Piek holds the following units in a unit trust:

Date purchased	No of units	Cost per unit	Cost
1 October 2001	200	1,50	R300
1 November 2001	100	1,60	R160
1 December 2001	300	1,70	R510
1 January 2002	200	1,35	R270
	800		R1 240

On 28 February 2002, Mr Piek sold 250 units.

Method 1: Specific identification

Mr Piek's records show that he sold the 100 units acquired on 1 November 2001 and 150 units of those acquired on 1 December 2001.

Units sold	Quantity sold	Cost per unit	Base cost
Acquired 1 November 2001	100	1,60	160
Acquired 1 December 2001	150	1,70	255
	250		415

Method 2: First-in-first-out (FIFO)

Under this method, the assumption is that the oldest units are sold first. In this case, the oldest units are the 200 purchased on 1 October 2001 and those purchased on 1 November 2001.

Units sold	Quantity sold	Cost per unit	Base cost
Acquired 1 October 2001	200	1,50	300
Acquired 1 November 2001	50	1,60	80
	250		380

Method 3: Weighted average method

The weighted average unit cost is 1240/800 = R1,55
The base cost of 250 units is, therefore, 250 x 1,55 = R387.50

CONCLUSION

Resulting from the above example, it is clear that in this scenario the specific identification method will be the most favourable comparing base costs: R416 : R380 : R387.50. However, it is important to remember that once a method has been adopted, it must be used until all the assets in the particular class have been disposed of.

Base cost of interest-bearing instruments acquired before 1 October 2001

The base cost, as at 1 October 2001, of interest-bearing instruments such as bank deposits, loans, stocks, bonds, debentures and similar assets must be determined by using one of the following methods:

Method 1: the "adjusted initial amount" method

This is the initial amount paid for the instrument, plus the cumulative amount of all interest accrued and paid, less all amounts received from date of acquisition to 1 October 2001. The result of the application of this method is illustrated in the example that follows.

Method 2: the "market value" method

This is the price which could have been obtained upon a sale of the instrument between a willing buyer and a willing seller dealing at arm's length in an open market.

Example: "Adjusted initial amount" method:

On 31 December 2000, ABC Ltd, a company with a 30 June financial year-end, acquired a financial instrument with a term of 2 years at a discount of R1 200 000 to the face value of R10 000 000. Interest was receivable 6-monthly, calculated at 3% of the face value of the instrument. At maturity date, 31 December 2002, the instrument was redeemed at par.

Step 1: Calculation of the yield to maturity

This calculation requires the calculation of the cash flow that may be summarised as follows:

31 December 2000	(R8 800 000)	[R10 000 000 - R1 200 000]
30 June 2001	R300 000	[R10 000 000 x 3%]
31 December 2001	R300 000	
30 June 2002	R300 000	
31 December 2002	R10 300 000	
	R2 400 000	

The accrual period was 6 months, and the resultant yield to maturity was, therefore, 6.50308% per accrual period.

Step 2: Calculation of interest accrued for the year ending 30 June 2001

Interest accrued R572 271 [R8 800 000 x 6.50308%]

Step 3: Calculation of interest accrued up to 1 October 2001

Interest accrued R294 988 [(R8 800 000 + R572 271 – R300 000) x 6.50308% x 3/6]

Step 4: Calculation of "adjusted initial amount" on 1 October 2001

Initial amount paid	*R8 800 000*	
Total cash inflows resulting from transactions	*(R300 000)*	
Total interest accrued to 30 September 2001	R867 259	[R572 271 + R294 988]
Adjusted initial amount	R9 367 259	

(SARS, 2003:71)

CONCLUSION

Where a person has adapted to the adjusted initial amount of an instrument as the valuation date value and the proceeds from the disposal are less than that amount, the valuation date value of the instrument is the time-apportionment base cost of that instrument. The effect of this rule is to prevent the full amount of a loss incurred before valuation date from being claimed after that date. Without this provision a person would effectively be entitled to a deduction against income as well as the expenditure being included in base cost in the determination of a capital gain or capital loss, or alternatively, the person would be allowed a deduction for expenditure that has been recovered.

Part Disposals

If a situation occurs where only part of an asset is disposed of, it is necessary to allocate part of the base cost of the asset to the part disposed of in order to determine the capital gain or loss in respect of that part. The base cost of the part disposed of is determined according to the following formula:

$$\frac{\text{Market value of part disposed of}}{\text{Market value of entire asset immediately prior to disposal}} \times \text{Base cost of entire asset}$$

The remainder of the base cost would be allowable on a future disposal of the part retained.

However, where a part of the base cost can be directly attributed to the part of the asset that is disposed of or retained, then the above apportionment does apply in respect of that part of the base cost. In this case, specific identification could be used to determine the part of the base cost disposed of.

The concept of market value of assets is not only relevant to assets held on valuation date, but also for many other circumstances as discussed in the following section.

3. MARKET VALUE

The market value of an asset is "... the price which could have been obtained upon a sale of the asset between a willing buyer and a willing seller dealing at arm's length in an open market in which the seller usually deals ..." (Ernst & Young, 2001:18).

In addition to the once-off opening valuation on 1 October 2001, it may be necessary to value assets on occasions other than when sold (bona fide sale) due to certain of the occasions resulting in a deemed disposal.

These occasions are as follows:

1. Where a disposal takes place between connected persons;
2. A donation of an asset;
3. The death of an owner;
4. A personal-use asset is taken into use for business purposes, or vice versa;
5. A capital asset of a business is converted into trading stock, or vice versa;
6. If a South African resident emigrates;
7. The declaration of an *in specie* dividend;
8. Capital distributions.

The market value of an asset to be used in the above circumstances will be as follows:

Type of asset	Market value
Financial instrument listed on a recognised exchange (local or overseas)	Average of listed buying and selling prices at the close of business on last trading day before disposal
Long-term insurance policy	Greater of - -surrender value; or -insurer's market value (assume policy runs to maturity)

Unit trusts and property unit trusts	Management company's repurchase price
Foreign unit trusts	Management company's repurchase price or, if not available, selling price based on willing buyer, willing seller acting at arm's length in open market
Fiduciary, usufructuary and other like interests	Present value of future benefits, discounted at 12% p.a. over life expectancy of person entitled to asset or lesser period of enjoyment. SARS may approve less than 12% where justified
Property subject to fiduciary, usufructuary and other like interests	Market value of full ownership, less value of fideicommisum or usufruct as determined above
Immovable farming property	Land Bank value (defined in Estate Duty Act) or price based on willing buyer, willing seller acting at arm's length in open market On disposal by death, donation or non-arm's length transaction, the Land Bank value may only be used if it is used in determining the base cost of the disposer on - - 1 October 2001; or, where applicable - date acquired by inheritance, donation or non-arm's length transaction at Land Bank value
Any other asset	Price based on willing buyer, willing seller acting at arm's length transaction in open market

(Source: SARS, 2002:85)

It is important to remember that all valuations had to be be carried out by 30 September 2003. If the valuation was carried out after October 1, 2001, but before 30 September 2003, the asset had to be valued according to its condition as at 1 October 2001.

The Capital Gains Tax legislation does not prescribe that a valuation must be performed by a registered valuer or an expert in a particular field. For a low value asset, it may be unreasonable to incur the costs of making a professional valuation whereas, conversely, for a substantial asset, it might be unwise not to employ outside expertise.

It must be noted that SARS can question valuations that they believe are unrealistic. The fact that a valuation has been undertaken by a qualified person will increase the probability that the valuation will be accepted by SARS, as long as the valuation has been prepared on the basis of what a willing buyer would be prepared to pay to a willing seller for the asset, where such persons are dealing at an arm's length basis. Where the Commissioner is not satisfied with a valuation he may request further information regarding the valuation or adjust the valuation. The following are examples of the details which the Commissioner may request:

- Valuation certificate, including basis of valuation and calculations;
- Physical address and size of property;
- Details and documents of improvements to the property;
- Plans of the property as at 1 October 2001;
- Comparative sales figures of recent property sales in the same area;
- Current municipal valuation of the property;
- Any other relevant information;
- In the case of farming property, taxpayers must either use and supply the Land Bank's valuation, or note the detail requested in the Land Bank's valuation, or note the detail requested in the Land Bank questionnaire used for valuing immovable property on which bona fide farming operations are carried on;
- In the case of mineral rights the taxpayer must supply the Commissioner with the valuer's valuation, including the basis of valuation and calculations, descriptions and location of the minerals.

Copies of valuations must accompany the relevant return of income (IT 14) for the year in which the asset was disposed of. Certain valuations had to be lodged with the first return of income submitted after 30 September 2003, irrespective of whether the asset had been disposed of or not. These categories can be summarised as follows:

Type of Asset	Applies	Where market value exceeds
Intangible asset	Per asset	R1 million
Unlisted shares	All shares held by shareholder in the company	R10 million
All other assets	Per asset	R10 million

The term "market value" in respect of valuation is used throughout the Eighth Schedule in a wide variety of circumstances. These circumstances are summarised in the following section.

4. EIGHTH SCHEDULE VALUATION REGULATIONS

The Eighth schedule specified the following paragraphs in relation to valuations:

Paragraph	Purpose
1	Defines a "value shifting arrangement"
16	Intangible assets acquired prior to valuation date
22	Amount of Donations tax to be included in base cost
23	Base cost in respect of value shifting arrangement
25	Determination of base cost of pre-valuation date assets
26	Valuation date value where proceeds exceed expenditure or where expenditure in respect of an asset cannot be determined
27	Valuation date value where proceeds do not exceed expenditure
29	Market value on valuation date
30	Time-apportionment base cost
31	Market value

35	Proceeds from disposal
38	Disposal by way of donation; consideration not measurable in money and transactions between connected persons not at an arm's length price
57	Disposal of small business assets
75	Distribution *in specie* by company
76	Distribution of cash or assets *in specie* to shareholder
78	Share distributions received by shareholder

The Eighth Schedule introduces a new concept into our tax law – that of value shifting. The value shifting provisions are directed at a particular type of tax avoidance and are contained in a number of different paragraphs.

Paragraph 1: Value shifting arrangement

This new concept involves the effective transfer of value from one entity to another without constituting an ordinary disposal for Capital Gains Tax purposes. It is found typically between "connected persons", i.e. parents and children or within a group of companies. The following elements must be present for an arrangement to constitute a "value-shifting" arrangement:

- an interest in a company, trust or partnership must be retained;
- there must be a change in the rights or entitlements of such an interest;
- the change in rights or entitlements must occur other than via a disposal at market value;
- the market value of the interest must decrease; and
- another person must either acquire a direct or indirect interest in that company, trust or partnership.

