The indexation of inflation for capital gains tax in South Africa

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ABSTRACT

This study investigates the possibility of indexing inflation on capital gains tax in South Africa. The research question asks to which extent inflation will have an effect on capital gains tax, and the study aims to answer this question by means of a comparative study between the South African and Canadian tax regimes. The benefit of this comparison lies in the fact that the Canadian tax regime provides for the indexation of inflation on capital gains tax. South African legislators should consider the differences between these tax regimes as there may be new lessons that may be learned from a Canadian perspective. The problem, however, is that no provision is made in the Income Tax Act 58 of 1952 or other legislation for the indexation of inflation on Capital gains tax in South Africa. Before recommending that the South African legislator amend current legislation to accommodate the indexation for inflation on Capital Gains Tax, inflation and its effect on the economy and investments in South Africa have to be considered.

Key terms: Capital gains tax; Inflation; Indexation of inflation; Canada, Tax regimes; Economy

DECLARATION

I, the undersigned, hereby acknowledge that the content of this thesis is my own work, except where otherwise specified, and that it has not been submitted, in part or full, to any other university for the purpose of obtaining a Master's degree.

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Signature Date

FRANCOA WILLEMSE

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LIST OF ABBREVIATIONS

CGT	Capital gains tax
CPI	Consumer Price Index
GDP	Gross domestic product
ITA	Income Tax Act
IRLE	International Review of Law and Economics
JSCOF	Joint Standing Committee on Finance
JSE	Johannesburg Stock Exchange
LCGTE	Lifetime capital gains tax exemption
NTJ	National Tax Journal
OHLJ	Osgoode Hall Law Journal
PCOF	Portfolio Committee on Finance
PSLR	Penn State Law Review
QSBC	Qualified small business corporation
SARB	South African Reserve Bank
SARS	South African Revenue Service
TLAA	Taxation Law Amendment Act 30 of 2000

Introduction and historical overview

The South African Reserve Bank[1] is the central bank of South Africa and it plays a dominant role in the regulation of all banks in South Africa.[2] The main purpose of the Reserve Bank is to protect and maintain the price stability of the Republic in the interest of balanced and sustainable economic growth.[3] One of the ways in which the SARB attempts to maintain economic growth and financial stability[4] is by applying monetary policies within an inflation-targeting framework.[5] In a modern-day world where the economy and the purchasing power of money is ever-changing, it has become a necessity for individuals to spend money more wisely and to make informed investment decisions.

In order for the government to perform its functions as set out in national, provincial and local legislation,[6] the South African Revenue Service[7] has to collect revenue from registered taxpayers. However, recent tax rate amendments[8] and corruption in South Africa infuriates many South African taxpayers. They have lost faith in SARS because the revenue money is not being used for the correct purposes.[9] It goes without saying that the pressure of the economy on individuals due to inflation is ever-present. Many South African residents are refusing to pay their rates and taxes, which could ultimately result

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1. South African Reserve Bank (hereafter referred to as SARB).
2. Sharrock *et al The Law of Banking and Payment in South Africa* 64.
3. Section 3 of *The South African Reserve Bank Act* 90 of 1989; section 224 of the *Constitution of the Republic of South Africa*, Act 108 of 1996; South African Reserve Bank 2019 https://www.resbank.co.za/Pages/default.aspx accessed 3 March 2019; Moneyweb 2019 https://www.moneyweb.co.za/moneyweb-opinion/explainer-sarb-ownership-mandate-and-independence/ accessed 3 March 2019.
4. Financial stability can be described as the absence of the macroeconomic costs of disturbances in the system of financial exchange between households, businesses and financial service firms.
5. Goodall *Investment Planning* 23.
6. This is also known as the doctrine of separation of powers (see De Waal *et al The Bill of Rights Handbook* 18).
7. South African Revenue Service (hereafter referred to as SARS).
8. *Income Tax Amendment Act* 99 of 1988; *South African Tax Guide* 2018 http://www.sataxguide.co.za/2018-budget-speech-summary/ accessed 19 February 2019.
9. The main reason why residents are frustrated is the increasing fraudulent practices. South Africa Government News Agency 2010 https://www.sanews.gov.za/business/mismanagement-funds-under-investigation accessed 4 March 2019; *Global Economic Crime and Fraud Survey* 2018 https://www.pwc.co.za/en/assets/pdf/gecs-2018.pdf accessed 4 March 2019.

in the organization of a tax revolt.[10] Most individuals also have a negative perception towards inflation. The consumer price index[11] for example, rises each year, making it difficult to save money for a family. But is inflation necessarily bad?

1.1 Structure of the study

Chapter one of this study offers a brief introduction and an overview of the historical background of capital gains tax[12], the reasons for its implementation, and the current CGT position in South Africa. Chapter two compares the CGT regimes of South Africa and Canada, as Canada has a similar CGT system with some differences. Some of the differences include that Canada provides for the indexation of inflation on CGT.[13] The differences between the two tax systems will bring about lessons that may be learned by South Africa from a Canadian perspective with regards to CGT.[14] Chapter three examines the indexation of inflation for CGT and the effects thereof on the economy. The study is concluded in Chapter four with the argument that indexing inflation on a capital gains calculation or decreasing the inclusion rate for individuals may be some of the ways to help save taxpayers money on investments and to inspire new faith in SARS.

The starting point in chapter one will be on inflation, its causes, challenges and the possible impact it has on South Africa. The study will then proceed to evaluate capital gains tax from its historical background to the reasons for its implementation. This will be reinforced by looking into the current position of capital gains tax in South Africa. Last will be the concluding summary taking into account the above-mentioned points.

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[10] A tax revolt can briefly be described as a situation where taxpayers refuse to pay taxes as a message to the government; Money web 2019 https://www.moneyweb.co.za/mymoney/moneyweb-tax/helen-zilles-tax-revolt-could-it-work/ accessed 19 February 2019.

[11] Consumer Price Index (hereafter referred to as *CPI*) is the measure of changes in the purchasing power of a currency and the rate of inflation.

[12] Capital gains tax (hereafter referred to as CGT).

[13] See Chapter 2 below; Turbo Tax Canada 2019 https://turbotax.intuit.ca/tips/changes-to-the-capital-gains-tax-6254 accessed 22 March 2019.

[14] Canada has, for example, lowered the capital gains inclusion rate from 75% to 50%; TSI Wealth Daily Advice 2019 https://www.tsinetwork.ca/daily-advice/how-to-invest/canadian-capital-gains-tax-the-cheapest-tax-you-will-ever-pay/ accessed 22 March 2019.

1.2 Causes, outcomes and the challenges of inflation

Inflation can broadly be defined as the continuous and considerable rise in the prices of goods and services rendered to the public.[15] Inflation has an influence in the South African tax system as a whole, but economists argue that the demand-pull inflation[16] and cost-push inflation[17] are the most influential factors in the economy.[18] Inflation tends to have a negative reputation due to the constant abrasion of the purchasing power of money and the rise in the consumer price index, which makes saving money challenging for most individuals. Besides the public feeling a heavy burden to pay more for goods and services, the effect of inflation is not obvious straight away, but differs over a longer period of time, especially with regard to investments.

During February 2000, the SARB moved to an official inflation targeting regime with the main aim of maintaining price stability and economic growth in South Africa.[19] In order for the SARB to achieve this aim, it had to ensure that inflation remained within the target band of 3–6 percent per annum.[20] Prior to February 2000, the SARB followed a multifaceted approach to monetary value in South Africa.[21] This approach involved the monitoring of a wide range of indicators, such as changes in the banking credit extension, as well as overall liquidity in the banking sector in South Africa.[22] However, after the enactment of the *South African Reserve Banks Act* 90 of 1989[23], the SARB was tasked to

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15 Rabenowitz *et al The South African Financial Planning Handbook* 266.

16 Demand-pull inflation is caused when the increased demand for goods and services is accommodated by the increased supply of money to buy those goods. The danger of this type of inflation is that it can become self-perpetuating.

17 Cost-push inflation occurs when the cost of production increases without a corresponding increase in output.

18 Province KwaZulu-Natal Provincial Treasury 2016http://www.kzntreasury.gov.za/ResourceCenter/Documents%20%20Fiscal%20Resource%20Management/INFLATION%20FINAL%20DRAFT%20%206%20june%202016.pdf accessed 4 March 2019; Rabenowitz *et al The South African Financial Planning Handbook* 2019 167.

19 Section 224(1) of the *Constitution of the Republic of South Africa* 108 of 1996; Section 3 of the *South African Reserve Bank Act* 90 of 1989 (hereafter referred to as SARB Act); Uwilingiye *Evaluating the inflation targeting regime of South Africa* 1.

20 Gupta 2010 *IRLE* 109.

21 This approach involves the monitoring of a wide range of indicators, such as changes in the banking credit extension as well as overall liquidity in the banking sector in South Africa; Uwilingiye *Evaluating the inflation targeting regime of South Africa* 1.

22 Uwilingiye *Evaluating the inflation targeting regime of South Africa* 1.

23 *South African Reserve Bank Act* 90 of 1989 (hereafter referred to as SARB Act).

closely monitor monetary policies. It follows that the SARB has an imperative task to monitor inflation in South Africa. Should they fail to do so, there may be serious threats to the purchasing power of assets over a longer period of time.[24] If CGT were to be fully indexed for inflation, a consistency in the effective capital gains tax rate and the statutory tax rate will begin to emerge.[25] South African investors are therefore becoming more aware of the constant abrasion of their monetary purchasing power through inflation.[26] With that being said, inflation can be regarded as a bad process, which may add to the problems in the economy.[27] Goodall[28] illustrates the problem of the effect of inflation on investments as follows:

> At an inflation rate of 12% per annum, the real purchasing power of money is halved every six years. Even at an inflation rate of six per cent per annum, the real purchasing power of money is halved every twelve years. A short cut method of working out the impact of inflation on the value of an investment is the rule of 72. Divide 72 by the rate of inflation. This shows how many years it will take for the real purchasing power of the capital or income to halve. Example: How long will it take for an income of R100 000 in today's money to be halved at an inflation rate of 4% per annum? Answer: 72/4 = 18 years. Therefore, at an inflation rate of four percent per annum, in eighteen years' time R100 000 will only buy what R50 000 buys today.[29]

Goodall's example makes it evident that inflation has an effect on the purchasing power of money, and especially investments, in South Africa. Taking the above into consideration, the challenge in South Africa with regard to inflation may arise from the fact that no reference is made in the *Income Tax Act* 58 of 1962[30] or any other legislation[31] prior to the *ITA* to index inflation for capital gains tax.

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24 Stefan *The inflation hedging properties of South African asset classes* 1.

25 *Capital Gains Tax in South Africa* 2001 http://www.ftomasek.com/NationalTreasury.pdf accessed 3 March 2019.

26 Goodall *Investment Planning* 234.

27 Rabenowitz *et al The South African Financial Planning Handbook 2019* 268; *Why is inflation bad?* 2007 https://www.resbank.co.za/AboutUs/Documents/Why is inflation bad.pdf accessed 23 February 2019.

28 Goodall *Investment Planning* 234.

29 Goodall *Investment Planning* 234.

30 *Income Tax Act* 58 of 1962 (hereafter referred to as *ITA*).

31 *Income Tax Act* 80 of 1961.

1.3 Capital gains tax in South Africa

It is noteworthy that CGT is not a separate tax, but a tax that forms part of the taxable income that is payable per year by an individual.[32] The idea of imposing a CGT, however, is not a new one. Many of South Africa's trade partners, such as Canada, imposed CGT years before South Africa.[33] Furthermore, various commissions have been established to interpret and comment on the potential implementation of CGT in South Africa.[34] The Katz Commission first considered the possibility of a CGT in their 1995 report[35], while the Franszen Commission supported a limited form thereof in 1969. [36] The Margo Commission was against all forms of wealth taxation in South Africa and recommended that CGT should not be taxed.