Without these specific rules, the value of an asset could be manipulated to obtain a Capital Gains Tax benefit, for example:

with the first return of income submitted after 30 September 2003, irrespective of whether the asset had been disposed of or not. These categories can be summarised as follows:

Type of Asset	Applies	Where market value exceeds
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The Eighth Schedule introduces a new concept into our tax law – that of value shifting. The value shifting provisions are directed at a particular type of tax avoidance and are contained in a number of different paragraphs.

Paragraph 1: Value shifting arrangement

This new concept involves the effective transfer of value from one entity to another without constituting an ordinary disposal for Capital Gains Tax purposes. It is found typically between "connected persons", i.e. parents and children or within a group of companies. The following elements must be present for an arrangement to constitute a "value-shifting" arrangement:

- an interest in a company, trust or partnership must be retained;
- there must be a change in the rights or entitlements of such an interest;
- the change in rights or entitlements must occur other than via a disposal at market value;
- the market value of the interest must decrease; and
- another person must either acquire a direct or indirect interest in that company, trust or partnership.

Without these specific rules, the value of an asset could be manipulated to obtain a Capital Gains Tax benefit, for example:

Example 1 – How a tainted capital gain can arise

Widget (Pty) Ltd carried on operations for many years as a manufacturer of widgets until it ceased trading operations in 2005. The company was dormant after that. It had an assessed capital loss of R1 million, which had arisen from the sale of its manufacturing assets. After lying on the shelf of Tickbird & Partners, a firm of accountants, until 2008 it was sold to Mr Shyster for R60 000. Its balance sheet reflected no assets and its only liability was a shareholder's loan account. After acquiring the company's shares, Mr Shyster sold a high growth share investment into the company solely for the purpose of utilising the assessed capital loss. Two years later the company sold the share at a capital gain of R900 000, which it sought to offset against its assessed capital loss. The company was informed by SARS that the gain was tainted in terms of s 103 (2) as it was part of a scheme to utilise the assessed capital loss. (SARS, 2003:215)

Example 2 – Ring fencing of tainted capital gain against capital loss

A company has a tainted capital gain of R100 000, an untainted capital gain of R25 000 and a capital loss of R200 000.

Taxable capital gain = R100 000 x 50% inclusion rate = R50 000
Assessed capital loss = R200 000 – 25 000 = R175 000

The taxable capital gain of R50 000 will be included in the company's taxable income, and the assessed capital loss will be carried forward to the following year of assessment. (SARS, 2003:215)

Example 3 – Ring fencing of tainted capital gain against assessed loss

A company has a tainted capital gain of R100 000, an untainted capital gain of R150 000 and an assessed loss before the inclusion of any taxable capital gain of R200 000.

Taxable capital gain = R100 000 + R150 000 = 250 000 x 50% = R125 000

Portion of taxable capital gain that may not be set off against assessed loss:

$$= \frac{\text{Tainted capital gain}}{\text{Sum of all capital gains and losses}} \times \text{Taxable capital gain}$$

(SARS, 2003:215)

Special rules regulate transactions between so-called "connected persons". These rules specifically address the potential manipulation of proceeds derived on disposal as well as any capital losses that may arise on any disposals of assets between connected persons.

DEFINITION OF "CONNECTED PERSON"

The definition of "connected persons" as per the Act includes the following:

(a) In relation to a natural person -

- any relative (i.e. the spouse of such a person or any other person related to him or his spouse); or
- any trust of which such a natural person or such a relative is a beneficiary.

(b) In relation to a trust -

- any beneficiary of such a trust; or
- any connected person to such a beneficiary .

It should be noted that all persons who are connected persons in relation to a trust will be regarded as connected persons in relation to each other.

(c) In relation to a company (A) -

- its holding company;
- any of its subsidiaries;
- a fellow subsidiary;
- any natural person, trust or close corporation who holds at least 20% of the equity share capital of A (either individually or jointly with any connected person in relation to himself);
- any other company that holds at least 20% of the equity share capital of A and no shareholder holds the majority voting rights of A; or
- any other company managed or controlled by any person who is a connected person in relation to A (or a person who is a connected person in relation to such person).

(d) In relation to a close corporation (B) -

- anyone of its members;
- any relative of such member or any trust that is a connected person in relation to such a member; or
- any other close corporation or company that is a connected person in relation to any member of B or the relative or trust contemplated above.

Where an asset is disposed of to a connected person, the person disposing of the asset is deemed to do so at its market value on the date of disposal. On the other hand, the connected person who acquires the asset disposed of does so at that same market value for purposes of establishing his base cost. The market value is the price that would be paid between a willing seller and a willing purchaser at arm's length in an open market.

It should be noted that all persons who are connected persons in relation to a trust will be regarded as connected persons in relation to each other.

(c) In relation to a company (A) -

- its holding company;
- any of its subsidiaries;
- a fellow subsidiary;
- any natural person, trust or close corporation who holds at least 20% of the equity share capital of A (either individually or jointly with any connected person in relation to himself);
- any other company that holds at least 20% of the equity share capital of A and no shareholder holds the majority voting rights of A; or
- any other company managed or controlled by any person who is a connected person in relation to A (or a person who is a connected person in relation to such person).

(d) In relation to a close corporation (B) -

- anyone of its members;
- any relative of such member or any trust that is a connected person in relation to such a member; or
- any other close corporation or company that is a connected person in relation to any member of B or the relative or trust contemplated above.

Where an asset is disposed of to a connected person, the person disposing of the asset is deemed to do so at its market value on the date of disposal. On the other hand, the connected person who acquires the asset disposed of does so at that same market value for purposes of establishing his base cost. The market value is the price that would be paid between a willing seller and a willing purchaser at arm's length in an open market.

PROCEEDS CONSIDERED NOT TO BE MARKET RELATED

Paragraph 38 states that transactions between connected persons that are not at an arm's length price, must be treated as taking place at market value. In Hicklin V SIR (1980 (1) SA 481 (A), 41 SATC179 (SARS, 2003:103), judge Trollip stated the following regarding transactions at arm's length: "...It connotes that each party is independent of the other and, in so dealing, will strive to get the utmost possible advantage out of the transaction for himself ..." Therefore a disposal of an asset to a connected person for a consideration which does not reflect an arm's length price, must be treated as a disposal of an asset by the seller and an acquisition of that asset by the purchaser at market value.

"CLOGGED" CAPITAL LOSSES

Where the disposal results in a deemed loss for the person disposing of the asset, that loss must be disregarded in determining the aggregate loss for the year. In the case of disposals to a connected person who is a relative, the usual definition of connected person is varied to include only parents, children, stepchildren, brothers, sisters, grandchildren and grandparents. Losses involved in disposals to more distant relatives can therefore be recognised. These capital losses determined in respect of the disposal of an asset to a connected person will be treated as a "clogged" loss. This means that the capital loss in question may not be brought into account in determining the seller's aggregate capital gains or losses for the tax year in which the disposal takes place. The loss will be ring-fenced so that it could be deducted only from capital gains determined in respect of other disposals during that or any subsequent year to the same person to whom the disposal giving rise to that loss was made. The person to whom the subsequent disposals are made would have to, moreover, still qualify as a connected person at the time of those disposals.

It should be noted that the definition of "connected person" will not extend, for the purposes of the above rule, to any relative of a natural person other than a spouse, parent, child, brother, sister, grandchild or grandparent of that person.

DISPOSAL OF DEBTS

Where a creditor disposes of a claim owed by a debtor, who is a connected person in relation to that creditor, that creditor must disregard any capital loss and not merely clog it unless the disposal results in a gain for the debtor, which is included in that debtor's aggregate gains or losses.

The above provision prevents persons from receiving the benefit of losses on debt when the debt involved most likely represents a disguised gift or capital contribution, neither of which would otherwise create a capital loss. Under the specifics of this rule, a creditor cannot receive a loss on any disposal of a debt owed by a connected person, even if the disposal of that claim is to an unconnected person.

Paragraph 23: Base cost in respect of value shifting arrangement

A "value shifting arrangement" refers to a decrease in value of a person's interest in a company, trust or partnership and is deemed to be a disposal for Capital Gains Tax purposes on the date when the value of that person's interest decreases due to the value shifting arrangement.

The base cost of such a decrease in value is calculated according toaccording to the following formula:

$$Y = \frac{(A - C)}{A} \times B$$

Where -

Y = the base cost to be determined;

A = the market value of the interest immediately prior to the deemed disposal;

B = the base cost of interest immediately prior to the deemed disposal; and

C = the market value of the interest immediately after the deemed disposal

The proceeds on disposal in a value shifting arrangement are deemed to be equal to the decrease in the market value of the interest of that person who is deemed to have disposed of that interest.

The proceeds calculated above are, in turn, deemed to be part of the base cost of the interest of the person whose interest in the company, trust or partnership has increased.

Example

A is the sole shareholder of B Ltd in which he holds 2 shares of R1 each. The retained income in the company amounts to R99 998. The market value of the shares on 1 October 2005 is R100 000. The base cost of A's 2 shares on

1 October 2001 was R50 000. On 1 October 2005, B Ltd issues a further share of R1 to A's daughter, C, at a cost of R1.

The above arrangement can be summarised as follows:

	Before	**After**
Share capital	R2	R3
Retained income	R98 998	R98 998
Market value 1/10/05	R 100 000	R 100 000
Market value per share	R50 000	R33 333

The issue of shares to C constitutes a value shifting arrangement in that:

- there is an arrangement;
- A has retained an interest in B Ltd;
- There has been a change in the rights or entitlements in B Ltd;
- The change in interest occurred other than as a result of a disposal at market value;
- The market value of A's interest has decreased from R100 000 to R66 666;
- C has acquired an interest in B Ltd.

Therefore, A will be deemed to have disposed of a portion of his interest in B Ltd.

Determination of A's proceeds:

Market value of A's interest before disposal	R 100 000
Market value of A's interest after disposal	R 66 666
Decrease in market value	R 33 333

The proceeds are, therefore, deemed to be R33 333.

Determination of A's base cost:

Applying the formula -

$$Y = \frac{(A-C)}{A} \times B$$

$$= \frac{(100\,000 - 66\,666)}{100\,000} \times 50\,000$$

$$= R16\,500$$

Determination of A's capital gain:

Capital gain = proceeds less base cost

= 33 333 –16 500

= R16 833

Determination of C's base cost:

Cost of C's share in B Ltd	R 1
Increase in C's interest in B Ltd	R33 333
Revised base cost	R33 334

(Mellet, 2001:25)

Paragraph 22: Donations tax to be included in Base cost

Although donations tax is imposed in terms of Part V of Chapter II of the Income Tax Act, donations tax is not a tax on income, but a tax on the disposal of capital.

A donation must be treated as a disposal of an asset by the donor and an acquisition of that asset by the donee at market value. The time of disposal will be the day on which all legal requirements of a donation have been complied with.

Example: (Paragraph 20)

Mr A donates a yacht exceeding 10 metres in length to Ms B as a token of his affection to her. There is no marital-like union between them. The yacht has a base cost of R1 000 000 and a market value of R2 500 000 at the time of the donation. Mr A and Ms B do not qualify as spouses. The base cost of R1 000 000 in the hands of Mr A is therefore not transferred to Ms B. The transaction is therefore treated as a disposal by Mr A for a consideration of R2 500 000. Mr A will therefore realise a capital gain of R1 500 000 in respect of the donation, while Ms B will be treated as having acquired the yacht at a base cost of R2 500 000.

INTERACTION BETWEEN CAPITAL GAINS TAX AND DONATIONS TAX

It should be noted that the donations tax payable by the donor may be included in the base cost of the donated asset in the calculation of the Capital Gains Tax that becomes payable by the donor in the event of a donation.

The rate of donations tax has been decreased from 25% to 20%. The reduced rate applies to any donation made on or after 1 October 2001.

That portion of the donations tax to be added must be calculated according toaccording to the following formula:

$$Y = \frac{(M - A)}{M} \times D$$

where

Y = the amount to be determined;

M = the market value of the donated asset;

A = expenditure incurred on asset; and

D = total amount of donations tax.

The purpose of the above calculation is to achieve parity with the estate duty that would have become payable on the gain had the donor died on the date of donation.

Example:

Mr A donates an asset to his son at the time when the market value is R1 250 000. The base cost of the asset, before taking into account any donations tax, is R750 000. Donations tax to the amount of R245 000 is paid. The donations tax is calculated as follows:

Market value of asset donated	1 250 000
Donations tax abatement	25 000
	1 225 000
Donations tax (@ 20%)	R245 000

Allowable addition to base cost:

$$Y = \frac{(M - A)}{M} \times D$$

= (1 250 000 - 750 000)/1 250 000 x 245 000

= R98 000

Therefore, base cost of asset = R750 000 + R98 000 = R848 000.

It may happen that the donations tax becomes payable by the donee if the doner fails to pay. In these circumstances, the base cost of the asset in the hands of the donee may be increased by an amount which bears to so much of the donations tax paid by the donor in the same ratio as the capital gain of the donor bears to the market value of the asset.

Example:

<table>
<tr><td colspan="3">Mr A donates an asset to his daughter at the time when the market value is R1 250 000. The donations tax due by Mr A is R245 000, calculated as follows:

Market value of asset donated   1 250 000
Donations tax abatement   <u>30 000</u>
<u>1 220 000</u>

Donations tax (@ 20%)   R244 000
Mr A fails to pay the tax to SARS and the daughter is held liable for the sum of R244 000. Assuming that her father was liable for Capital Gains Tax on a gain of R500 000 as a result of the donation, she may add the following amount to the base cost of the asset:</td></tr>
<tr><td>Allowable addition to base cost</td><td>=</td><td><u>Capital gain of donor</u>
Market value of asset x Donations tax
=   500 000/1 250 000 x 245 000
=   R98 000</td></tr>
</table>

Donations to public benefit organisations

Any capital gain or loss arising from a donation of an asset to an approved public benefit organisation must be disregarded for Capital Gains Tax purposes. (Examples: Mellet, 2001:46)

5. CALCULATION OF BASE COST OF ASSETS ACQUIRED BEFORE 1 OCTOBER 2001

As indicated in Chapter 1, a capital gain or loss will be the difference between proceeds and base cost of the asset disposed of.

That will certainly be the case for assets acquired after 1 October 2001, being the date that Capital Gains Tax became effective. Although, for assets already owned on that date, the law provides for the following options to calculate the base cost:

a) Market value at 1 October 2001 + actual costs; or
b) Time-apportionment base cost; or
c) 20% of proceeds

The decision between these options will be determined by the following scenarios:

5.1 SCENARIO 1: THE PROCEEDS ON DISPOSAL EXCEED EXPENDITURE INCURRED ON THE ASSET

In this scenario, a taxpayer has three options in determining the valuation date value of an asset, being:

- the valuation method;
- the 20% rule; and
- the time apportionment method.

These options are discussed in the following paragraphs.

5.1.1 Option 1: The "Valuation Method"

The seller can undertake a valuation of the asset and rely upon such value as the valuation date value. Where this basis is used, the whole gain is subject to the following rules:

Shares listed on the JSE

The valuation date value of a share listed on the JSE and for which a price was quoted both before and after 1 October 2001 will be the price as published by SARS in the Government Gazette. This price is based on the average of the last price quoted in respect of that share on each of the 5 days preceding 1 October 2001. The "last price quoted" will be the average of the buying and selling prices quoted at the close of business on the day.

Shares listed on a stock exchange outside South Africa

The base cost of a share listed on a stock exchange outside South Africa and for which a price was quoted both before and after 1 October 2001, will be the last price quoted on that exchange in respect of that share on the last trading day before 1 October 2001. Again, the "last price quoted" will be the average of the buying and selling prices quoted at the close of business on the day.

Other assets

The base cost of any other asset will be the price which could have been obtained upon a sale of the asset between a willing buyer and a willing seller dealing at arm's length in an open market. It should be noted that, when determining the market value of any shares in a company not quoted on a recognised stock exchange, no regard must be given to any provisions in the memorandum and articles of association, etc. restricting the transferability of shares or any provisions whereby or whereunder the value of the shares is to be determined.

5.1.2 Option 2: The "20% rule"

In terms of this rule, 20% of the proceeds received by the seller will be deemed to be the base cost after deducting from those proceeds any capital expenditure incurred on the asset after 1 October 2001.

It is unlikely that many taxpayers will rely on this method in that it yields a very low base cost and, therefore, results in an exceptionally high gain liable to tax.

5.1.3 Option 3: The "Time-Apportionment Method"

This method may not be used if a taxpayer has used the "weighted average method".

Again, when using this option, the taxpayer will have to take into account the following situations:

Situation 1: No additions/reductions to asset in more than one year of assessment prior to 1 October 2001

Where all capital expenditure in acquiring/improving the asset was incurred in a single year of assessment before 1 October 2001, the time-apportionment base cost of an asset is determined according toaccording to the following formula (expenditure includes reductions to base cost such as wear and tear allowances):

$$Y = B + [(P - B) \times \frac{N}{T+N}]$$

Where -

Y = the amount to be determined;

B = the amount of the expenditure incurred on the asset that is attributable to the period of ownership before 1 October 2001;

P = the amount of the proceeds;

N = the number of years the asset was owned prior to valuation date;

T = the number of years the asset was owned after valuation date.

Where any improvements have been made after 1 October 2001, the value at 1 October 2001 in terms of the time-apportionment base cost would not have been affected. Expenditure incurred after that date would simply be added to the time-apportionment base cost value to determine the total base cost of the asset.

Example:

Assume an asset was acquired by a company on 30 September 1998 for R20 000 000 and sold for R30 000 000 (net of costs) on 1 October 2003. Base cost using the "time-apportionment" method will be as follows: $Y = B + [(P - B) \times \frac{N}{T+N}]$ = R20 000 000 + [(R30 000 000 - R20 000 000) x 3/(2 + 3) = R26 000 000 The net capital gain is therefore R4 000 000 (i.e. the proceeds of R30 000 000 less the base cost of R26 000 000).

Situation 2: Additions/reductions to asset in more than one year of assessment prior to 1 October 2001

Where the capital expenditure in acquiring/improving an asset was incurred during more than one year of assessment prior to 1 October 2001, the following formula must be used to determine the time-apportionment base cost (expenditure includes reductions to base cost such as wear and tear allowances):

$$Y = B + [(P - B) \times \frac{N}{T+N}]$$

Where -

Y = the amount to be determined;

B = the amount of the expenditure incurred on the asset that is attributable to the period of ownership before 1 October 2001;

P = the amount of the proceeds calculated according toaccording to the formula set out hereunder;

N = the number of years the asset was owned prior to valuation date (in this formula, N may not exceed 20);

T = the number of years the asset was owned after valuation date.

It should be noted that where expenditure was incurred in more than one year of assessment prior to 1 October 2001, "N" in the above formula is limited to 20 years.

$$P = \frac{T \times B}{(A + B)}$$

P = the amount to be determined and to be used in the above formula;

T = the total amount of the proceeds;

A = the amount of the expenditure incurred on the asset that is attributable to the period of ownership on or after 1 October 2001;

B = the amount of the expenditure incurred on the asset that is attributable to the period of ownership before 1 October 2001.

The purpose of the above formula is to allocate the percentage of the proceeds attributable to the period of ownership before valuation date.

Example 1:

ABC Ltd acquired a piece of land in Cape Town 30 years prior to 1 October 2001 for R400 000. A shopping centre was erected on that land 2 years before 1 October 2001 for R10 000 000 and one year after 1 October 2001 further improvements amounting to R2 000 000 were effected to the shopping complex. The shopping complex along with the land were disposed of for R24 000 000, 10 years after 1 October 2001.

As the amount of expenditure allowable was incurred in more than one year of assessment, the proceeds to be used in the time-apportionment base cost must be determined according toaccording to a formula.

ABC Ltd had not valued the land on 1 October 2001 and adopted the time-apportionment basis in determining the value at 1 October 2001. The capital gain that arises in the hands of ABC Ltd is as follows:

$$P = \frac{T \times B}{(A + B)}$$

= 24 000 000 X [(400 000 + 10 000 000)/(2 000 000 + (400 000 + 10 0000 000))]

= R20 129 032

The purpose of this formula is to allocate the percentage of proceeds attributable to the period of ownership before valuation date.