CGT was first introduced by the South African Minister of Finance in his[37] budget speech on 23 February 2000 where he proposed that all registered taxpayers who sell an immovable asset must pay a tax called "capital gains tax" on the proceeds on or after 1 October 2001.[38] The historical development of CGT sheds light on the main reasons why CGT was implemented as part of the South African tax regime and it is therefore discussed below. Some of these reasons include international benchmarking, the introduction of

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32 Coetzee *et al 'n Studentebenadering tot inkomstebelasting 2018* 485.

33 The tax in Canada became effective in 1972, while Australia's capital gains tax applies to assets acquired on or after 19 September 1985; SARS 2019 *Comprehensive Guide to Capital Gains Tax Issue 7 at* 36.

34 The Franszen Commission was established in 1969 while the Katz Commission was established in 1995; Capital Gains Tax in South Africa 2001 http://www.ftomasek.com/NationalTreasury.pdf accessed 6 March 2019.

35 This report was entitled the *Third Interim Report of the Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa*, 1995.

36 McGrrath *Economic Choices for Post-Apartheid South Africa* https://www.sahistory.org.za/sites/default/files/DC/rejan91.6/rejan91.6.pdf 17 accessed 6 March 2019; SARS 2019 *Comprehensive Guide to Capital Gains Tax issue 7* at 38; Capital Gains Tax in South Africa 2001 http://www.ftomasek.com/NationalTreasury.pdf accessed 6 March 2019; Report of the Commission of Inquiry into the Tax Structure of the Republic of South Africa, 20 November 1986, Government Printer, RP34/1987, Pretoria; Parliamentary Monitoring Group 2001 https://pmg.org.za/committee-meeting/41/ accessed 6 March 2019;

37 Although reference is made to masculine terminology, it should be accepted that feminine terminology is included in this reference.

38 *Capital Gains Tax in South Africa* 2001 http://www.ftomasek.com/NationalTreasury.pdf accessed 3 March 2019.

horizontal and vertical equity as well as economic efficiency.[39] It is therefore prudent to evaluate the historical background of capital gains tax in South Africa.

1.3.1 Historical background

Prior to the implementation of CGT in South Africa, the post-apartheid government carefully observed what other countries experienced with regard to the taxation of CGT.[40] The process of observing and adopting foreign legislation is better known as a legal transplant and can only be considered if both countries share a common legal tradition.[41] Adopting a foreign principle in procedural law may be difficult, but in tax terms it is has become considerably more common and successful.[42] Hence, the adoption of CGT principles from international trade partners such as Canada.

The Katz Commission acknowledged the principle of capital gains tax in the *Third Interim Report of the Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa* in 1995, but argued that there was an insufficient administrative capacity to manage the complicated nature of the tax.[43] The Margo Commission had also proposed a structural reform of the South African Revenue Authority in 1986, and after the Joint Standing Committee on Finance[44] examined and considered the Katz Report, it reported the following:

> By reason of the lack of capacity on the part of the tax administration, there should not be a capital gains tax in South Africa at this stage. When restructuring tax administration has been completed in line with the Commission's recommendations in its first report, the contentions for and against a possible introduction of this tax and its suitability for South Africa should be revisited and cognisance should be undertaken of the considerations set out in this Chapter.[45]

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39 SARS 2019 *Comprehensive Guide to Capital Gains Tax issue 7* at 1-3; *Capital Gains Tax in South Africa* 2001 http://www.ftomasek.com/NationalTreasury.pdf accessed 3 March 2019.
40 William *2005 PSLR* 716.
41 Watson *Legal Transplants: An Approach to Comparative Law* 20.
42 William *2005 PSLR* 717; Mattei *1994 IRLE* 3.
43 SARS *Guide to capital gains tax* 2000 http://www.treasury.gov.za/documents/national%20budget/2000/cgt/cgt.pdf accessed 5 May 2019.
44 Joint Standing Committee on Finance (hereafter referred to as JSOF); Stiglingh *Developing a model to evaluate the quality of the services rendered by the South African revenue service* 2.
45 *Katz Commission Report into Taxation* 1995 http://www.treasury.gov.za/publications/other/katz/3.pdf 14 accessed 7 May 2019.

When taking the above into consideration, it follows that there was an urgent need for structural reform in the tax administration before CGT could be implemented and properly administrated in South Africa. The *Constitution of the Republic of South Africa*, 1996[46] is the supreme law of the Republic and provides for taxation equality.[47] Nevertheless, public submissions expressed support for the Katz Report in that CGT should not be implemented in South Africa.[48] The recommendations made by the JSCOF, however, was not aimed specifically on the CGT question at hand, which perpetuates some uncertainty.

Notwithstanding the public's negative perception towards the taxation of CGT, the South African legislator seriously considered the recommendations made by both Commissions. As a result of these recommendations, SARS was established in 1997 in terms of the *South African Revenue Service Act* 34 of 1997 and thereafter became a separate organ of state.[49] This had the effect that SARS was able to magnify their administrative capacity to accommodate the complicated nature of CGT as recommended by the Katz Commission. Stiglingh[50] supports this transformation in the tax administration and states the following:

> The transformation of a fragmented revenue administration was one of the most important reforms the government introduced after 1994.[51]

In addition, since the establishment of SARS, South Africa did not tax CGT prior to the enactment of the *Taxation Law Amendment Act* 30 of 2000.[52] The rationale for this is derived from the firm wording in the *TLA* Act which states that receipts and accruals of a

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46 *The Constitution of the Republic of South Africa*, 108 of 1996 (hereafter referred to as the Constitution).

47 Section 2 of the *Constitution of the Republic of South Africa*, 108 of 1996; De Waal *et al The Bill of Rights Handbook* 38; William *2005 PSLR* 719.

48 Katz Commission *Report into Taxation* 1995 http://www.treasury.gov.za/publications/other/katz/3.pdf 14 accessed 7 May 2019.

49 Stiglingh *Developing a Model to Evaluate the Quality of the Services Rendered by the South African Revenue Service* 2; Parliament Monitoring Group 2001 https://pmg.org.za/committee-meeting/41/ accessed 8 May 2019.

50 Stiglingh *Developing a Model to Evaluate the Quality of the Services Rendered by the South African Revenue Service* 3.

51 Stiglingh *Developing a Model to Evaluate the Quality of the Services Rendered by the South African Revenue Service* 3.

52 *Taxation Law Amendment Act* 30 of 2000 (hereafter referred to as *TLA* Act).

capital nature are excluded from an individual's gross income.[53] The reasons for the implementation of CGT in South Africa are set out below.

1.3.2 Reasons for the implementation of capital gains tax

SARS and the National Treasury cited several reasons for the introduction of CGT in South Africa.[54] The first of these reasons is to conform to international benchmarks and standards set by trade partners, and the second is to introduce horizontal and vertical equity. The last reason is economic efficiency.[55] The South African legislator also introduced CGT to serve as a mechanism to broaden the tax net in order to prevent individuals from avoiding tax.[56] The shift from income to capital also had a pivotal influence in the introduction of CGT in South Africa. The implementation of CGT as part of the South African tax system may perhaps be justified mainly on fiscal equity grounds.

1.3.2.1 International benchmarking

In order to assure taxation equality between individuals, it is of utmost importance that South Africa benchmark its tax legislation against the international standards set by trade partners. CGT is not a new term in South Africa, and many developing African countries such as Botswana and Egypt recognised CGT before South Africa, but to a more limited extent for administrative reasons.[57] These limitations do not, however, apply to South African residents in that CGT is payable according to the Eighth Schedule of the *ITA* on any deemed disposal of property.[58] This principle is regarded as a general rule in countries such as Canada and South Africa also adopted it into its tax legislation.[59] The principles

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[53] Divaris *et al South African Tax Guide 2018/2019* 26; William 2005 *PSLR* 725.
[54] SARS 2019 *Comprehensive Guide to Capital Gains tax* 36
[55] SARS 2019 *Comprehensive Guide to Capital Gains tax* 2.
[56] William *2005 PSLR* 720.
[57] SARS 2019 *Comprehensive Guide to Capital Gains tax* 36.
[58] Eighth Schedule to the *Income Tax Act* 58 of 1962; De Koker *et al Income Tax in South Africa 2019* 92.
[59] There is a general deduction in both South African and Canadian tax legislation applicable to the disposal of a primary residence. This is discussed in Chapters 2 and 3; Section 26A of the *Income Tax Act* 58 of 1962; Wealthsimple 2019 https://www.wealthsimple.com/en-ca/learn/capital-gains-tax-canada accessed 2 May 2019.

of horizontal and vertical equity came into existence as a result of the adoption of Canadian principles as part of South African law.

1.3.2.2 Horizontal and vertical equity

Horizontal equity demands that every individual should bear similar tax burdens.[60] The form of an individual's income therefore irrelevant because every individual bears the same tax obligations and consequences.[61] Vertical equity, however, demands that individuals who receive more income should be burdened to pay more taxes because of their ability to do so.[62] A taxpayer's income thus plays an imperative role in vertical equity. It is therefore important to know what the term comprehensive income means for tax purposes. Haig and Simmons[63] define comprehensive income as the following:

> The sum of the market value of rights exercised in consumption and the change in the value of the store of property rights between the beginning and the end of the period in question.[64]

Comprehensive income is included in the definition of gross income in terms of the *ITA* and has the effect that an individual is being taxed on any amount received or accrued to him during the given year of assessment.[65] A capital gain can therefore not be seen as economically different from income and is therefore included in an individual's taxable income.[66] Taxation of CGT forms part of vertical equity in that all individuals do not pay

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60 Economics Help 2019 https://www.economicshelp.org/blog/935/economics/horizontal-and-vertical-equity/ accessed 2 May 2019.

61 Joseph 2019 https://www.urban.org/sites/default/files/publication/71101/1000533-Horizontal-Equity.PDF accessed 30 April 2019; SARS 2019 *Comprehensive Guide to Capital Gains Tax Issue 7* at 36; Musgrave 1990 *NTJ* 113.

62 Investopedia 2018 https://www.investopedia.com/terms/v/vertical_equity.asp accessed 30 April 2019; SARS 2019 *Comprehensive Guide to Capital Gains Tax Issue 7* at 37.

63 Haig *et al The Federal Income Tax* 5; Simons *Personal Income Taxation* 81.

64 Haig *et al The Federal Income Tax* 5; *Simons Personal Income Taxation* 81.

65 The year of assessment (commonly known as the tax year) runs from 1 March to 28 February each year. Section 1(i) of the *Income Tax Act* 58 of 1962; de Koker *et al Silke on South African Income Tax 2019* 49; Divaris *et al South African Tax Guide 2018/2019* 26; Section 1 of the *Income Tax Act* 58 of 1962; Coetzee *et al 'n Studentebenadering tot inkomstebelasting* 35.

66 Section 26A of the *Income Tax Act* 58 of 1962; Section 1(jA) of the definition of gross income in the *Income Tax Act* 58 of 1962; Goodall *et al The financial planning handbook 2019* 460; De Koker *et al Income Tax in South Africa 2019* 90; Coetzee *et al 'n Studentebenadering tot inkomstebelasting* 485.

the same amount of tax, but individuals pay more tax on the gain realised from the disposed of property. Vertical equity may thus add to the economic efficiency of CGT.