The above proceeds are then used in the following formula:

Y = B + [(P -B) x N/(T+N))]

= (400 000 + 10 000 000) + [(20 129 032 - (400 000 + 10 000 000)) x 20/(10 + 20))]

= R16 886 022

Therefore, the time-apportionment value as at 1 October 2001 equals R16 886 022.

The capital gain is as follows:

Proceeds	R24 000 000	
Base cost	R18 886 022	(R16 886 022 + R2 000 000)
Capital gain	R 5 113 978	

Note that where expenditure was incurred in more than one year of assessment prior to the valuation date, "N" in the above formula is limited to 20 years. In this example, 10 years WERE LOST in respect of piece of land. However, this also means that although the major portion of the allowable expenditure relates to a period shortly before the valuation date, this too is spread back to the date of the first allowable expense forming the base cost of the asset.

Example 2:

ABC Ltd wishes to dispose of one of its factories along with all plants used in that factory. It concludes a deal to dispose of the factory with effect from 1 October 2011 for R24 000 000.

- The factory, together with the land specifically acquired for it, were erected during 1986 at a cost of R4 000 000 and were used wholly or mainly in a process of manufacture. The building qualifies for an initial allowance of 17,5% and an annual allowance of 2%;
- Plant costing R2 000 000 was acquired on 1 October 1986 and wear and tear was allowed by the Commissioner at the rate of 10% per annum on the reducing balance;
- Additional new plant costing R3 000 000 was acquired on 1 October 1989 and was written off over 3 years for income tax purposes;
- Additional plant costing R5 000 000 was acquired on 1 October 2008 and was written off over 5 years for income tax purposes.

The company's year-end is 31 December. No valuation was carried out on 1 October 2001 and the company elected the time-apportionment basis to determine the capital gain.

Factory building

Cost	R4 000 000
Initial allowance (17.5%)	(R700 000)
Cumulative annual allowances (2%)	(R1 716 000)
Tax value as at 1 October 2011	R1 584 000
Recoupment on disposal	R 2 416 000

Plant acquired in 1986	
Cost	R2 000 000
Cumulative wear and tear	(R1 870 778)
Tax value as at 1 October 2011	R129 220
Recoupment on disposal	R1 870 778
Plant acquired in 1989	
Cost	R3 000 000
Cumulative wear and tear	(R 3 000 000)
Tax value as at 1 October 2011	R nil
Recoupment on disposal	R3 000 000
Plant acquired in 2008	
Cost	R5 000 000
Cumulative wear and tear	(R3 000 000)
Tax value as at 1 October 2011	R2 000 000
Recoupment on disposal	R3 000 000

In order to determine the proceeds for Capital Gains Tax purposes, the recoupments must be deducted from proceeds received on disposal.

Therefore, Capital Gains Tax proceeds =
R13 713 222 [24 000 000 - 2 416 000 - 1 870 778 - 3 000 000 - 3 000 000]

As the amount of expenditure allowable was incurred in more than one year of assessment, the proceeds to be used in the time-apportionment base cost must be determined according toaccording to the formula -

$$P = \frac{T \times B}{(A + B)}$$

= 13 713 222 (1 584 000 + 129 220 + nil)/(1 584 000 + 129 220 + nil + 2 000 000)

= R6 308 082

The above proceeds are then used in the following formula:

$$Y = B + [(P-B) \times \frac{N}{T+N}]$$

= (1 584 000 + 129 220 +nil) + [(6 308 082 - (1 584 000 + 129 220 + nil)) x 15/(11 + 15)]

=R4 364 102

The plant acquired in 2008 for R2 000 000 was acquired after 1 October 2001 and is therefore not part of the above formula.

Therefore, the time-apportionment value as at 1 October 2001 equals R4 364 102.

The capital gain is as follows:

Proceeds	R13 713 222	
Base cost	R6 364 102	(R4 364 102 + R2 000 000)
Capital gain	R7 349 120	

5.2 SCENARIO 2: THE EXPENDITURE INCURRED ON THE ASSET CANNOT BE DETERMINED

Where the expenditure incurred before 1 October 2001 cannot be determined or is unknown, the taxpayer may adopt either one of the two methods, being:

- the valuation method (refer paragraph 5.1.1), or
- the "20% rule" (refer paragraph 5.1.2)

5.3 SCENARIO 3: PROCEEDS ON DISPOSAL DO NOT EXCEED EXPENDITURE INCURRED ON THE ASSET

If the proceeds on disposal of the asset do not exceed the expenditure incurred on acquiring/improving the asset, both before and after 1 October 2001, the seller has the option to adopt either one of the following options in determining the valuation date value of the asset, being:

- the time-apportionment method
- the valuation method

If the seller adopted the Valuation method, he must use the **lower** of the following values as the base cost:

a) The market value as determined under the "Valuation Method"
b) The base cost determined under the "Time-Apportionment Method"

However, where the expenditure incurred on acquiring/improving the asset exceeds both the proceeds from the disposal and the market value of the asset, the Valuation Date Value will be the higher of the market value or the proceeds less any capital expenditure incurred on the asset after 1 October 2001.

Example:

Assume a company acquired a business as a going concern on 1 October 1990 for R10 million and the business sold for R8 million on 1 October 2002. Business valued at R7 000 000 on 1 October 2001. Time-apportionment base cost: Y = R1 000 000 + [(R8 000 000 – R10 000 000) x 1/((11 + 1)] = R9 833 334

In calculating the capital gain, the seller was obliged to use the lower of the 1 October 2001 market value (i.e. the R7 000 000) and the R9 833 334.

However, because the expenditure exceeded the proceeds from disposal as well as the market value of the asset, the base cost was deemed to be the higher of market value on 1 October 2001, or the proceeds received less the expenditure incurred after valuation date.

The capital gain was therefore Rnil (Proceeds of R8 000 000 less deemed value of R8 000 000).

6. THE BASE COST OF AN ASSET ACQUIRED ON OR AFTER 1 OCTOBER 2001

Where an asset was acquired on or after 1 October 2001, regard must be had to the costs incurred in acquiring such an asset, together with those further costs that are regarded as part of the base cost in terms of the rules contained in the Capital Gains Tax legislation. The following base cost valuation options are available:

a) Actual cost; or
b) Time-apportionment base cost; or
c) 0% of proceeds.

The following costs will form part of the base cost of an asset acquired on or after 1 October 2001:

1. Expenditure actually incurred in respect of acquisition or creation of an asset;

2. Expenditure incurred in respect of the valuation of an asset for the purpose of determining a capital gain or loss in respect of that asset;

3. Expenditure directly related to the acquisition or disposal of an asset. These costs include the following:

   3.1 The remuneration of a surveyor, valuer, auctioneer, accountant, broker, agent, legal advisor, etc. for services rendered;
   3.2 Transfer costs;
   3.3 Stamp duty, transfer duty or similar duty;
   3.4 Advertising costs to find a seller or buyer;
   3.5 The cost of moving that asset from one location to another;
   3.6 The cost of installation of that asset, including cost of foundations and supporting structures;
   3.7 Donations tax payable by the donor or donee;
   3.8 The cost of an option that is exercised;

4. Costs of establishing, maintaining or defending legal title to or rights in an asset;

5. Expenditure actually incurred in effecting an improvement or enhancement to the asset, provided that improvement or enhancement is still reflected in the state or nature of that asset at the time of its disposal;

6. Certain holding costs of assets that are used wholly and exclusively for business purposes, shares listed on a recognised stock exchange or an interest in a unit portfolio. These holding costs are as follows:

   6.1 Repairs & maintenance; insurance, protection;
   6.2 Rates & taxes on immovable property;
   6.3 Interest on loans used to directly finance the cost of acquiring an asset and any improvements thereto (in the case of listed shares and unit trusts, only one-third of the above expenditure may be added to the base cost).

7. Where, after the termination of a lease, a recoupment is included in the lessee's taxable income as a result of the acquisition of the leased asset, the amount of the recoupment;

8. Where the acquisition of an asset gives rise to a taxable fringe benefit, the amount of that fringe benefit, provided the amount has not already been included in the cost of acquisition;

9. As far as controlled foreign entities (CFE) are concerned, the net income of that CFE, which has been included in the income of the South African resident shareholder less any dividend distributed by that CFE, which are not taxed as it has or will be included in the income of the shareholder in terms of the CFE provisions;

10. Where an asset was acquired by exercise after 1 October 2001 of an option acquired prior to 1 October 2001, the valuation date value of that option;

11. In the situation where an option to acquire shares is exercised, the amount of a section 8A gain.

Amounts not to be included in base cost

The following amounts must be excluded from the calculation of base cost:

(i) borrowing costs, including any interest and raising fees (other than the costs discussed in 6.3 above);

(ii) expenditure on repairs, maintenance, insurance, protection, rates & taxes, etc. (other than the costs discussed in 6.1 and 6.2 above).

Deductions from base cost

The base cost of an asset must be reduced by any amount included in such base cost if the amount –

(a) is or was allowable as a deduction for income tax purposes (before the inclusion of a taxable capital gain);

(b) it has not been paid and is not due and payable in a year of assessment; or

(c) it has been recovered from any other person.

7. CONCLUSION

The importance of valuations has increased dramatically with the implementation of Capital Gains Tax on 1 October 2001. Taxpayers need to measure the financial wealth of their businesses and personal assets. In making an objective contribution to the determination of market value where the taxpayer is unsure of a fair price, valuation is the answer.