1.3.2.3 Economic efficiency

In a recent paper submitted to the Portfolio Committee on Finance,[67] Professor Neil Brooks[68] states the following about capital gains tax and the economy:

> Taxing capital gains not only enhanced the fairness of an income tax system but also increased the efficiency with which resources are allocated in the economy and thus raised the average standard of living. Moreover, taxing capital gains enabled a rationalization of the administration of income tax.[69]

According to Professor Brooks,[70] the rationale for the taxation of CGT is solely based on fairness. He furthermore supports the principle of vertical equity which provides ethical justification for taxable income.[71] When considering the effect on the allocation of investments in South Africa, however, the support for capital gains tax is not uncommon.[72] Since the introduction of CGT in South Africa, the tax base[73] has broadened significantly, which facilitates lower overall tax rates.[74] This results in individuals being encouraged to invest in assets such as real estate, which in turn provides profits in the form of capital gains instead of income-producing assets.[75] This has a positive influence on the South African economy and for these reasons, CGT was introduced into South African legislation.[76]

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67 Portfolio Committee on Finance (hereafter referred to as PCOF).

68 Brookes 2001 *Why Taxing Capital Gains is Good for the Tax System, the Economy and Tax Administration* 42.

69 Brookes 2001 *Why Taxing Capital Gains is Good for the Tax System, the Economy and Tax Administration* 42; Stretch *et al The case for taxing capital gains* 3.

70 Stretch *2001 Taxgram* 42.

71 Stretch *2001 Taxgram* 42.

72 SARS 2019 *Comprehensive Guide to Capital Gains Tax Issue 7* at 38.

73 A tax base is a total amount of assets or income that can be taxed by a taxing authority, usually by the government. It is used to calculate tax liabilities.

74 *Capital Gains Tax in South Africa* 2001 http://www.ftomasek.com/NationalTreasury.pdf accessed 3 March 2019; SARS 2019 *Comprehensive Guide to Capital Gains Tax Issue 7* at 38; Coetzee *et al 'n Studentebenadering tot inkomstebelasting* 485; Clegg *et al Income tax in South Africa* 90; William *2005 PSLR* 720.

75 Income-producing income includes, for example, the letting of machinery or equipment; SARS 2019 *Comprehensive Guide to Capital Gains Tax Issue 7* at 38.

76 Eighth Schedule to the *Income Tax Act* 58 of 1962.

1.4 The current position of capital gains tax in South Africa

As mentioned above, CGT is payable on any disposal or deemed disposal[77] of an asset acquired on or after October 2001 by any natural or legal person residing in the Republic of South Africa.[78] In the event where the natural person is situated outside the Republic, CGT is payable on any disposal or deemed disposal of property situated within the Republic.[79] Non-residents will therefore be taxed on their income from a South African source.[80] Current legislation giving effect to the taxation of CGT is set out in the *Eighth Schedule* of the *ITA*.[81]

If an asset was acquired prior to 2001, the owner thereof is obliged to do a valuation on the property in question to determine the base cost of the asset.[82] The base cost is used to determine an individual's aggregated capital gain or loss. If the property was acquired prior to October 2001, the tax would be levied on the base cost plus any improvements to the property. Paragraph 20 of the *Eighth Schedule* to the *ITA* sets out a comprehensive list of costs that can be added to the asset's base cost.[83] Some of these include for example the actual cost incurred by the owner to acquire the property; transfer duty in the event of immovable property; actual costs incurred for the evaluation of the property and advertisement fees for finding a purchaser for the property.[84] If the property was acquired after October 2001, the tax would be levied on the proceeds minus the base cost of the asset by using the prescribed rates in the equation.

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77 An individual makes a deemed disposal if he or she holds on to an asset until the date of death. At the date of death, all assets are deemed to have been disposed of by the individual. With some exclusions afforded in the *ITA,* estate duty and CGT are payable in this regard.

78 SARS *Guide to Capital Gains Tax* 2000 http://www.treasury.gov.za/documents/national%20budget/2000/cgt/cgt.pdf accessed 5 May 2019.

79 Coetzee *et al 'n Studentebenadering tot inkomstebelasting* 35; Section 1 of the definition of "gross income" in the *Income Tax Act* 58 of 1962.

80 SARS 2019 https://www.sars.gov.za/ClientSegments/Individuals/Tax-Stages/Tax-and-Non-Residents/Pages/default.aspx accessed 15 July 2019; Coetzee *et al 'n Studentebenadering tot inkomstebelasting 2018* 35.

81 Section 26A of the *Income Tax Act* 58 of 1962.

82 SARS 2018 https://www.sars.gov.za/FAQs/Pages/902.aspx accessed 14 July 2019.

83 Coetzee *et al 'n Studentebenadering tot inkomstebelasting* 493.

84 Coetzee *et al 'n Studentebenadering tot inkomstebelasting* 493, 494.

1.4.1 Rates, gains and losses

Instead of fully indexing inflation for CGT, the legislator includes an inclusion rate for individuals, trusts and businesses, which in theory is regarded as a substitute for inflation on a CGT calculation.[85] The inclusion rates is 40% for both individuals and trusts and 80% for companies as defined in the *Companies Act* 71 of 2008.[86] The net result of the effective rates payable is 18% for individuals, 36% for trusts and 22.4% for companies.[87] However, the focus in this regard remains on the individual taxpayer and the inclusion rates of trusts and companies are therefore not discussed. It is furthermore noteworthy that an individual is held liable for a maximum of 18% CGT on the disposal or deemed disposal of an asset. The amount of the CGT the individual is liable for will depend on his gross income in the given year of assessment as he is taxed according to his progressive scale. The reason for this is that CGT is not taxed separately, but forms part of an individual's taxable income.[88]

Although CGT forms part of an individual's taxable income, there is an annual exclusion for individuals which strengthens the legislator's argument not to index inflation for CGT. The aim of the annual exclusion rate is to reduce compliance costs and its administration by eliminating small gains and losses out of the tax system.[89] In addition to this, the Minister of Finance proposed in his budget speech on 23 February 2011 that the annual exclusion rate be increased from R17 500 to approximately R20 000.[90] This proposal was approved, which had the effect that the exclusion rate for individuals was increased on a yearly basis. The current inclusion rate for individuals in 2019 is R40 000 per year of

85 Coetzee *et al 'n Studentebenadering tot inkomstebelasting 2018* 527.
86 Paragraphs 9, 10 of the Eighth Schedule to the *Income Tax Act* 58 of 1962; Clegg *et al Income Tax in South Africa* 91; Section 1 of the *Companies Act* 71 of 2008.
87 Clegg *et al Income Tax in South Africa* 92.
88 See paragraph 1.3 above.
89 SARS 2018 https://www.sars.gov.za/TaxTypes/CGT/Proceeds/Calc-Tax-Capital/Pages/Annual-Exclusion.aspx accessed 18 June 2019.
90 Stein *Stein on Capital Gains Tax* 23; National Treasury 2011 http://www.treasury.gov.za/documents/national%20budget/2011/speech/speech2011.pdf accessed 18 June 2019.

assessment and R300 000 at the time of death of an individual in the given year of assessment.[91]

Unlike value-added tax, CGT is a direct tax which is payable by an individual when an asset is disposed of.[92] For the purposes of the CGT calculation, it is important to define an asset. According to the Oxford dictionary, an asset may be defined as "a useful or valuable thing" which may add value to an individual's estate.[93] This definition may be interpreted very widely to include any rights to or in property.[94] However, the *ITA* defines an asset more comprehensively to include:

> (a) Property of whatever nature, whether movable or immovable, corporeal or incorporeal, excluding any currency, but including any coin made mainly from gold or platinum; and (b) a right or interest of whatever nature to or in such property.[95]

It is evident that an individual has to dispose of an asset to trigger CGT in South Africa.[96] A disposal is also defined very broadly to include "the action or process of getting rid of something".[97] It follows that a disposal of an asset may include a donation from one party to another or the sale of either movable or immovable property by a South African resident. It may furthermore be said that an asset is disposed of the moment there is a change in ownership of the property in question.[98] Regardless of the wide meaning of the term, paragraph 1 and 11 of the *ITA* read in conjunction with the *Eighth Schedule* to the *ITA* defines a disposal more specifically to mean the following:

> Any event, act, forbearance or operation of law which results in the creation, variation, transfer or extinction of an asset.[99]

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91 SARS 2018 https://www.sars.gov.za/TaxTypes/CGT/Proceeds/Calc-Tax-Capital/Pages/Annual-Exclusion.aspx accessed 18 June 2019.

92 Venter *et al 'n Studentebenadering tot Inkomstebelasting* 3.

93 Oxford Dictionary 2019 https://www.lexico.com/en/definition/asset accessed 20 June 2019.

94 Stiglingh *et al Silke: Income Tax in South Africa 2019* para 24.2; Paragraph 1 of the *Income Tax Act* 58 of 1962.

95 Paragraph 1 of the Eighth Schedule to the *Income Tax Act* 58 of 1962.

96 Clegg *et al Income Tax in South Africa* 95.

97 Oxford Dictionary 2019 https://www.lexico.com/en/definition/disposal accessed 18 June 2019.

98 Stiglingh *et al Silke: Income Tax in South Africa 2019* para 24.2.

99 Clegg *et al Income Tax in South Africa* 94.

The *ITA* furthermore provides clarity as to what the term "disposal" expressly includes in paragraph 11. Some of the disposals include, but are not limited to the following:[100]

> The sale, donation, expropriation, conversion, grant, cession, exchange or any other alienation or transfer of ownership of an asset;[101] The forfeiture, termination, redemption, cancellation, surrender, discharge, relinquishment, release, waiver, renunciation, expiry or abandonment of an asset;[102] The scrapping, loss or destruction of an asset;[103] The vesting of an interest in a trust asset in a beneficiary;[104] The distribution of an asset by a company to a holder of shares.[105]

When an individual makes a disposal or deemed disposal of an asset, there is an aggregated capital gains or aggregated loss. According to Clegg,[106] an aggregate capital gain or loss is defined as:

> The product of all capital gains and losses during the tax year, reduced by an annual *de minimis* exclusion. Where the accrual of proceeds from a disposal is deferred, any loss is not included in this calculation.[107]

When taking the above definition into consideration, it should be clear that only an aggregate gain is taxable. According to the Eighth Schedule to the *ITA*, a person is not liable to pay CGT if he made a negative capital gain[108] on the disposal of an asset. If an individual makes a capital loss, he or she will not be taxed, but the aggregated loss will be carried over to the next year of assessment.[109] The *ITA* does, however, afford some exemptions on disposals and deemed disposals made by individuals for CGT purposes. These exclusions are discussed briefly below.

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100 Stiglingh *et al Silke: Income Tax in South Africa 2019* para 24.23.
101 Paragraph 11(1)(a) of the *Income Tax Act* 58 of 1962.
102 Paragraph 11(1)(b) of the *Income Tax Act* 58 of 1962.
103 Paragraph 11(1)(c) of the *Income Tax Act* 58 of 1962.
104 Paragraph 11(1)(d) of the *Income Tax Act* 58 of 1962.
105 Paragraph 11(1)(e) of the *Income Tax Act* 58 of 1962.
106 Clegg *et al Income Tax in South Africa* 91.
107 Clegg *et al Income Tax in South Africa* 91; paras 1, 6, 7, and 39A of the *Income Tax Act* 58 of 1962.
108 A negative capital gain arises where the proceeds from a disposal does not exceed the asset's base cost. In this discussion a negative capital gain is referred to as a capital loss.
109 Coetzee *et al 'n Studentebenadering tot inkomstebelasting* 487, 489.

1.4.2 Exclusions from capital gains tax

When calculating an individual's aggregated capital gain or loss, there are some gains and losses which may be excluded from the calculation for CGT purposes. Besides the annual individual exclusion of R40 000 explained above, there are numerous transactions that are wholly or partially excluded from the ambit of CGT.[110] One of the most popular exclusions is the primary residence exclusion held by a resident or special trust, as well as the exclusion of personal use assets.[111] A further deduction afforded in the *ITA* is the so-called rollover between spouses. These exclusions and other exclusions afforded in the Eighth Schedule to the *ITA* are briefly discussed below.

1.4.2.1 Primary residence exclusion

Paragraph 44 of the Eighth Schedule to the *ITA* governs the exclusion of a primary residence for CGT purposes. A primary residence includes a dwelling where a natural person or a special trust holds an interest in the property and where an individual uses the dwelling as his primary residence.[112] The Eighth Schedule to the *ITA* provides for a R2 million exclusion of a gain or loss arising from the disposal of an individual's primary residence when his aggregated capital gain is being calculated.[113] The same principle applies to a trust whose beneficiary occupies the trust's property.[114]

However, as is the case with any right guaranteed in legislation, the right to claim this exclusion is not absolute in that the amount which may be excluded from the CGT calculation is limited to the first R2 million of the disposal of a primary residence held by an individual or trust.[115] If an individual were to sell his primary residence for R3 million, the first R2 million may be abandoned for the CGT calculation. The opposite is also true if the primary residence was sold for less than R2 million. In this case, the whole amount

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110 Clegg *et al Income Tax in South Africa* 144.
111 Paragraphs 44, 53 of the Eighth Schedule to the *Income Tax Act* 58 of 1962.
112 Paragraph 1, 44 of the Eighth Schedule to the *Income Tax Act* 58 of 1962.
113 Paragraph 45(b) of Eighth Schedule to the *Income Tax Act* 58 of 1962.
114 Paragraph 51 of the Eighth Schedule to the *Income Tax Act* 58 of 1962.
115 Stiglingh *et al Silke: Income Tax in South Africa 2019* para 24.111.

would be excluded from the calculation.[116] Before this exclusion may be claimed by an individual or a beneficiary of a trust, it is essential that all requirements have to be met.

In order for an individual to qualify for this exclusion, it is imperative that the individual is regarded as an ordinarily resident and that he used the primary residence as his main residence mainly for domestic purposes.[117] The term residence may be defined as the following:

> Any structure, including a boat, caravan or mobile home, which is used as a place of residence by a natural person, together with any appurtenance belonging thereto and enjoyed therewith.[118]

In the case of *Cohen v Commissioner for Inland Revenue*[119], for example, the principle was handed down by the court that a person's ordinarily residence is the place where he or she returns after his or her wanderings.[120] In the case of *Commissioner for Inland Revenue v Kuttel*[121], the court stated that a person is an ordinarily resident where he normally resides apart from his temporary absences.[122] In addition, if an individual does not hold an interest in the primary residence nor used the residence as his primary residence, he will not be eligible to claim the primary residence exclusion afforded in the Eighth Schedule to the *ITA.* It therefore follows that the exclusion is not applicable to non-residents of the Republic. The primary residence exclusion is also limited to the first 2 hectares of the property in question. However, a South African resident may also qualify for the exclusion of a number of personal use assets.

1.4.2.2 Personal use assets

An aggregated capital gain or loss realised on a personal use asset may be set aside for an individual's CGT calculation. The reason for this may be derived from the fact that

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116 Coetzee *et al 'n Studentebenadering tot inkomstebelasting* 512.
117 Divaris *et al South African Income Tax Guide 2018/2019* 338.
118 Section 1 of the *Income Tax Act* 58 of 1962; Stiglingh *et al Silke: Income Tax in South Africa 2019* para 24.13.
119 *Cohen v Commissioner for Inland Revenue* 13 SATC 362.
120 Stiglingh *et al Silke: Income Tax in South Africa 2019* para 5.2.
121 *Commissioner for Inland Revenue v Kuttel* 54 SATC 298.
122 Coetzee *et al 'n Studentebenadering tot inkomstebelasting* 38; Stiglingh *et al Silke: Income Tax in South Africa 2019* para 5.2; Divaris *et al South African Income Tax Guide 2018/2019* 338.

personal assets, such as assets that are being used for purposes other than business, depreciates over time and thus realises a capital loss when the asset is disposed of.[123] In addition, assets which are used by an individual for non-trade purposes that "is likely to generate a capital gain as a result of market forces" are included in the individual's CGT liability when such an asset is disposed of.[124] Such assets may include, for example, artwork, jewellery, a savings account or other assets which are used mainly for private purposes.[125] Assets that may be used for purposes other than the carrying on of trade may include the following: Immovable property; an aircraft with an empty mass exceeding 450kg; A boat exceeding 10 metres in length; Fiduciary, usufructuary or similar interests of which the value depreciates over time; A lease of immovable property longer than 10 years or any rights or interests in the these assets.[126]

Although various assets may be excluded from qualifying as a personal use asset, some of these assets may qualify for special treatment in terms of paragraph 15 of the Eighth Schedule to the *ITA*. Clegg[127] states that the special treatment may be used to the extent:

> That assets are used for private purposes, losses incurred in respect of their disposal are ignored whereas gains are brought to account for CGT in full.[128]

Taking the above into consideration, it is evident that if an asset is used mainly for private pleasure, it would be subject to CGT unless an aggregated capital loss is realised on the disposal thereof.[129] Nonetheless, the assets mentioned above qualify for this special treatment.[130] In addition to the primary residence and personal use assets exclusion,

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123 Clegg *et al Income Tax in South Africa* 144; Cleartax 2019 https://cleartax.in/s/depreciation-income-tax-act accessed 18 June 2019.

124 SARS 2014 https://www.sars.gov.za/TaxTypes/CGT/Assets-CGT/Pages/Personal-use-aircraft,-boats-and-certain-rights-and-interests.aspx accessed 18 June 2019.

125 Clegg *et al Income Tax in South Africa* 144.

126 Coetzee *et al 'n Studentebenadering tot inkomstebelasting* 517; SARS 2014 https://www.sars.gov.za/TaxTypes/CGT/Assets-CGT/Pages/Personal-use-aircraft,-boats-and-certain-rights-and-interests.aspx accessed 18 June 2019.

127 Clegg *et al Income Tax in South Africa* 144.

128 Clegg *et al Income Tax in South Africa* 144.

129 Paragraph 15 of the Eighth Schedule to the *Income Tax Act* 58 of 1962.

130 Coetzee *et al 'n Studentebenadering tot inkomstebelasting* 517, 518; Paragraph 15 of the Eighth schedule to the *Income Tax Act* 58 of 1962.

there are other exclusions afforded in the Eighth Schedule to the *ITA* which must also be mentioned.

1.4.2.3 Transactions between spouses

The Eight Schedule to the *ITA* affords a spousal beneficiary exclusion in the event where property is transferred from one spouse to another.[131] This exclusion is directly in line with donations tax between spouses. As a general rule, donation tax between spouses should be disregarded, and as such, any transaction between spouses should be ignored for CGT purposes.[132] This is better known as a rollover between spouses, which grants a temporary relief for CGT purposes. CGT is therefore normally payable by the surviving spouse at a future date.[133] It is therefore technically incorrect to say that CGT would not be payable in the event where a spouse disposes of an asset to another spouse.[134] Rollover relief is furthermore only applicable in the case where assets are transferred to a resident of the Republic.[135]

A rollover between spouses usually occurs at the date of death of the transferor and, as mentioned above, the transferor is deemed to have disposed of all his assets at the date of death at fair market value. At the time of death of the transferor, the surviving spouse is treated as having acquired full ownership of the asset on the same date on which the deceased acquired ownership of the property.[136] The surviving spouse would furthermore be treated as having incurred the same liabilities on the same date and currency that is incurred by the transferor.[137] Therefore, the surviving spouse will be held liable to pay CGT on the aggregated gain on any disposed of assets. The primary residence exclusion

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131 Paragraph 67 of the Eighth schedule to the *Income Tax Act* 58 of 1962.

132 Section 56(2) of the *Income Tax Act* 58 of 1962; Stiglingh *et al Silke: Income Tax in South Africa 2019* para 24.165; see also Bruwer *The levying of estate duty and capital gains tax as double tax in South Africa* 39.

133 Section 9HB of the *Income Tax Act* 58 of 1962.

134 The spouse that is deemed to have made the disposal is also known as the transferor.

135 SARS *Guide to capital gains tax* 2000 http://www.treasury.gov.za/documents/national%20budget/2000/cgt/cgt.pdf accessed 5 May 2019.

136 Stiglingh *et al Silke: Income Tax in South Africa 2019* para 24.141A.

137 Paragraph 67(1)(*b*)(ii) of the Eighth Schedule to the *Income Tax Act* 58 of 1962.

must, however, be kept in mind in the CGT calculation in that the surviving spouse still qualifies for this exclusion.

1.4.2.4 Other exclusions

The above-mentioned exclusions may be regarded as general exclusions offered by the *ITA* for South African residents. The reason for this being that most individuals are acquainted with these exclusions in that they already qualify for such exclusions. However, there are other exclusions that are worth mentioning. These exclusions are briefly discussed in the paragraphs that follow.

1.4.2.4.1 Life policies

All holder's gains and losses in respect of the maturity or disposal of life policies may be ignored for CGT purposes.[138] It must be noted that the exclusion afforded in the *ITA* only applies to long-term policies as defined in the *Long Term Insurance Act* 52 of 1998.[139] These policies include life insurance, disability insurance and so forth.[140]

Similar to the primary residence exclusion, an individual has to meet certain requirements in order to claim the life policies exclusion afforded in legislation. Some of these requirements are that the recipient of the proceeds must be one of the following persons:

> The original owner of the policy or his or her spouse, nominee or dependant as defined in the *Pension Fund Act* 24 of 1956;[141] The former spouse of the original owner, provided it was ceded on divorce or under a court ordered division of assets; The owner of the policy if the life assured is or was an employee or director of the owner, provided any policy premiums paid by the employer are deductible for normal income tax purposes and the event insured is death.[142]

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138 Clegg *et al Income Tax in South Africa* 115.

139 Paragraph 55 of the Eighth Schedule of the *Income Tax Act* 58 of 1962; Section 1 of the *Long Term Insurance Act* 52 of 1998.

140 Clegg *et al Income Tax in South Africa* 116.

141 Section 1 of the *Pension Fund Act* 24 of 1956; Para 55(1)(*a*)(i) and (ii) of the Eighth Schedule to the *Income Tax Act* 58 of 1962.

142 Clegg *et al Income Tax in South Africa* 115; Paragraph 55(1)(*b*) of the Eighth Schedule to the *Income Tax Act* 58 of 1962.

Only once all the requirements have been met, an individual is eligible to claim the deduction in terms of the *ITA.*

1.4.2.4.2 Retirement benefits

Another exclusion from the CGT calculation is retirement benefits. Paragraph 54 makes provision that all lump sum benefits from pension or provident funds may be left out for CGT purposes.[143] It must be noted that the lump sum benefit received in the form an annuity constitutes income and will thus be taxed as income tax.[144]

1.4.2.4.3 Small and micro-businesses

A further exclusion afforded in the *ITA* is for the disposal or deemed disposal of assets that are mainly used for the purpose of a micro-business as defined in the Sixth Schedule to the *ITA.*[145] The small business exclusion, on the other hand, only applies to individuals who realise an aggregated capital gain on the disposal of their interest in the sole proprietorship or a partnership.[146] Paragraph 57(1) of the Eighth Schedule to the *ITA* defines a small business to mean the following:

> a business of which the market value of all its assets, as at the date of the disposal of the asset or interest contemplated in subparagraph (2), does not exceed R10 million.[147]

If a business has a turnover exceeding R10 000 000, the exclusion may not be claimed. It follows that current legislation limits the small business exclusion to a maximum gain of R1 800 000 per lifetime. This exclusion cannot be claimed every time a business disposes of a business asset.[148] This limitation also applies to individuals who own more than one small business. Paragraph 57 furthermore states that the aggregated capital

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143 Paragraph 55(1)(*b*) of the Eighth Schedule to the *Income Tax Act* 58 of 1962.