The following diagrams illustrate how "valuation" interfaces with the various capital gain scenarios and base cost options (Hendrikse & Hendrikse, 2002:12-16):

DIAGRAM 1 CAPITAL GAINS TAX

PROCEEDS

Less

BASE COST

=

Capital gain
Capital loss

DIAGRAM 2 DISPOSAL OF ASSETS ACQUIRED BEFORE 1 OCTOBER 2001

Proceeds ← Market value applies in relation to specified disposals and deemed disposals

Less

Base Cost ← Valuation date **Plus** qualifying subsequent cost

=

Capital gain
Capital loss

DIAGRAM 3 DISPOSAL OF ASSETS ACQUIRED AFTER 1 OCTOBER 2001

Proceeds ← Market value applies in relation to specified disposals and deemed disposals

Less

Base Cost ← Actual costs

=

Capital gain
Capital loss

DIAGRAM 4 MECHANICS OF CAPITAL GAINS TAX

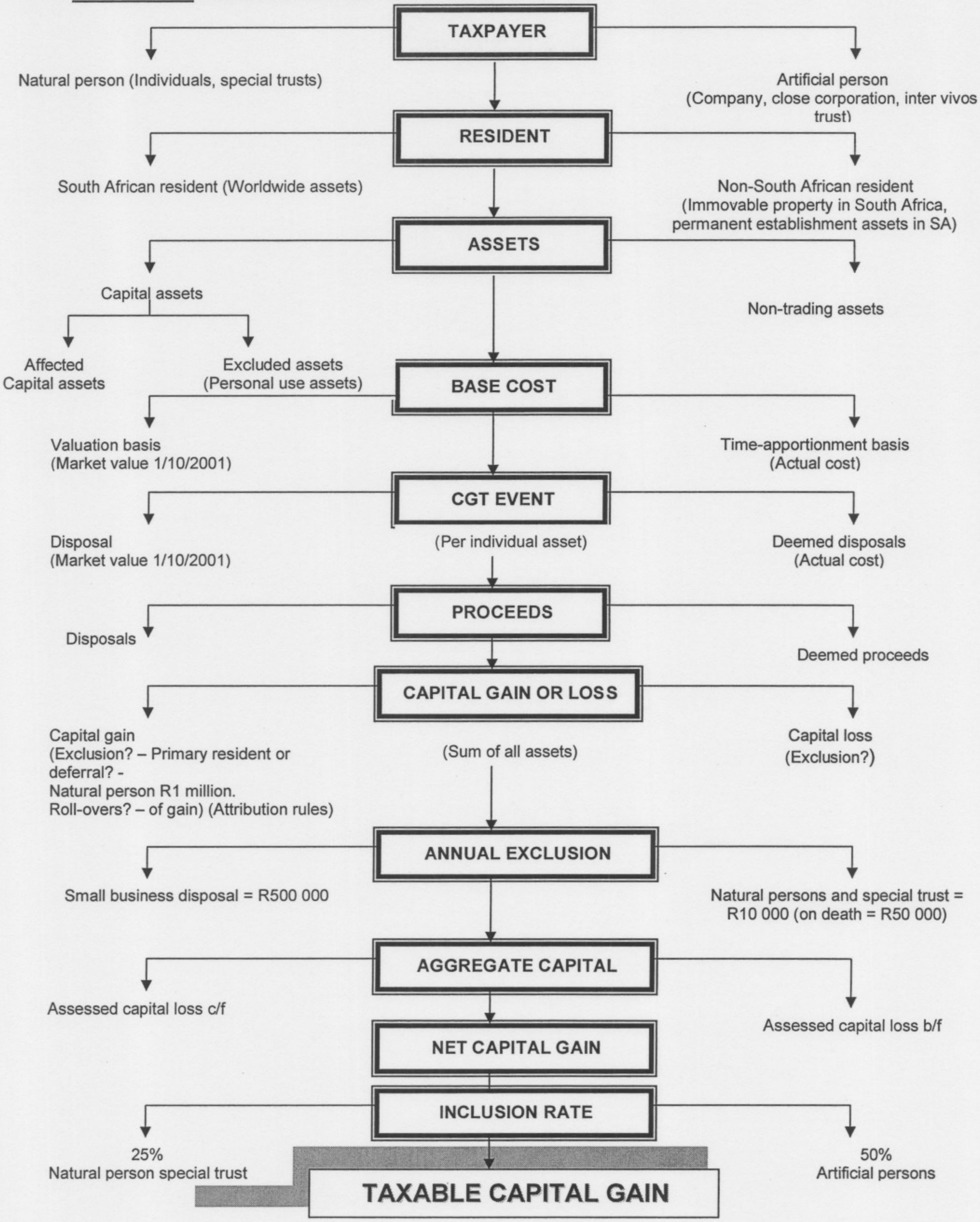
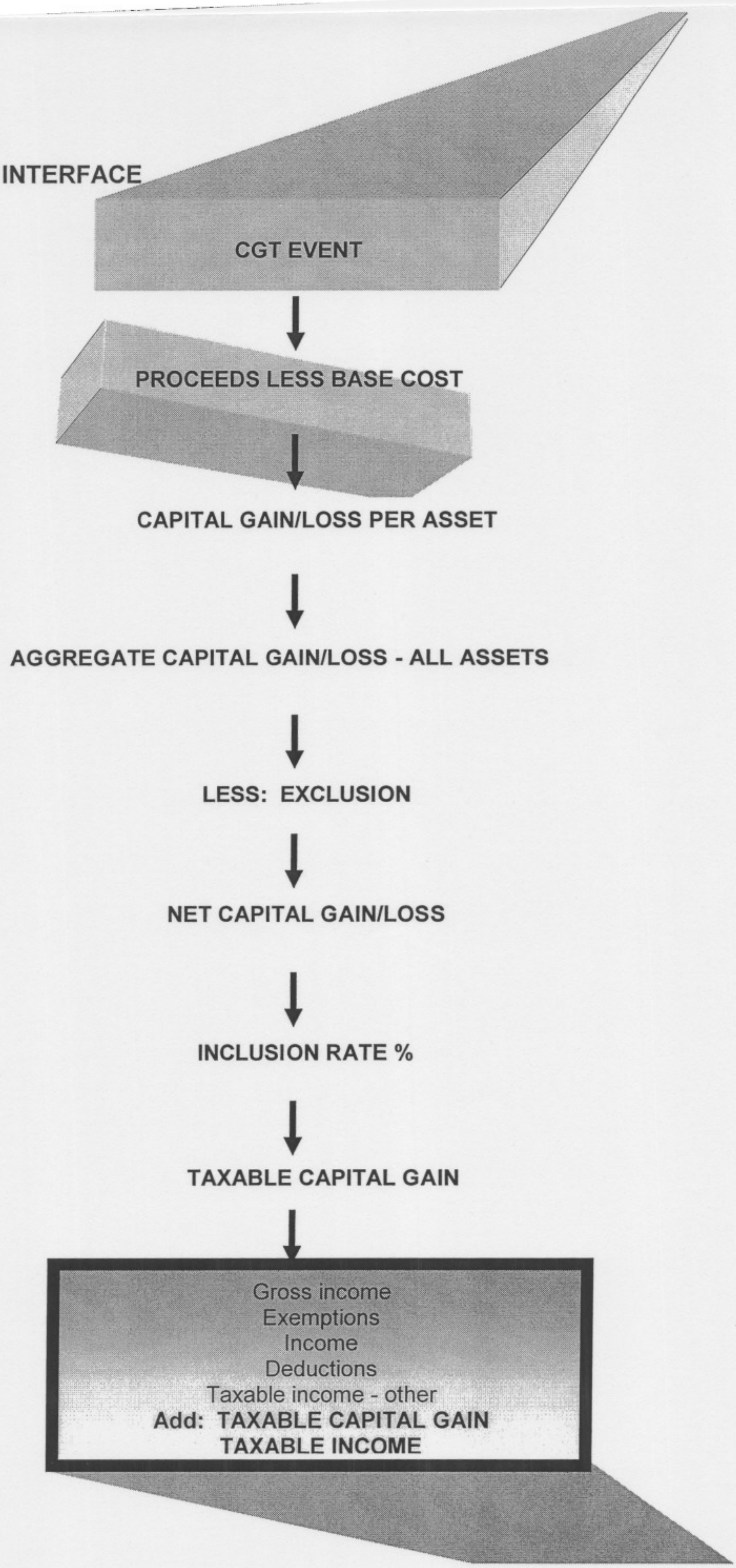


DIAGRAM 5:

CAPITAL GAINS TAX INTERFACE



CHAPTER 4

DIFFERENT ENTITIES

1. INTRODUCTION

For the next few years after implementing Capital Gains Tax, taxpayers in South Africa can expect some difficulties as they attempt to master the new tax system. The most important factor that should be dealt with from the beginning is the correct valuing of assets. It is also very important to keep detailed records of all transaction regarding the purchase or sale of assets. One should always keep in mind that tax is applied differently to different assets and entities. It is therefore necessary to look at all the different possibilities and entities before acquiring a new asset.

The differences between individuals and statutory entities can be summarised as follows:

CAPITAL GAINS TAX IMPLICATIONS	INDIVIDUALS AND SPECIAL TRUSTS*	TRUSTS	STATUTORY ENTITIES COMPANIES AND CCs
CAPITAL GAIN	R50 000	R50 000	R50 000
EXCLUSION	R10 000 p.a. (R50 000 if taxpayer dies during the year)	N/A	N/A
INCLUSION RATE	25%	50%	50%
TAXABLE GAIN	R10 000	R25 000	R25 000
TAX RATE	Variable: Max 42%	32% to 42%	Fixed: 30%
EFFECTIVE CAPITAL GAINS TAX RATE	Maximum 10.5%	16% to 21%	15%
FURTHER TAX			12.5% on any dividends or distributions

***Note:** a special trust is one that has been created solely for the benefit of a mentally ill person or a person who suffers from any serious physical disability, in cases where the mental illness or disability prevents the person from maintaining himself/herself.

The aim of the next paragraph is to discuss the effect of capital gains tax on the individual.

2. NATURAL PERSONS

For most people, their primary residence is by far the most valuable asset they will ever own. Some of them also have a second property in the form of a holiday home. According to Matthew Lester, a professor at Rhodes University (Personal Finance, 2001:46), the first thing to remember in dealing with property is not to make Capital Gains Tax decisions before anything else. The second is not to over-react to the effect of the tax on your current property holdings. For natural persons there are several issues that have to be taken into account before making a decision:

- Capital gains on primary residence are tax free up to a gain of R1 million made on the value of the property after October 1.
- To qualify for the full exemption, the property must be less than 2 hectares in size.
- If the property is bigger than 2 hectares, the excess portion will be subject to Capital Gains Tax on disposal.
- The property must be registered in your name or your spouse's name in order to qualify for the R1 million exemption.
- You or your spouse must ordinarily reside in or on the property.
- The property must be used mainly for domestic purposes.
- A natural person does not qualify for the exemption if his property, even if it is his primary residence, is registered in the name of a company, close corporation or trust. The Receiver has given special permission to transfer such assets (registered before April 5, 2001) to your own name without paying transfer cost if the transfer had taken place before October 1, 2003. There are, however, other fees payable such as legal fees, bond

registrations and negotiation fees. One should also keep in mind the reasons why the property was registered in a trust or company's name in the first place, such as:

- your estate will be liable to pay 20% estate duty when you die; and
- if the R1 million is not linked to inflation, it will become less beneficial over the years.