144 10X investments 2019 https://www.10x.co.za/retirement-annuity-and-tax accessed 20 June 2019.

145 A micro-business may be defined as a business that has a turnover not exceeding R1 000 000 per year. Paragraph 57A of the Eighth Schedule to the *Income Tax Act* 58 of 1962; Coetzee *et al 'n Studentebenadering tot inkomstebelasting* 519.

146 Clegg *et al Income Tax in South Africa* 116.

147 Paragraph 57(1) of the Eighth Schedule to the *Income Tax Act* 58 of 1962.

148 Clegg *et al Income Tax in South Africa* 116.

gain on the business assets must have been realised within a 24-month period in order to qualify for the exclusion.

1.4.2.4.4 Assets producing exempt income

Where a taxpayer makes a disposition of an asset that produced exempt income, any aggregated gain or loss may be set aside for CGT purposes.[149] The disposed of asset must be exempt in terms of the *ITA* to qualify for this exclusion.[150] There are, however, exempt income received by an individual that does not form part of the exclusion, namely the annual interest exemption;[151] dividends received in terms of section 10(1) (k) of the *ITA* and income received from a charity club or a recreational club.[152]

1.5 Conclusion

The current position with regard to CGT in South Africa is that an individual must have made a disposal or deemed disposal of an asset to trigger CGT consequences. Although the *ITA* affords exclusions from an individual's CGT calculation, it is evident that the tax implications regarding the sale of immovable property have become a serious concern for most individuals over the past few years. In an effort to avoid imprisonment for non-compliance or criminal offences such as fraud, taxpayers are burdened with the onus to pay CGT according to the provisions set out in the *ITA.*

At this point in research it is clear that the legislator neglected to take inflation into account when calculating the CGT liability of South African residents. This poses serious threats to investments in that the monetary purchasing power at the time of the sale of the property is directly compared to that of ten to twenty years ago when the immovable property was bought. It may be said that the exclusions afforded in the *ITA* may provide justification for the legislator's reason not to index inflation for CGT. However, the government puts the taxpayer on the back foot in view of the fact that any proceeds made on the sale of the asset would be taxable. If taxation of CGT in the presence of

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[149] Clegg *et al Income Tax in South Africa* 117.
[150] Ss 10, 12K of the *Income Tax Act* 58 of 1962.
[151] Section 10(1)(i) of the *Income Tax Act* 58 of 1962.
[152] Ss 10(1)(cN), 10(1)(cO) of the *Income Tax Act* 58 of 1962.

inflation was to be fully indexed, the property might be less than it was fifty years ago. This would result in individuals being taxed on a negative capital gain, which is not permissible in terms of the *ITA.*[153] The inclusion rate for individuals or the exclusions mentioned above can thus not be directly compared to accumulating inflation.[154] In order to determine whether or not the legislator's reasons for not indexing inflation for CGT may be justified mainly on the inclusion rate for individuals, it is necessary to compare South Africa's CGT regime to that of Canada to establish to which extent inflation will affect CGT in South Africa. Therefore, the next chapter evaluates the existing differences between the South African and Canadian CGT regimes.

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153 SARS 2019 http://www.sars.gov.za/TaxTypes/CGT/Proceeds/Calc-Tax-Capital/Pages/Assessed-capital-loss.aspx accessed 9 March 2019.

154 Budget proposals – tax overview 2016 https://www.werksmans.com/legal-updates-and-opinions/20162017-budget-proposals-tax-overview/ accessed 9 March 2019.

Comparing Canadian capital gains tax to South Africa

2.1 Introduction

Canada is one of South Africa's trade partners which has implemented CGT years before South Africa. Canadian CGT became effective in 1979, whereas South Africa did not implement CGT prior to October 2001.[155] South Africa has a similar CGT system as Canada and it may be said that South Africa adopted large portions of the Canadian tax system into South African legislation to govern the taxation of CGT.[156]

CGT in Canada is levied in terms of part 1 of schedule C of the *Income Tax Act,* 1985.[157] Canada introduced CGT early in 1979, and the taxation thereof is often seen as the most common type of income tax payable by a Canadian resident when he sells property for more than he purchased it for.[158] However, there are differences and similarities between the South African and Canadian tax systems that are relevant to the research in question. This chapter compares the Canadian CGT regime to that of South Africa highlighting relevant similarities and differences. The main aim is to show why the indexation of inflation for CGT is an important factor which the South African legislator may have to consider. Although reference is made to Chapter 1, the current position of CGT in South Africa is not repeated for this discussion.

2.2 Similarities and differences between tax regimes

2.2.1 Similarities

2.2.1.1 Disposal of property

An aggregated capital gain has to be realised on the disposal of property for CGT to become payable by a Canadian resident in any given year of assessment.[159] In Canadian

155 See paragraph 1.3 above; Bird 1978 *Osgoode Hall Law Journal* 135-136
156 Capital gains tax 2001 http://www.ftomasek.com/NationalTreasury.pdf accessed 24 July 2019.
157 Canadian *Income Tax Act* R.C.S 1985 c.1 (5th Suppl.) (Hereafter referred to as *Income Tax Act*).
158 Turbo Tax 2019 https://turbotax.intuit.ca/tips/changes-to-the-capital-gains-tax-6254 accessed 24 June 2019.
159 Government of Canada 2018 https://www.canada.ca/en/revenue-agency/services/forms-publications/publications/t4037/capital-gains-2016.html#P279_29831 accessed 24 July 2019.

tax law, when an individual makes a disposal of any property, the gain or loss made thereon may be seen as either a capital transaction or an income transaction.[160] A capital transaction arises where an individual sells or considers selling capital property such as immovable property or shares in a company.[161] Property is deemed to be disposed of by a Canadian resident when he donates property, when the property is exchanged for another property or even where an individual's property has been stolen.[162] In any event, a Canadian resident will be liable to pay 50% of the capital gain made on the disposal of property.[163] An income transaction, on the other hand, is regarded as any income received by an individual from services rendered or goods sold. It follows that for income to be realised, it must be related to a business transaction.[164] The Canadian Revenue Agency,[165] for example, regards any rental income as an income transaction which has to be declared for normal tax purposes.[166] However, the Canadian CGT regime is similar to South Africa in that it is considered to be a separate tax that forms part of an individual's taxable income payable per year of assessment. CGT would therefore form part of an individual's income tax which is payable according to the Canadian federal tax brackets.[167] Di Verdi[168] illustrates the taxation of CGT in Canada as follows:

> Only half of the capital gain on any given sale is taxed all at your marginal tax rate. On a capital gain of $50,000 for instance, only half of that, or $25,000, would be taxable.

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160 Section 39(1) of the *Income Tax Act,* 1985; Canada Revenue Agency 2018 https://www.canada.ca/content/dam/cra-arc/formspubs/pub/t4037/t4037-18e.pdf 9 accessed 24 June 2019; Government of Canada 2019 https://www.canada.ca/en/revenue-agency/services/forms-publications/publications/t4037/capital-gains-2016.html accessed 24 June 2019.

161 Section 54(1) of the Canadian *Income Tax Act*, 1985 defines capital property to mean any property other than depreciable property.

162 Canada Revenue Agency 2018 https://www.canada.ca/content/dam/cra-arc/formspubs/pub/t4037/t4037-18e.pdf 9 accessed 24 June 2019.

163 Section 38(1) of the *Income Tax Act,* 1985.

164 According to the Oxford Dictionary, a transaction is defined as the action of conducting business and the exchange between people; The Strategic CF 2013 https://strategiccfo.com/accounting-income-definition/ accessed 16 July 2019; Oxford Dictionary 2019 https://www.lexico.com/en/definition/transaction accessed 16 July 2019.

165 Canadian Revenue Agency (hereafter referred to as CRA) is a separate organ of states which has the duty to collect revenue from registered taxpayers in Canada. The CRA and SARS has similar duties and functions.

166 Government of Canada 2019 https://www.canada.ca/en/revenue-agency/services/tax/businesses/small-businesses-self-employed-income/business-income-tax-reporting/business-income/sources-income.html accessed 16 July 2019.

167 *Federal Personal Tax Rates* 2019 https://www.taxtips.ca/taxrates/canada.htm accessed 24 June 2019.

168 Di Verdi 2019 http://www.moneysense.ca/save/taxes/capital-gains-explained/ accessed 24 June 2019.

> For a Canadian in a 33% tax bracket for example, a $25,000 taxable capital gain would result in $8,250 taxes owing. The remaining $41,750 is the investors' to keep.[169]

When taking the example into consideration, it is clear that an individual who made a capital gain on the disposal of property would be liable to pay 50% CGT on the proceeds.[170] This is better known as the inclusion rate for Canadian residents which was lowered from 75% in 1999 to 50% in the 2018/2019 year of assessment.[171] The inclusion rate remains fixed for both capital gains and losses incurred by individuals when they dispose of property. South Africa has, in sharp contrast with Canada, increased their individual inclusion rate from 33.3% to 40%, which had the effect that 40% of capital gains would be included in an individual's taxable income.[172] However, a capital loss on the disposal of an asset in Canada may also not be taxed and therefore forms part of the individual's "computation of his net capital loss for the year".[173] According to the CRA, a capital loss occurs when:

> An individual sells, or considered to have sold, a capital property for less than its adjusted cost base plus the outlays and expenses involved in selling the property.[174]

It is noteworthy that any capital loss made by a Canadian resident may be carried over to the following year of assessment for a period not exceeding three years. With that being said, an individual who made a capital loss in the 2018 year of assessment may carry the net loss back to 2015, 2016 and 2017 to reduce his taxable capital gain.[175]

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169 Di Verdi 2019 http://www.moneysense.ca/save/taxes/capital-gains-explained/ accessed 24 June 2019.

170 Section 38 of the *Income Tax Act,* 1985.

171 TSI Wealth Daily Advice 2019 https://www.tsinetwork.ca/daily-advice/how-to-invest/canadian-capital-gains-tax-the-cheapest-tax-you-will-ever-pay/ accessed 24 June 2019; Canada Revenue Agency 2018 https://www.canada.ca/content/dam/cra-arc/formspubs/pub/t4037/t4037-18e.pdf 30 accessed 24 June 2019.

172 Werksman Attorneys 2016 https://www.werksmans.com/legal-updates-and-opinions/20162017-budget-proposals-tax-overview/ accessed 24 June 2019.

173 Canada Revenue Agency 2018 https://www.canada.ca/content/dam/cra-arc/formspubs/pub/t4037/t4037-18e.pdf 30 accessed 24 June 2019.

174 Government of Canada 2019 https://www.canada.ca/en/revenue-agency/services/tax/individuals/topics/about-your-tax-return/tax-return/completing-a-tax-return/personal-income/line-127-capital-gains/capital-losses-deductions/you-use-a-capital-loss.html accessed 24 June 2019.

175 Canada Revenue Agency 2018 https://www.canada.ca/content/dam/cra-arc/formspubs/pub/t4037/t4037-18e.pdf 30 accessed 24 June 2019.

2.2.1.2 Deemed disposals at the date of death

In South Africa and Canada, a deceased person is deemed to have disposed of all his capital assets the moment before death at fair market value.[176] This is a principle which is applied both in South Africa and Canada when calculating an individual's CGT liability. A deemed disposal furthermore has the effect that the person receiving the property will be held liable for the taxable capital gain which is calculated by deducting the adjusted cost base[177] plus all allowable expenses from the proceeds.[178] However, in any of these events, the Canadian resident would only pay CGT. The rationale for this is that Canada has abolished death taxes in 1972 when the new CGT principle was introduced.[179] Abolishing estate duty is perhaps a principle that the South African legislator may adopt to avoid the uncertainty it has perpetuated with regard to double taxation at the date of a natural person's death.[180] Estate duty in South Africa is also considered to constitute a form of wealth taxation, which is tax according to the *Estate Duty Act.*[181] The main aim of the *EDA* is to tax the transfer of wealth at the date of death, which is very similar to the taxation of CGT when South African resident makes a deemed disposal. It follows that there is a fine line between the taxation of wealth through estate duty and CGT in South Africa, especially at the date of a natural person's death.[182] The adoption of this Canadian principle into the South African tax regime would dissolve the double taxation uncertainty which has been perpetuated through legislation.

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176 Bruwer *The levying of estate duty and capital gains tax as double tax in South Africa* 32; Ss 70(5)(a), 70(5)(b) of the *Income Tax Act*, 1985; Section 3(2) of the *Estate Duty Act* 45 of 1955 (hereafter referred to as *EDA*).

177 Adjusted Cost Base (hereafter referred to ACB).

178 Di Verdi 2019 http://www.moneysense.ca/save/taxes/capital-gains-explained/ accessed 24 June 2019.

179 Bird *et al The Tax System in Industrialized Countries, Canada* 57; Benson *Summary of 1971 Tax Reform Legislation* 30.

180 Bruwer *The levying of estate duty and capital gains tax as double tax in South Africa* 18; Wells *The Theory and Practice of Taxation* 438.

181 Bruwer *The levying of estate duty and capital gains tax as double tax in South Africa* 18; *Estate Duty Act* 45 of 1955 (hereafter referred to as EDA).

182 This, in turn, perpetuates uncertainty in that an individual may be taxed twice on the same assets at the date of death; Bruwer *The levying of estate duty and capital gains tax as double tax in South Africa* 18; Wells *The Theory and Practice of Taxation* 1.

2.2.1.3 Personal use assets

Further similarities between the South African and the Canadian CGT regime is derived from a capital gain realised on the disposal of any personal use property.[183] Personal use assets such as furniture, motor vehicles or boats do not trigger CGT and is therefore considered to be fully exempt for CGT purposes.[184] The rationale for the exemption may be justified on the fact that when an individual disposes personal use assets, a capital gain made thereon is improbable.[185] It is evident that there is a capital loss due to the depreciation value of the property. If a Canadian resident furthermore realises a capital gain from gifted or donated property, the individual is entitled to an inclusion rate of zero on any of those gains realised.[186] Some of the property which may be subject to a zero rate includes any shares of the capital stock, a unit of a mutual fund trust or a right in those properties.[187] However, there are a few exemptions within the Canadian CGT regime for which a Canadian resident may qualify and that may reduce his taxable income in any given year of assessment. These differences are briefly discussed below.

2.2.2 Differences

2.2.2.1 Principle residence

The Canadian *Income Tax Act,* 1985[188] provides for certain exemptions that may be abandoned when calculating a resident's CGT liability when property has been disposed of. One of these exemptions, which is similar to South Africa, is the primary residence exemption. However, in Canadian tax law, this exemption is better known as the

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183 Paragraph 53 of the *Income Tax Act* 58 of 1962; Canadian *Income Tax Act* R.C.S 1985 c.1 (5th Suppl.)

184 Bruwer *The Levying of Estate Duty and Capital Gains Tax as Double Tax in South Africa* 41; Canada Revenue Agency http://www.cra-arc.gc.ca/E/pub/tg/t4037/t4037-e.html#Whatisthe accessed 25 June 2019.

185 Canada Revenue Agency 2018 https://www.canada.ca/content/dam/cra-arc/formspubs/pub/t4037/t4037-18e.pdf 10 accessed 24 June 2019.

186 Government of Canada 2019 https://www.canada.ca/en/revenue-agency/services/tax/individuals/topics/about-your-tax-return/tax-return/completing-a-tax-return/deductions-credits-expenses/line-349-donations-gifts/capital-gains-realized-on-gifts-certain-capital-property.html accessed 24 June 2019.

187 Canada Revenue Agency 2018 https://www.canada.ca/content/dam/cra-arc/formspubs/pub/t4037/t4037-18e.pdf 28 accessed 24 June 2019.

188 Canadian *Income Tax Act* R.C.S 1985 c.1 (5th Suppl.).

"principle residence" exemption and it differs slightly from the South African primary residence exclusion.

As mentioned above, the Eighth Schedule of the *ITA* provides for a R2 million exclusion on the disposal of a primary residence.[189] In contrast, the Canadian *Income Tax Act,* 1985 provides that if an individual sells or considers to sell immovable property classified as an individual's principle residence, it would not be subject to CGT.[190] A further exemption is the so-called "plus one rule", which may only be claimed by Canadian residents.[191] According to Aird and Berlis,[192] the plus one rule may be explained as follows:

> This "plus one rule" ensures that a taxpayer who sold one home and purchased another in the same year can eliminate the full gain in value on the first home for the year in which it was sold and can also eliminate the full gain in value on the second home for the year in which it was purchased.[193]

It is noteworthy that if the individual who made the disposal of the principle residence is a non-resident of Canada during the year of assessment in which the property was acquired, he or she will not be able to claim this exemption.[194] Thus, in order to qualify for this exemption, it is imperative that the individual must be a resident of Canada.

2.2.2.2 Rollovers and the lifetime capital gains tax exemption

Section 73(1) of the Canadian *Income Tax Act*, 1985 furthermore provides for a rollover between spouses similar to the exclusion afforded in the South African tax regime.[195] This

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189 See paragraph 1.4.2.1 above; Paragraph 44 of the Eighth Schedule to the *Income Tax Act* 58 of 1962;

190 This principle has the effect that no CGT would be payable on the disposal of a principle residents, regardless of the value of the property; Aird and Berlis LLP 2016 https://www.airdberlis.com/docs/default-source/newsletters/changes-to-the-principal-residence-exemption.pdf?sfvrsn=2 1 accessed 24 June 2019.

191 This requirement was introduced in 2016 and had the effect that only residents may claim this benefit. Canada Revenue Agency 2018 https://www.canada.ca/content/dam/cra-arc/formspubs/pub/t4037/t4037-18e.pdf 41 accessed 24 June 2019.

192 Aird and Berlis LLP 2016 https://www.airdberlis.com/docs/default-source/newsletters/changes-to-the-principal-residence-exemption.pdf?sfvrsn=2 1 accessed 24 June 2019.

193 Aird and Berlis LLP 2016 https://www.airdberlis.com/docs/default-source/newsletters/changes-to-the-principal-residence-exemption.pdf?sfvrsn=2 1 accessed 24 June 2019.

194 Canada Revenue Agency 2018 https://www.canada.ca/content/dam/cra-arc/formspubs/pub/t4037/t4037-18e.pdf 30 accessed 24 June 2019.

195 Section 73(3) of the *Income Tax Act,* 1985; Paragraph 67 of the *Income Tax Act* 58 of 1962.

has the effect that the capital gains made on the disposal of property is deferred up until the surviving spouse disposes the property which was received.[196]

However, if a spouse transfers shares in a qualified small business corporation[197] to another spouse, for example, the spouse may claim the so-called lifetime exemption afforded in the *Income Tax Act* 1985 on the disposal of these shares. This is known as the lifetime capital gains tax exemption[198] which provides for three types of properties that qualify for these exemptions. The properties that fall into the ambit of the LCGTE is firstly the sale of shares listed in QSBC, secondly qualified farm property, and lastly, qualified fishing property.[199] The LCGTE is currently limited to an amount of $866 912 (approximately R1 243 462.53).[200] In contrast with the South African annual individual exclusion, the LCGTE is not a fixed amount and will be adjusted for inflation each year according to the official rate of inflation as published by Statistics Canada.[201] This exemption is furthermore a lifetime cumulative exemption, which has the effect that Canadian residents may claim any part of the $866 912 when they make a disposal of the qualified property mentioned above.[202]

Furthermore, in order to use the LCGTE afforded in the *Income Tax Act* 1985, there are three tests which has to be adhered to. The three tests include that, firstly, a Canadian resident must be the rightful owner of the property, secondly, that the owner of the property in question must have exercised reasonable control over the asset, and lastly,

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196 Bruwer *The Levying of Estate Duty and Capital Gains Tax as Double Tax in South Africa* 35; Section 73(3) of the *Income Tax Act,* 1985.

197 Qualified small business corporation (hereafter referred to as QSBC).

198 Lifetime capital gains tax exemption (hereafter referred to as LCGTE).

199 Bruwer *The Levying of Estate Duty and Capital Gains Tax as Double Tax in South Africa* 34; Subsections 110.6(1) and 110.6(1.3) of Division C of the *Income Tax Act*, 1985; Turbo Tax 2019 https://turbotax.intuit.ca/tips/claiming-the-capital-gains-exemption-376 accessed 25 June 2019.

200 This calculation was done on 26 June 2019 with a dollar/rand ratio of R14.34; Labarge Weinstein https://www.lwlaw.com/lifetime-capital-gains-exemption-increased-as-of-january-1-2019/ accessed 26 June 2019.

201 Turbo Tax 2019 https://turbotax.intuit.ca/tips/claiming-the-capital-gains-exemption-376 accessed 25 June 2019.

202 In the case where a Canadian resident disposed of qualified farming- or fishing property, the lifetime exemption is limited to $1 000 000; Taxpage 2018 https://taxpage.com/lifetime-capital-gains-exemption/ accessed 26 June 2019.Turbo Tax 2019 https://turbotax.intuit.ca/tips/claiming-the-capital-gains-exemption-376 accessed 25 June 2019.

the assets in question must have been used principally[203] in an active business situated primarily in Canada.[204] It follows that shares may be exempt for CGT purposes. Furthermore, for the shares listed in a QSBC to qualify for the LCGTE, there is a further two fold test which has to be applied.[205] This includes that 90% of the assets in the active business must be used in a QSBC on the date on which the shares are disposed of, and secondly, 50% of those assets has to be active 24 months prior to their disposal.

2.3 Conclusion

A conclusion may be drawn from the above that although Canada and South Africa have similar tax regimes to regulate the taxation of CGT, there are some differences between these systems. Some of the main similarities between these tax systems are derived from the exclusions afforded to citizens in terms of the relevant tax laws. Although these exclusions may be regarded as similar, they differ slightly in that there are requirements that individual taxpayers have to meet to qualify for the exclusions set out in the above paragraphs.[206] Nevertheless, these differences are important and may be adopted by the legislator to improve the South African tax regime, especially with regard to the adoption of indexing inflation for CGT. It follows that the main difference between these tax systems is derived from the fact that Canada provides for the indexation of inflation on the LCGTE whereas the South African legislator only provides an annual exclusion amount which is not indexed for inflation. This major difference means that the taxation of CGT in Canada is seemingly more favourable than in South Africa. Although Canada has a higher inclusion rate than South Africa, it is imperative to note that Canada indexes the LCGTE to inflation, which results in providing Canadian residents certainty about the purchasing power of their money. The South African legislator, on the other hand, perpetuates uncertainty of its resident's purchasing power of money by failing to take inflation into account when calculating an individual's CGT liability. However, indexing inflation for CGT in South Africa will have an effect on the South African economy and

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[203] The term "principally" indicates that the assets in question must have been used more than 50% in an active business.
[204] Taxpage 2018 https://taxpage.com/lifetime-capital-gains-exemption/ accessed 26 June 2019.
[205] Subsection 110.6(1) of Division D of the *Income Tax Act,* 1985.
[206] See paragraph 1.4.2 above.

the effects thereof must firstly be considered before recommending that the South African legislator should adopt this Canadian principle into its tax legislation. The chapter that follows discusses the possible impact of indexing inflation for CGT on the South African economy.