- When more than one person (a couple) own a property that is their primary residence, the R1 million exemption is apportioned between the two on disposal of the property.
- Spouses cannot claim two properties simultaneously as primary residence, sell it when they retire and get the R1 million exemption. When they eventually sell their retirement property (at that stage their primary residence) they will qualify again for the R1 million exemption. This exemption will not apply to the portion of the capital gain on the holiday home that relates to the period when it was not their primary residence.

For example, if you owned the property for 20 years, but only for 12 years as primary residence, and on disposal make a capital gain of R2 million, the Capital Gains Tax will be calculated as follows:

$$\frac{12}{20} = 60\%$$

60% x R2 million = R1 200 000

R1 200 000 – R1 000 000 = R200 000

The R200 000 is subject to Capital Gains Tax.

Plus the rental income, for example, if the house was rented out for the period in which it was not the primary residence, the rental income must be added to the R200 000 and the total is then subject to Capital Gains Tax.

- In the case where a new primary residence is bought before the old one is disposed of, the taxpayer has a two year time period to dispose of the old asset before the disposal will have a Capital Gains Tax implication.

- Using part of your primary residence as offices will have a definite Capital Gains Tax implication.

For example, if 10% of your primary residence was used for office space and on disposal the capital gain equals R1,5 million: 10% x R1,5 million = R150 000 R1,5 million – R150 000 = R1 350 000 The R1 million exemption can be used against the R1 350 000. Therefore only the R350 000 + R150 000 is subject to Capital Gains Tax.

It is advisable to have a property valued as at October 1, 2001. (This value is called the base cost). The three methods of the base cost that can be used can be summarised as follows:

METHOD 1: MARKET VALUATION

Legislation does not prescribe how a valuation should be done, but the onus is on the taxpayer to justify the amount that is used as base cost. Although it is less likely that there will be problems if a sworn appraiser is used, it can be an expensive exercise. This method should be considered where a capital asset was acquired within three years prior to October 1, 2001, and there had been a substantial increase in the value of the asset up to October 1, 2001. The valuation can either be performed by an estate agent or personally by using the original purchase price plus the cost of all the improvements (of which the proof must be available), plus property inflation for the period before October 1. Proof of valuations on similar property in the area must also be collected, for example, newspaper advertisements and other sale agreements. Legislation also requires that proof of the valuations must be submitted with the tax return in the year in which the asset is disposed of.

METHOD 2: TIME APPORTIONMENT

By using this method the capital gain is calculated by apportioning the entire capital gain between the number of years the capital asset was held before October 1, 2001 and the number of years it was held thereafter. In other words, the valuation is calculated on the disposal date of the asset. This method is advisable if you owned the property long before October 1, 2001. The longer the property is owned, the lower the effective rate of Capital Gains Tax that will be applied on the total difference between original price plus improvements and the sales price. The following table can be used for quick reference:

EFFECTIVE RATE OF CAPITAL GAINS TAX WITH TIME APPORTIONMENT											
		DATE SOLD									
DATE ACQUIRED		2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
	1981	0.00	0.53	1.05	1.58	2.10	2.63	3.15	3.68	4.20	4.73
	1982	0.00	0.53	1.05	1.58	2.10	2.63	3.15	3.68	4.20	4.73
	1983	0.00	0.55	1.11	1.58	2.10	2.63	3.15	3.68	4.20	4.73
	1984	0.00	0.58		1.58	2.10	2.63	3.15	3.68	4.20	4.73
	1985	0.00	0.62	1.17	1.66	2.10	2.63	3.15	3.68	4.20	4.73
	1986	0.00	0.66	1.24	1.75	2.21	2.63	3.15	3.68	4.20	4.73
	1987	0.00	0.70	1.31	1.85	2.33	2.76	3.15	3.68	4.20	4.73
	1988	0.00	0.75	1.40	1.97	2.47	2.92	3.32	3.68	4.20	4.73
	1989	0.00	0.81	1.50	2.10	2.63	3.09	3.50	3.87	4.20	4.73
	1990	0.00	0.88	1.62	2.25	2.80	3.28	3.71	4.08	4.42	4.73
	1991	0.00	0.95	1.75	2.42	3.00	3.50	3.94	4.32	4.67	4.97
	1992	0.00	1.05	1.91	2.63	3.23	3.75	4.20	4.59	4.94	5.25
	1993	0.00	1.17	2.10	2.86	3.50	4.04	4.50	4.90	5.25	5.56
	1994	0.00	1.31	2.33	3.15	3.82	4.38	4.85	5.25	5.60	5.91
	1995	0.00	1.50	2.63	3.50	4.20	4.77	5.25	5.65	6.00	6.30
	1996	0.00	1.75	3.00	3.94	4.67	5.25	5.73	6.13	6.46	6.75
	1997	0.00	2.10	3.50	4.50	5.25	5.83	6.30	6.68	7.00	7.27
	1998	0.00	2.63	4.20	5.25	6.00	6.56	7.00	7.35	7.64	7.88
	1999	0.00	3.50	5.25	6.30	7.00	7.50	7.88	8.17	8.40	8.59
	2000	0.00	5.25	7.00	7.88	8.40	8.75	9.00	9.19	9.33	9.45

(Mellet, 2001:19)

The following example explains the time apportionment method:

An asset was acquired on October 1, 1991 and the owner disposed of it on October 1, 2005. The proceeds equal R1 000 000.

Proceeds from disposal	R1 000 000
Less: Acquisition cost	(R200 000)
Less: Improvements	(R200 000)
Capital Gain	R600 000

Apportionment:

The asset was held for 14 years

$$\frac{\text{Capital Gain}}{\text{Total years}}$$

$$= \frac{\text{R600 000}}{\text{14 years}}$$

= R42 857

Taxable amount:

R42 857 x number of years after 1 October, 2001

= R42 857 x 4

= R171 428

The Base cost:

= Disposal Value Less Taxable amount

= R1 000 000 – R171 428

=R828 572 (Base cost on October 1, 2001)

Note: The maximum number of years allowed for the period before October 1, 2001 is 20 years.

METHOD 3: THE 20% CALCULATION

In the case where little or no records are kept regarding the acquisition of an asset acquired before October 1, 2001, or if the market valuation method was not used, this method could be used. However, this could prove to be costly. When using this method, 20% of the proceeds from the disposal of an asset, less improvements after October 1, 2001, equals the base cost. The actual disposal date is not taken into account. In effect, this method creates an 80% capital gain and it is therefore preferable to use the market value method in most cases.

Example of the 20% calculation method:

Proceeds from disposal	R1 000 000
Less: Improvements after October 1	(R200 000)
	R800 000
Less: Base cost (20% x 800 000)	(R160 000)
Capital gain subject to Capital Gains Tax	R640 000

In reaching a final decision on the valuation method to be used, it is best to keep all options open and decide which method gives the most favourable Capital Gains Tax rate, but it is important that a decision had to be made before February 2003.

Calculating the actual capital gain or loss

The Capital Gains Tax effect of an asset will depend on the date acquired. To ascertain the capital gain or loss of an asset, two calculations are applicable:

1. Assets acquired before October 1, 2001; and
2. Assets acquired after October 1, 2001.

Before October	**After October**
Disposal Price	Disposal price
Less: Base Price (October 1)	Less: Acquisition price
Less: Improvements	Less: Improvements
Capital Gain/Loss	Capital Gain/Loss

Note: The total of all capital losses in any one tax year must be subtracted from the total of all capital gains. If an overall loss is made it must be carried over to the next year. If an overall gain is made the R10 000 exemption must be subtracted. Also keep in mind that a loss cannot be created with the exemption. It is important to remember that the annual exemption of R10 000 reduces both gains and losses. If the total sum of gains and losses equals a loss of R12 000, only R2 000 can be carried over to the next year. If the overall loss is R7 000, it would be reduced to zero.

Tax Rates

There is no standard rate for Capital Gains Tax. The rates that should be applied is the income tax rate of the taxpayer or person in question. The current inclusion rate for natural persons is 25% on the calculated capital gain. The taxable capital gain is finally added to normal taxable income. The different tax rates appear to favour holding assets in your own name rather than in a trust or company, but you should consider the other non-tax reasons, for example, Estate duty, for holding assets in a trust or company before transferring assets to your own name. Keep proper records of all the capital transactions, including transactions regarding your primary residence, i.e. date and purchase price, date and price of improvements, base cost on October 1, 2001 and date and price of disposal.

Estate planning

With the introduction of Capital Gains Tax it is now more important than ever to plan and structure estates. Because Capital Gains Tax and estate duty are payable, the taxpayer needs to ensure that his estate has the resources to pay all the taxes. Although the rate of estate duty has been reduced from 25% to 20% and the abatement on assets of R1,5 million is still applicable, the taxpayer still has the Capital Gains Tax burden to recon with. When planning estates it will be advisable to keep the following in mind:

- While Capital Gains Tax is calculated on the growth of the assets, estate duty is calculated on net assets (assets less liabilities).
- At the time of the taxpayer's death, all assets will be considered to be disposed of to the estate at market value i.e.
- Capital Gain or Loss = market value less base cost.
- Rate of Capital Gains Tax for estates = 25%; maximum effective rate = 10,5%.
- Estates are treated as natural persons. The capital gain or loss of an estate is subject to Capital Gains Tax of 25%. However, if an asset is transferred to an heir (at market value), no Capital Gains Tax arises, as the heir is deemed to have acquired the asset equal to its base cost. If, for example, the executor of an estate disposes of both shares and unit trust to heirs at market value, no Capital Gains Tax is due. However, if he sells assets for R1,3 million and the estate is liable for Capital Gains Tax at a marginal rate of 32% the following Capital Gains Tax will become payable:

Disposal value	R	1 300 000
Less market value	R	1 000 000
	R	300 000
25% Capital Gains Tax rate	R	75 000
Capital Gains Tax payable @ 32% marginal rate	R	17 660

Therefore, in most cases it would be better to dispose of an asset to a beneficiary rather than to sell it.

3. TRUSTS

As we are all aware of, a trust has become an important business entity over the past few years. Because all assets are subject to estate duty, it effectively distribution, the trust is liable for the tax. In the event where an asset is distributed by the trustees to a beneficiary (base cost = market value), a Capital Gains Tax event is created in the hands of the trust. Michael Stein says in a Momentum Wealth publication on the principles and planning of Capital Gains Tax, that you need to take extra care with the wording of a trust deed when choosing between a vesting or a discretionary trust, and trustees should be empowered to vest assets or rights in local beneficiaries at their discretion because an individual pays a lower tax rate than a trust and qualifies for R10 000 annual exemption, the trustees can then be assured that the beneficiary and not the trust pays the tax.

Types of Trusts

The rate of Capital Gains Tax depends on the type of trust. There are three types of trust, i.e. intervivos, testamentary and special trusts. The intervivo trust is also known as the living or asset protection trust and is created during a person's lifetime for various reasons such as protecting assets, separating personal and business affairs and planning and structuring of estates. Because of the continuity, independent of death, all assets are transferred to the trust. The assets are therefore not subject to estate duty when the person dies.

Testamentary trusts are known as will trusts and are more or less similar to the intervivos trusts. Where the intervivos trusts are set up during the person's lifetime, the testamentary trust is set up in terms of a person' s will when he or she dies. The purpose of this type of trust is to ensure that the children or dependants are properly cared for after the person passed away. As stated in chapter 1, special trusts are treated as an individual with the most favourable effective tax rate. They are established for physically or mentally ill people who are unable to earn a normal living and can be either intervivos or testamentary trusts. In the case of individuals, a disposal triggers a Capital Gains Tax event, but for trusts there are two additional events that are also considered to be a disposal. Every time a trust sells a property, even if it is a primary residence and every time they change a beneficiary, a Capital Gains Tax event is triggered.

Capital Gains Tax can affect different assets in different ways. Although the first R1 million in profit on the sale of a primary residence is exempt for natural persons, this is not the case for trusts. Trusts pay income tax at 32% on income up to R100 000 and 42% on income above R100 000.
Capital Gains Tax is assessed on 50% of the capital gain resulting in an effective rate of between 16% and 21%. If a property was registered in the name of a company, close corporation or a trust before April 5, 2001, SARS has given a special dispensation to transfer the property into a natural person's name without paying the transfer duty or Capital Gains Tax if the transfer had been completed before October 1, 2003.

Advantages for using a trust

After the implementation of Capital Gains Tax, people tended to steer away from trusts merely because of the higher Capital Gains Tax rate. What we should rather do is to take into account the main reasons and advantages for using a trust, which are as follows:

- Estate duty savings at death;
- Preservation of assets after death;
- Ongoing management of assets prevents losses by selling in unfavourable conditions;
- Protection of assets from personal creditors;
- Safeguarding of assets until beneficiaries (children) are old enough to spend the money wisely and in the case of a spouse, protection against second marriage spenders;
- Tax liability can be reduced by splitting income from a trust between a couple. In the case where one spouse's marginal rate is 40% and the other's is 32%, the income from the trust would rather be given to the spouse with the lower marginal rate;
- Beneficiaries receive all the benefits immediately. Where assets are not held in a trust, benefits to beneficiaries can be delayed for a long time when an estate is wound up. A trust can avoid many of the complications;

- Trusts are useful when dividing assets such as farms or businesses between heirs;
- When a professional trustee is appointed, beneficiaries will be treated equally without favouring one as so many times happen when the trustee is one of the family;
- When a natural person dies, his will becomes a public document. This is not the case with a trust where all information remains confidential;
- Trusts provide wider choices and flexibility if tax, political or economical situations change;
- Trusts generate cost savings in respect of legal fees and expenses of an estate.

4. COMPANIES AND CLOSE CORPORATIONS

In the past, one of the main reasons for setting up Companies and Close Corporations was to keep investments in a different entity rather than in your own name and so avoid the incurrence of tax liabilities. Before the introduction of Capital Gains Tax, this might have been a good strategy – keeping capital profits tax free, but it is certainly not the case anymore. The aspects regarding the liability of Companies regarding Capital Gains Tax in respect of dividends and shares are discussed in the following paragraphs.

Dividends

Because companies have already paid tax on their earnings, dividends in shares of local companies are not subject to Capital Gains Tax and income tax. Certain foreign companies, however, are not paying tax in South Africa, therefore those dividends are subject to income tax but not Capital Gains Tax. However, Capital Gains Tax on shares and other financial instruments are more complicated.

Shares

Shares and other financial instruments listed on a recognised exchange in the Republic must be valued according to one of the following three choices:

- Average price on October 1, 2001: This method is used where the base cost of the shares are calculated using the last five trading days before October 1, 2001 and dividing the price by the number of shares traded to give a weighted average price. The weighted average price will be compared with the ruling prices for the first 14 trading days in September: A definition of the "ruling price" of a listed financial instrument is used in a number of subparagraphs in the Act instead of the phrase "last price quoted". The maximum variation allowed is 5% after which SARS have the power to adjust the price. There are many potential problems arising from this calculation. For example, say a taxpayer bought shares before October 1, 2001 and the average price then was lower than what you paid, this lowers the base value. If the taxpayer sold the shares at a lower price than what he bought it for, but at a higher price than the average price on October 1, a theoretical capital gain was made, but in actual fact it was a loss. In situations like these, SARS agreed that the loss or gain could be set to zero, the so-called "limitation of losses".
- For the proportional calculation, applicable to shares bought before October 1, 2001 and sold afterwards, the capital gain can be apportioned over the full period. For example:

Shares were bought on October 1, 1997 for R20 000 and the base value on October 1, 2001 was R30 000.

Purchase price	R20 000
Base cost October 1, 2001	R30 000
Selling price October 1, 2010	R50 000
Capital Gain	R30 000

The total period = 13 years and 9 years after October 1, 2001.

$\therefore$ Taxable Capital gain =

$$\frac{\text{Capital gain over full period}}{\text{Number of years}} \text{x number of years after October 1, 2001}$$

$$\therefore \frac{R30\,000}{13} x\, 9$$

= R20 769

- The 20% calculation: This calculation is used when no documents of the original price are available.
  Taxable Capital Gain = 20% of proceeds

Speculation

SARS is watching closely on the issue of income-generating speculation of shares. The general five year rule is applied by most tax consultants (a9b). If a taxpayer holds the shares for five or more years the proceeds are deemed to be of capital nature (9B). Although taxpayers neglected to give all the information regarding the trading of shares in the past, SARS now demands the following information, not only from taxpayers, but from anyone who administers a portfolio of shares:

- Name, identification number and address;
- The number of shares you disposed of;
- October 1, 2001, valuation;
- The cost of the shares acquired on or after October 1, 2001;
- The proceeds received from any disposal; and
- The amount of the capital gain made.

However you look at it, the onus is still on the taxpayer to prove that he is not share dealing.

Sale of businesses

Deborah Tickle (2001:63-64), tax partner at KPMG says, "Owners of small businesses have been given a special dispensation when they sell their businesses to retire. This is because many small business owners build up retirement capital in their businesses.

It does not matter whether the small business is held directly or whether it is a company, close corporation or partnership. The gain or loss on the business is disregarded under the following conditions:

- The market value of the assets of the business does not exceed R5 million;
- You hold at least 10 percent of the share capital;
- You have been involved in the operations of the company;
- You have held ownership or shares for at least five years;
- When you sell, you are at least 55 years old or in ill-health and unable to continue with the business;
- Your estate receives the benefit if you die;
- You do not exceed a total exemption from Capital Gains Tax of R500 000 in your life time.

The dispensation can expire if you buy and sell a number of businesses:

- All such gains must be realised within two years of the first disposal; and
- If you are selling more than one business, the total amount cannot exceed R5 million".

As in the case of other entities, it is advisable to place an individual value on all the investments in the company or close corporation as at October 1, 2001. The option to use this actual value as the "base cost" appears to be the better option when comparing with the apportionment method where the equal rate of growth in the value of the asset over the period is used. Capital Gains Tax must not be taken lightly; seek professional advice and make sure that all implications are taken into consideration before taking any actions at all.

CHAPTER 5

ANTI-AVOIDANCE MEASURES

"... The announcement that capital gains tax (CGT) would be introduced this year was greeted by a chorus of disapproval from taxpayers. The reasons for the discontent were many and varied, ranging from the simple fact that people don't like change, to the fear that we would, in future, need doctorates to be able to complete our income tax returns.

The timing of the arrival of Capital Gains Tax, a sophisticated First World tax, into an emerging market with stagnant economic growth is, in my opinion, inappropriate. Earlier this year, Allan Greenspan, chairman of the United States Federal Reserve, said he felt Capital Gains Tax should be set at zero, and the new US administration has introduced tax cuts in order to stimulate the economy. The political pressure to implement a tax that will raise relatively little additional revenue, but dramatically hinder economic growth and job creation, must have been very great indeed.

In a country with such a wide gulf between rich and poor, it stands to reason that the "haves" must carry a heavier load until the disparities of the past have been erased, but it would have been preferable if other avenues had been found.

Capital Gains Tax has massive implications for the economy in general and investors in particular. As far as the "big picture" is concerned, Capital Gains Tax will solidify the economy, discouraging investment and resulting in the sub-optimal allocation of resources, as people reassess their willingness to buy and sell assets. It is common cause that the new tax will raise relatively modest sums, but the huge complexity of the legislation will result in massive policing costs for the South African Revenue Service as well as additional compliance costs to taxpayers and business in general ..." (Sylvester, 2001:67).

In light of the above, taxpayers will, now more than ever, seek ways of arranging their business and personal affairs in such a way that they postpone their liability or escape tax completely. It is important to distinguish between tax avoidance and tax evasion. Where tax avoidance connotes stratagems, which are lawful unless specifically proscribed by the Act, tax evasion connotes inherently unlawful methods, for example, the non-disclosure of income or exaggeration of expenses in income tax returns. However, a taxpayer has no obligation to pay a greater tax than is legally due.

This principle is clearly brought out by the following extract from the judgment of Lord Tomlin in *Duke of Westminister v IRC* (1953) (at 520):

"...Every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, however unappreciative the Commissioners of Inland Revenue or his fellow-taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax ..."

The anti-avoidance provisions fall into two categories:

- specific anti-avoidance provisions which apply to specific transactions (ss 7(3) – (6) and the 7th Schedule); and
- a general anti-avoidance provision namely s 103(1).