Indexing inflation for capital gains tax

It would be prudent for the South African legislator to weigh a number of possible factors before deciding to index inflation for CGT. These factors are, firstly, to determine who will benefit if inflation were to be indexed on a CGT calculation, and secondly, whether the indexation of inflation for CGT will facilitate or distort economic growth in South Africa. This chapter discusses the possible effect of indexing inflation for capital gains tax by examining these two factors to determine whether or not indexing inflation for CGT would be advisable in South Africa. The functions of the SARB and the effect of inflation in the economy are examined as part of the considerations. Furthermore, when interpreting these factors, the question of whether the legislator's reasons for not indexing inflation for CGT is revisited to conclude the chapter.

3.1 The importance of inflation targeting as a monetary policy framework

The *Constitution* states that sustainable economic growth is the primary objective of the SARB.[207] The price stability in a country is furthermore considered to be a major precursor to faster, sustainable economic growth.[208] In order to achieve economic objectives such as price stability, the SARB has the duty to control inflation in South Africa.[209] When the inflation rate is high and not effectively controlled or monitored by the SARB, it injures the economy.[210] In addition, inflation can only be controlled effectively in a financially sound and stable environment.

Indexing inflation for CGT in South Africa has the potential to disrupt economic growth.[211] The rationale for this statement is that if inflation were to be indexed on a CGT calculation, it would have the effect that an individual would pay fewer taxes, because inflation decreases an individual's monetary purchasing power over a certain period, especially

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[207] See paragraph 1.2 above.

[208] Galodikwe *Exploring the Relationship Between Producer Price Index and Consumer Price Index in South Africa* 11.

[209] Section 224(1) of the *Constitution of the Republic of South Africa* 108 of 1996.

[210] The balance 2019 https://www.thebalance.com/inflation-impact-on-economy-3306102 accessed 30 June 2019.

[211] Econofact 2018 https://econofact.org/the-capital-gains-tax-and-inflation accessed 5 August 2019.

with regard to investments.[212] Although individual taxpayers would benefit by paying fewer taxes, a more objective view has to be considered. When taxpayers pay fewer taxes, SARS will collect less revenue, which directly affects economic growth in South Africa. The economic growth of a country can be defined as follows:

> An increase in the production of economic goods and services, compared from one period of time to another.[213]

It is furthermore worth mentioning that economic growth is measured by the gross domestic product[214] per capita of a country. GDP may also be seen as an indicator of the standards of living of the residents in an economy.[215] In other words, GDP can be seen as a "comprehensive scorecard of the country's economic health".[216] A country's economic growth is measured quarterly and it takes the entire country's output, such as goods produced and services rendered by a business, into account.[217]

The economic growth definition above furthermore clarifies the fact that by taxing residents on the disposal or deemed disposal of assets would add to the economic growth in South Africa. Hence the introduction of CGT in South Africa.[218] However, in addition to CGT adding to economic growth, the required taxation regime must be "inexpensive to administer, convenient to comply with and difficult to evade".[219] With that being said, when the South African legislator considers indexing inflation for CGT, there is a possibility that it may complicate the taxation regime when calculating an individual's CGT

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212 Goodall *Investment planning* 234, 252; Investopedia 2019 https://www.investopedia.com/terms/p/purchasingpower.asp accessed 19 July 2019.
213 Investopedia 2019 https://www.investopedia.com/terms/e/economicgrowth.asp accessed 29 June 2019.
214 Gross domestic product (hereafter referred to as GDP).
215 GDP is the total monetary or market value of all the finished goods and services produced within a country's borders in a specific time period; Economics online 2009 https://www.economicsonline.co.uk/Managing_the_economy/Sustainable_growth.html accessed 29 June 2019.
216 Investopedia 2019 https://www.investopedia.com/terms/g/gdp.asp accessed 29 June 2019.
217 The balance 2019 https://www.thebalance.com/inflation-impact-on-economy-3306102 accessed 30 June 2019.
218 See paragraph 2.1.3 above.
219 Stretch *Taxgram* 2001.

liabilities.[220] The government furthermore views inflation as a constant challenge and addresses it by adopting a "conservative and sustainable fiscal monetary policy".[221] Indexing inflation for CGT may add to this challenge as the administration of the taxation of CGT becomes technically too difficult.[222] Furthermore, failing to properly monitor inflation may also negatively affect an individual's monetary purchasing power.

3.2 Monetary purchasing power and inflation

3.2.1 The effect of inflation on the monetary purchasing power

Inflation is considered one of the most important factors an individual should consider before investing funds into a financial product or real estate which may trigger CGT.[223] Goodall[224] defines an investment to mean the following:

> The current commitment of money for a period of time in order to derive future benefits that will compensate the investor for the time the funds are committed; the expected rate of inflation and the uncertainty of the future payments.[225]

In the definition above, the expected rate of inflation refers to the investor's need to earn a real return in excess of the rate of inflation in order for capital to maintain its purchasing power.[226] A real return on an investment may be defined as an annual percentage return that is adjusted for changes in prices and goods due to inflation and external factors.[227] It follows that an investment that only returns the rate of inflation provides no increase in an individual's purchasing power. This may be explained by way of the following example:

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220 This would most probably lead to an administration adaption in that SARS may require skilled personnel to administrate the difficult process in calculating an individual's CGT liability; Stretch *Taxgram* 2001.

221 Galodikwe *Exploring the Relationship Between Producer Price Index and Consumer Price Index in South Africa* 12; International Monetary Fund 1998 https://www.imf.org/external/pubs/ft/issues/issues15/ accessed 29 June 2019.

222 Stretch *Taxgram* 2001.

223 Goodall *et al The South African Planning Handbook 2019* 233.

224 Goodall *et al The South African Planning Handbook 2019* 230.

225 Goodall *et al The South African Planning Handbook 2019* 230; Brown and Reilly *Investment Analysis and Portfolio Management* 4.

226 Goodall *et al The South African Planning Handbook 2019* 230.

227 Marshall Hargrave 2019 https://www.investopedia.com/terms/r/realrateofreturn.asp accessed 30 June 2019.

> A registered taxpayer buys an asset in 2001 for R1 000 and disposes of that asset in 2012. Assuming the inflation rate during that period was 6% compounded annually and the taxpayer realised a nominal gain of 10% compounded annually, it will result in a 4% real return above the inflation rate. Assuming further that the asset was disposed of for R2 853, the investor would have made a gain of R1 853.[228]

CGT would be payable on the capital gain, which in this example benefits the taxpayer in that he still made a large profit on the disposal of the asset after being taxed on the proceeds. However, when inflation is indexed into the CGT calculation, the real profit would be R539.[229] Although this might seem like a good investment, it must be borne in mind that the inflation rate does not exist in a vacuum and it may, therefore, change any time during the period of the investment. Therefore, the SARB has the duty to maintain overall low rates of inflation in order to facilitate economic growth and price stability.[230] If inflation rates are not maintained by the SARB it will perpetuate uncertainty with regard to the taxpayer's monetary purchasing power, which in turn will lead to investors investing more cautiously, or not at all.

Another factor that the legislator should take into account is that the top income earners, commonly known as the rich, play an imperative role in the development of the economy and in economic growth due to the amount of income they earn and the taxes they pay.[231] It may be said that the CGT burden is mainly aimed at wealthier individuals as opposed to average income earning households.[232] This statement is supported by statistics that confirm that since CGT was introduced on October 2001, the net yield has been exceptionally low, averaging only between 1% and 2% of the total revenues collected by SARS.[233] This is because individuals earning less income than wealthier individuals do not fall into the tax net of capital gains because their income does not allow them to purchase assets that can realise a significant capital gain. In addition, in the

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[228] Ben Strauss date unknown http://www.sataxguide.co.za/capital-gains-tax-savings-and-inflation/?print=print accessed 30 June 2019; Cliffe Dekker Hofmeyr 2014 https://www.saica.co.za/integritax/2014/2285._The_effects_of_inflation.htm; accessed 30 June 2019.

[229] Cliffe Dekker Hofmeyr 2014 https://www.saica.co.za/integritax/2014/2285._The_effects_of_inflation.htm accessed 30 June 2019.

[230] Section 224(1) of the *Constitution of the Republic of South Africa,* 108 of 1996.

[231] Steenkamp *Taxing the Rich at Higher Rates in South Africa* 2.

[232] Steenkamp *Taxing the Rich at Higher Rates in South Africa* 2.

[233] Grid *A Capital Gains Tax* 1995.

2017/2018 year of assessment, the revenue collected by SARS through CGT in South Africa showed a narrow increase of 3.3% of the total revenue collected for the year of assessment.[234] However, despite an increase in CGT revenue, the total tax revenue received during the 2017/2018 year of assessment did not exceed GDP growth.[235] It follows that it is most likely that only the wealthier individuals will benefit if CGT were to be indexed for inflation. This directly links to the possibility of taxation inequality.

3.2.2 Taxation equality

As mentioned before, one of the reasons why CGT was implemented in South Africa was to ensure taxation equality between individuals.[236] However, when inflation is indexed for CGT, it would be hard to draw a distinction in equality between wealthy individuals and average income earning households.[237] The rationale for this is derived from the fact that the tax burden falls mainly on wealthier taxpayers who already pay higher taxes according to their progressive scale.[238] In order to ensure horizontal equity taxation of CGT, it is imperative that all individuals pay taxes on a similar tax scale.[239] This is achieved by providing a 40% inclusion rate on all CGT calculations for South African residents who made a capital gain on the disposal or deemed disposal of property.[240] At this point in research it seems that, although the inclusion rate in South Africa is considered rather low compared to that of Canada, the fixed inclusion rate and an annual exclusion amount of R40 000 for natural persons is more beneficial to the economy and individuals as opposed to indexing inflation for CGT in South Africa.

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[234] The total tax revenue collected amounted to R1 216.5 billion in 2017/2018, growing year-on-year by R72.4 billion (6.3%) which is mainly supported by personal income tax, which grew by R37.0 billion (8.7%); SARS 2019 https://www.sars.gov.za/Media/MediaReleases/Pages/20-December-2018---Tax-Statistics-2018.aspx accessed 1 July 2019.

[235] SARS 2019 https://www.sars.gov.za/Media/MediaReleases/Pages/20-December-2018---Tax-Statistics-2018.aspx; National treasury date unknown http://www.treasury.gov.za/publications/tax%20statistics/default.aspx accessed 1 July 2019.

[236] See Chapter 1.3.3.2 above; Section 2 of the Constitution of the Republic of South Africa, 108 of 1996; De Waal *et al The Bill of Rights Handbook* 38; William *2005 PSLR* 719.

[237] Businesstech 2018 https://businesstech.co.za/news/business/218475/taxing-south-africas-rich-will-only-chase-them-away/ accessed 10 August 2019.

[238] Grid *A Capital Gains Tax* 1995.