Specific anti-avoidance provisions

- Sale and Leaseback arrangements – s23G have been used frequently in the past to avoid tax mainly by involving a party that is not liable for tax under the Act. For example, a local authority can obtain long-term finance via a sale and leaseback of assets rather than borrowing the money from a bank. The financier, who purchases the assets, can claim wear and tear and depreciation and pass on some tax savings to the tax-exempt body by charging lower interest and finance charges. On the 5th of June 1997 section 23G was introduced as an anti-avoidance provision, which states that the lessor or lessee in a sale and leaseback arrangement is exempt from tax. The provisions of s 103 (1) may be applied to a capital gain where the requirements of the section are met. The assessed loss anti-avoidance provisions of s 103 (2) have been extended to deal with the utilisation of an assessed loss, capital loss or assessed capital loss against a "tainted" capital gain. The section deals with such capital gains in much the same way as the existing law deals with tainted income that has been sought to be set off against an assessed loss. The set-off of the offending capital gain is disregarded, meaning in effect that the assessed loss, capital loss or assessed capital loss is ring-fenced and only available for set-off against untainted capital gains. (SARS, 2003:215).

- Par. C in section 1 deals with receipts or accruals for services rendered by another person.
- Section 7(2) – (10) deals with income derived by a person as a result of a donation by another person.
- Section 8E deems certain dividend accruals to be interest.
- Section 22(8) deals with the donation of private consumption of trading stock.
- Section 54 to 64 deals with donations tax.
- Section 103(1) deals with transactions, operations or schemes to avoid tax.

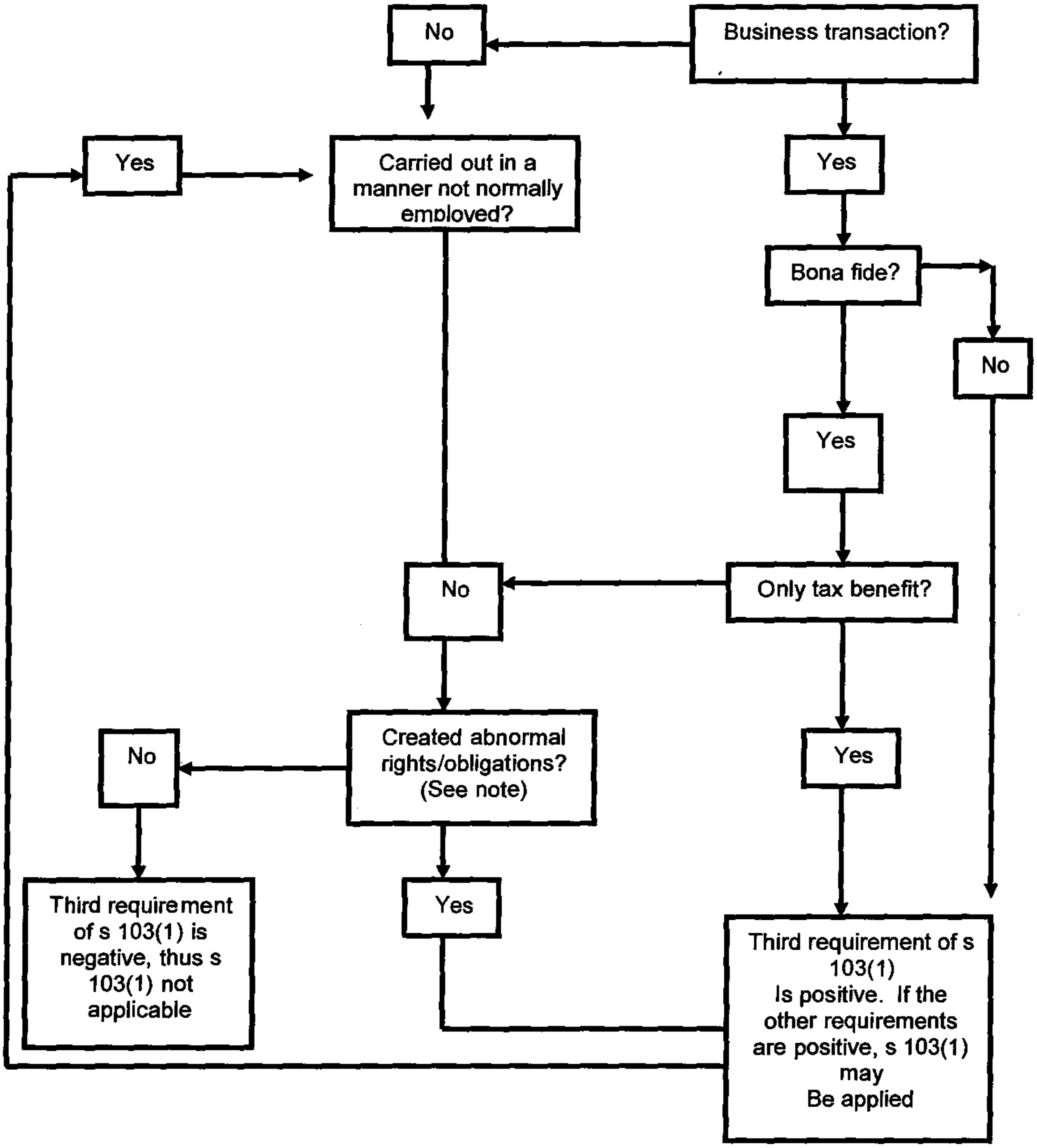
The following requirements must be present simultaneously in order to apply this section:

- A transaction, operation or scheme has been entered into or has been carried out.
- This transaction must have had the effect of avoiding, reducing or postponing an income, secondary or donations tax liability.
- The bona fide business purpose test or abnormality test and abnormal rights test as illustrated below:

DECISION TREE FOR THE APPLICATION OF SECTION 103(1)(b)

THE BONA FIDE BUSINESS PURPOSE/ABNORMALITY/ABNORMAL RIGHTS REQUIREMENT

(Requirement no. 3 in terms of s 103(1)(b))



Note

It is important to note that this third test can only be negative if the answer to "created abnormal rights/obligations" is "no". Whether a transaction is a business or non-business transaction, in order to avoid the third test being positive, the transaction should not create any abnormal rights or obligations.

(Silke, 2002:474)

- The transaction was carried out mainly for the purpose of obtaining a tax benefit.

- Section 103(2) Assessed losses of companies:

  This section was introduced to specifically avoid the trafficking in assessed losses of companies whenever

  "the Commissioner is satisfied that

  (a) any agreement affecting any company or trust; or if

  (b) any change in

  (i) the shareholding in any company; or

  (ii) in the members' interest in any company which is a close corporation; or

  (iii) the trustees or beneficiaries of any trust,

  as direct or indirect result of which

  (A) income has been received by or has accrued to that company or trust during any year of assessment, or

  (B) any proceeds received by or accrued to or deemed to have been received by or to have accrued to that company or trust in consequence of the disposal of any asset, as contemplated in the Eighth Schedule, resulting in a capital gain during any year of assessment,

  has at any time been entered into or effected by any person solely or mainly for the purpose of utilising any assessed loss, any balance of assessed loss, any capital loss or any assessed capital loss, as the case may be, incurred by the company or trust, in order to avoid liability on the part of that company or trust or any other person for the payment of any tax, duty or levy or levy on income, or to reduce the amount thereof -

  (aa) the set-off of any such assessed loss or balance of assessed loss against any such income shall be disallowed;

  (bb) the set-off of any such assessed loss or balance of assessed loss *against any taxable* capital gain, shall be disallowed; or (cc) the set-off of such capital gain or assessed capital loss against such capital gain shall be disallowed".

- Section 103(s). Interest - dividend swaps:
  This section is effective from 22 December 1988 and in form S 103(1) in 2 important aspects. Neither objective abnormality nor a subject tax avoidance purpose is required, and the power of the Commissioner is limited to "annihilation" of the offending transaction.

CONCLUSION

There is no difference between tax fraud and any other kind of fraud. Basically, it requires misrepresentation to harm other parties. Socially and politically, tax fraud is not only harming the state, but also all of the inhabitants of that state who are the consumers of all the goods and services. Ironically it is the middle and lower-income groups who suffer most as a result of the wealthy individuals and the corporate sectors who are the major beneficiaries of tax avoidance stratagems.
In the past this imbalance was enhanced in countries such as South Africa, which had no capital gains tax.

Economically, tax avoidance is not only harmful to the national economy, but also hinders contributions to the national product. The easiest way to stay out of trouble is never ever to buy or sell assets in a related-party transaction at a cent more or less than true market value and to stay clear of tax avoidance schemes.

CHAPTER 6

CONCLUSION

Capital Gains tax has, in spite of all the negative predictions, become a reality. For the next few years taxpayers can expect hassles as they attempt to master the new taxation system. It is of the utmost importance that assets should be valued correctly and proper records of all transactions must be kept if taxpayers want to avoid paying more than they should. This is, however, not where the complexity stops. Taxpayers need to be aware that the tax is applied differently to different assets and different rates applied to different entities.

Because Capital Gains Tax is not a stand-alone tax, but has been incorporated into the existing income tax system, the amount payable is determined to a large extent by the current rate at which the taxpayer's income is taxed. According to Cameron, (Cameron, 2001:40) SARS has not yet considered all the many aspects of asset acquisition and disposals and will have to make rulings as it goes along, resulting in on-going changes to the laws and rulings affecting the new tax. It is important not to make investment decisions based on tax considerations alone. If you do, you could significantly undermine your potential to make sound investment returns on your savings. Trevor Manual, the Minister of Finance, said when he first mooted Capital Gains Tax, that it is intended as a gatekeeper tax to prevent people from converting taxable income into capital gains and thereby avoiding paying tax. However, it has also become obvious that Capital Gains Tax will have at least one upside for people who diligently pay taxes – it will help trap many people who are evading tax altogether.

The advantage of this is that the more taxpayers there are, the less everyone can expect to pay.

"... Initial rates for Capital Gains Tax have been set comparatively low, so there are still opportunities for what is called tax arbitrage. This means structuring your financial affairs so that you pay the lowest possible tax rate. As long as you are not breaking the law, you are entitled to do this. ..." (Cameron, 2001:40).

The massive implications of Capital Gains Tax for investors and the economy in general are undebatable. It will definitely discourage investment as taxpayers reassess their willingness to buy and sell assets. According to Sylvester (Cameron, 2001:40), the new tax system will raise relatively modest sums, but the huge complexity of legislation will result in massive policing costs for SARS as well as additional compliance cost to taxpayers and business in general. Whichever way you look at it, do your homework, keep adequate records and valuate your properties to enable compliance with the tax and do not allow Capital Gains Tax to influence your investment decisions.

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