[239] See paragraph 2.1.1.2 above.

[240] Stiglingh *et al Silke: South African Income Tax 2019* par 10.28; Coetzee *et al 'n Studentebenadering tot inkomstebelasting* 527; Paragraph 9, 10 of the Eighth schedule to the *Income Tax Act* 58 of 1962.

Although the annual exclusion amount in South Africa is not indexed for inflation as in the case of the Canadian LCGTE, a South African resident qualifies for the annual exemption each year of assessment.[241] A low inclusion rate and an annual exclusion may justify the legislator's reasons not to index inflation for CGT. In this instance, it adds to taxation equality between individuals with different income classes. It is furthermore noteworthy that if the legislator were to increase the inclusion rate for individuals, it would have the effect that more taxes would be payable to SARS, which leads to higher revenue returns and better economic growth. The opposite is also true if the inclusion rate was decreased. In this regard, it may perhaps benefit registered taxpayers by reducing their tax liabilities, but economic growth will be disrupted.

3.3 Conclusion

The conclusion from the above is that a more objective view should be considered before recommending that inflation be indexed for CGT in South Africa. With that being said, the interest of the individual taxpayer must be weighed up against the interest of the South African economy to determine who will benefit the most. This chapter contemplated this balance by discussing the possible effects of inflation on the individual and the economy as well as the possible effects of indexing inflation on a CGT calculation. It became evident that only one party will be able to benefit if inflation were to be indexed for CGT in South Africa, i.e. the individual taxpayer or SARS. Wealthier individuals are most likely to benefit if inflation were to be indexed for CGT by paying fewer taxes due to the constant erosion of the monetary purchasing power through inflation. SARS, on the other hand, would receive less revenue income to properly perform their duties, which may add to the economic growth challenge in South Africa. Indexing inflation for CGT will thus have the effect of only the wealthiest individuals falling within the ambit of CGT, which would lead to taxation inequality and deprivation of economic growth. This is because inflation erodes the monetary purchasing power with regard to investments which has the effect that middle-class income households evade the capital gains tax net and SARS collects less revenue through the taxation of CGT. The statistics show that the revenue collected

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241 Clegg *Income tax in South Africa* 91.

from CGT is exceptionally low compared to revenue collected through income tax. In this regard, it seems as if the legislator may be justified in its decision not to index inflation on a CGT calculation due to the annual exclusion afforded in the *ITA* as well as the low inclusion rate individuals qualify for in any given year of assessment. Although CGT would be difficult to evade, the indexation for inflation may complicate the taxation regime in that it would require additional expenses to administer by SARS and it would not be convenient to comply with. Recommendations to the South African legislator as to whether or not inflation must be indexed on a CGT calculation are made in the concluding chapter.

Conclusions and recommendations

4 Conclusion

This chapter offers a summary of the findings from the study as well as recommendations for further research within the field of South African Tax Law. The study investigated the possibility of indexing inflation on CGT in South Africa and aimed to answer the question to which extent inflation will have an effect on Capital gains tax.

In answering the research question, the historical development of CGT in South Africa and the reasons for its implementation were provided to serve as a general introduction. Moreover, the current position with regard to CGT in South Africa was discussed to establish the possible challenges that may arise if the South African legislator indexed inflation for CGT. When interpreting the current CGT position, it became evident that one of the persisting current challenges is that the indexation of inflation for CGT is currently not governed by the *ITA* or any other legislation prior thereto. This has the effect that indexing inflation for CGT may add to current challenges and developments in South African tax law. Adding to this challenge is the fact that tax law principles, practice and inflation do not exist in a vacuum and are therefore ever-changing.

Before recommending the South African legislator to amend current legislation to accommodate the indexation of inflation on all CGT calculations, a comparison between the South African and Canadian tax regime was necessary. When comparing these two tax regimes, it became evident that the South African and Canadian tax regimes are very similar, but differ slightly with regard to the exemptions afforded in their respective legislation. However, it is important for the South African legislator to take the differences with the Canadian tax regime into account when considering whether or not to index inflation for CGT in South Africa. An investigation between the two tax regimes revealed that the main difference is that the Canadian tax regime provides for the indexation of inflation on the so-called LCGTE as opposed to the South African legislation which neglected to take inflation into account when calculating an individual's CGT liability.

Nevertheless, inflation is one of the most important aspects the South African legislator has to take into account when considering whether or not to index inflation for CGT.

The causes, outcomes and challenges with regard to inflation in South Africa were subsequently discussed. The absence of inflation on investments was clearly illustrated by way of Goodall's[242] example. This example illustrates the pivotal role of inflation in the presence of an investment in order to provide investors a real rate of return above the annual inflation rate. The absence of inflation on an investment will evidently have a negative effect on the investor's monetary purchasing power. It is furthermore the duty of the SARB to monitor inflation in South Africa effectively. Failure to monitor inflation through an inflation targeting framework will disturb the economy as well as individual investments.

With due regards to the indexation of inflation for CGT in South Africa, however, it is the submission in this study that, after comparing the Canadian tax regime to that of South Africa, the South African legislator should not consider indexing inflation for CGT. The rationale for this statement is twofold. Firstly, although Canada indexes inflation for CGT to provide monetary certainty to its taxpayers, it will be more difficult to administer as part of the South African taxation regime. This may require additional administrative capacity due to the complex nature in calculating a South African resident's CGT liabilities. Indexing inflation for CGT in South Africa would not only complicate its taxation, but it may be more expensive to administer and monitor and would also be inconvenient to comply with.[243] Furthermore, the LCGTE afforded in Canadian tax law only applies to certain property owned by individual taxpayers. The property eligible for this exemption includes the sale of shares in QSBCs, qualified farm property and qualified fishing property.[244] Adopting the LCGTE principle into South African tax law on the disposition of all assets, for example, would make the taxation regime in South Africa more complicated. In addition, indexing inflation on CGT in South Africa will shift a heavier burden onto the shoulders of the SARB as it would have to effectively monitor and control inflation because

242 Goodall *Investment Planning* 234.
243 See paragraph 3.1 above.
244 See paragraph 2.2.3.2 above.

of the effect inflation will have on investments and an individual's CGT calculation. The recent interest rate amendments the SARB made serves as an example. It may add to the administration difficulties when indexing inflation on CGT calculations.[245]

Secondly, indexing inflation for CGT in South Africa may lead to taxation inequality. Having researched the possible effects inflation might have on CGT, it is the submission in this study that a more objective view has to be considered as to who will benefit if inflation were to be indexed for CGT. In other words, the South African economy must be weighed up against the interest of the individual taxpayer.

If inflation were to be indexed on a capital gain, it would have the effect that average income households will evidently escape the CGT net. It follows that only wealthier individuals will fall within the ambit of CGT, which will roughly contribute one to two percent of the total revenue collected through the taxation of CGT.[246] In all probability, the revenue collected by SARS through the taxation of CGT would be less than the current income statistics if the South African legislator indexes inflation for CGT.[247] However, the South African legislator affords all natural persons an annual 40% inclusion rate on a CGT calculation.[248] This establishes horizontal equity in that all taxpayers bear the same tax obligations with regard to the disposition of assets. Professor Brooks[249] regards this as a fair and just principle, a view with which I agree.[250] Furthermore, although registered taxpayers will benefit by paying fewer taxes, the consideration by the South African legislator to index inflation on CGT would have a detrimental effect on investments and the South African economy in that SARS will receive less revenue to properly perform

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245 The interest rate cuts were confirmed by Lesetja Kganyago, governor of the South African Reserve Bank, in his statement on the monetary policy committee dated 18 July 2019; South African Reserve Bank 2019 https://www.resbank.co.za/Lists/News%20and%20Publications/Attachments/9387/MPC%20Statement_18%20July%202019.pdf accessed 26 September 2019.

246 See Chapter 3.2.1 above

247 SARS 2019 https://www.sars.gov.za/Media/MediaReleases/Pages/20-December-2018---Tax-Statistics-2018.aspx accessed 1 July 2019.

248 Paragraph 9 and 10 of the Eighth Schedule to the *ITA.*

249 Stretch *2001 Taxgram* 42.

250 See paragraph 1.3.3.3 above.

their statutory duties.[251] The legislator's reasons for not indexing inflation for CGT may be justified based solely on the annual exclusion amount and low inclusion rate.

5 Recommendations

The research revealed certain principles of the Canadian tax regime that the South African legislator may want to consider adopting into the South African tax regime. These principles include, firstly, the abolishment of so-called death taxes which Canada abolished when CGT was first introduced in 1979.

Currently, South Africa levies both estate duty and CGT on the estate of a natural person at the date of his death. This is better known as double taxation which occurs when two separate taxes are levied by the legislator for interchangeable objectives.[252] Double taxation in South Africa raises concerns in that both estate duty and CGT may be applicable to a deceased estate, which results in CGT intertwining with estate duty.[253] Both taxes are furthermore considered to be a taxation on the transfer of an individual taxpayer's wealth.[254] Abolishing estate duty, and thus the double taxation ambiguity in South Africa, will provide legal certainty to residents as to what the tax implications at the time of a natural person's death will be. Canada primarily abolished death taxes due to the adverse tax implications for their residents.[255] In addition, it is recommended that the South African legislator considers abolishing estate duty to clarify the ambiguous provisions in legislation with regard to the levying of both estate duty and CGT at the time of a natural person's death.

Secondly, the South African legislator may also want to consider adopting the so-called principle residence exclusion afforded to residents in the Canadian tax regime. This exemption entails that there are no CGT consequences on the disposition of a primary

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[251] See paragraph 3.2.1 above.

[252] Bruwer *The Levying of Estate Duty and Capital Gains Tax as Double Tax in South Africa* 43; Cooley *The Law of Taxation* 223; Ger 2012 *Time for Estate Duty to Go?* http://www.derebus.org.za/time-estate-duty-go/ accessed 6 October 2019.

[253] Ramson *The Interface Between Capital Gains Tax and Estate Duty and the Double Tax Implications Thereof* 20.

[254] See paragraph 3.2.1.2 above.

[255] Maloney 1988 *Ottawa Law Review* 605.

residence by a Canadian resident. In addition, no CGT is payable on the disposal or deemed disposal of a primary residence by a Canadian resident due to the "plus one" rule.[256] Investigation has established that the rule grants a registered taxpayer the benefit of eliminating the full gain in value on the first home for the year in which it was sold as well as the full gain in value on the second home for the year in which it was purchased.[257]

Adopting such principles into South African law will have the effect that taxpayers would pay fewer taxes on the disposal of a primary residence, which may perhaps put back faith in the revenue system. It would furthermore motivate individuals to invest the capital gain made on the disposal of the primary residence in other assets or investments. Encouraging taxpayers to invest their money in other assets may also add to economic growth in South Africa. Since less revenue will be collected through the taxation on the disposal of a primary residence through the taxation of CGT, the legislator may possibly increase the inclusion rate accordingly to accommodate the loss in revenue through the taxation of CGT.

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256 See paragraph 2.2.3.1 above

257 Aird and Berlis LLP 2016 https://www.airdberlis.com/docs/default-source/newsletters/changes-to-the-principal-residence-exemption.pdf?sfvrsn=2_ 1 accessed 24 June 2019; See paragraph 2.2.3.1 above.

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ANNEXURES

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DECLARATION OF LANGUAGE EDITING

I, Christina Maria Etrecia Terblanche, hereby declare that I edited the research study titled:

The indexation of inflation for capital gains tax in South Africa

for **Francoa Willemse** for the purpose of submission as a postgraduate research study. Changes were indicated in track changes and implementation was left to the author.

Regards,

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