

NORTH WEST UNIVERSITY

THE IMPACT OF CAPITAL GAINS TAX ON THE ECONOMY OF SOUTH AFRICA

BY

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DECLARATION

I hereby declare that this dissertation for this degree of Master in Business Administration at the North West University is submitted in its originality without duplicity from any other document of its nature, and has never been submitted by me at any other academic institution. All the work has been acknowledged for its originality in design, execution and materials provided.



Lobengula Andrew Maluleka

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LIST OF ABBREVIATIONS AND ACRONYMS

Abbreviation	Meaning
CGT	CAPITAL GAINS TAX
CIR	COMMISSIONER OF INLAND REVENUE
SATC	SOUTH AFRICAN TAX COURT
EU	EUROPEAN UNION
RSA	REPUBLIC OF SOUTH AFRICA
UK	UNITED KINGDOM
USA	UNITED STATES OF AMERICA

CHAPTER 1

ORIENTATION

1. INTRODUCTION

This study seeks to analyse the impact that Capital Gains Tax (CGT) had on the South African economy from the beginning of October 2001 when it was promulgated. The South African economy has for centuries been characterised by a skewed redistribution of wealth among Whites, Indians, Coloureds and Blacks. The South African Tax system had been a swamp of unfairness, complexity, and inefficiency. The accumulation of exclusions, deductions credits designed to help particular groups or advance special purposes conflicting with one another, were poorly designed and represented no consistent policy. Tax rates were very high, like in most developing countries.

The media quoted the Head of South African Revenue Services as saying that the country lost millions of rand in tax revenues because some taxpayers before October 2001 avoided tax by converting income that would normally be taxed into free capital gains. Individuals and companies tended to plough income into capital investment to avoid tax. It was also stated that structural changes to the Income Tax to include CGT was necessary to ensure that the South African tax system keeps pace with globalisation and the integration of the country with the world economy. Further the CGT as introduced, would bring the country into line with international trends and its major trading partners like the European Union, the United States of America and Canada (Sowetan, 24 February. 2000).

1.1. Capital Gains Tax Introduction



The South African Government Minister of Finance Mr Trevor Manuel announced the most far-reaching structural reforms to the tax system in his Budget Speech on 23 February 2000. Several proposals were introduced with

prospective effect. One of the most significant of the taxes introduced was the Capital Gains Tax. Capital gains tax in South Africa is actually normal income tax on the taxable portion of a capital gain. Individuals, 'special' trusts and deceased and insolvent estates will pay normal income tax on 25 percent of the capital gains – that is capital profits – they make, whereas companies, close corporations, and ordinary trusts will pay normal income tax on 50 percent of the capital profits that they make. The tax on capital gains will apply to any asset of a South African resident. This means that a South African resident is taxed on capital gains made on the disposal of assets which he owns anywhere in the world. For non-residents the following assets are covered by the capital gains tax provision; the disposal of immovable (fixed) property situated in South Africa, and the disposal of assets of a South African permanent establishment (Huxham et al, 2002:580).

It is submitted that this tax reform is for the high-income bracket taxpayers who have more than one property. The South African tax system like most tax systems in Europe and America is based on the premise that the wealthy and affluent should carry a greater proportion of the burden of funding the State than the poor. In line with the rest of the world, South Africa has in recent years moved away from a tax system which was based predominantly on direct taxation to a system which is a mixture of direct and indirect taxation.

1.2. Legislation

The Taxation Laws Amendment Act, of 2001 (Act. No. 5 of 2001), introduced Capital Gains Tax into the Income Tax Act (Act 58 of 1962). Geach (2001:1) propounds that the Government could have introduced CGT by way of the enactment of a separate Act, for example The Capital Gains Tax Act, like it has been done with other taxes like the Estate Duty, Transfer Duty, Stamp Duty, and Value Added Tax. The paramount reason given for the introduction of CGT in South Africa is that a gain realised on capital asset is economically no different to any other item of income. The tax is not on capital or wealth itself, because it is only gains and not the fundamental capital base which is taxed (www.lexisnexis.co.za).

1.2.1. Reactions by taxpayers

The proposal of Capital Gains Tax in parliament was followed by an outcry of foul, by the media. A lot of energy was lost in trying to bar this new taxation reform, with statements such as “it is going to be costly to implement”, and “the revenue collected will be insignificant to make a difference”.

1.3 DEFINITION OF CONCEPTS

The following definitions are not comprehensive because of the constraints dictated too by the scope of this study.

1.3.1 Capital gains tax

Capital gains tax is a tax, which is levied on the sale of a property, or shares. Property in this regard refers to a house either than the house used for accommodation for the family unit. It refers to a house owned over, and above the one already stated, an extra house. For instance, before the promulgation of the Taxation Laws Amendment Bill, 2001, and before the 1st October 2001, when one owned a house or a block of flats, and using these for renting out, rent collected was part of income and was taxed as such. But when the house or block of flats were sold at a profit no tax was levied on the receipts or accrual, because the transactions in most instances were deemed as of capital nature the onus of prove vesting on the tax payer, also when shares were sold at a profit, tax was not charged, although both in all respect constituted an income to the taxpayer. Although widely referred to as “capital gains tax” this tax is more correctly described as a tax on capital gains.

James et al (1992:138 - 139) propound that most forms of capital gains have much the same characteristics as income, because several types of capital gains are income in camouflage. He further states that the precise definition of income has been the subject of considerable debate. He quotes three authors Haig (1921) who for example, gave the following definition; “income is the money-value of the net accretion to economic power between two points of

time”. Henry Simons (1938) states that: “Personal income may be defined as the algebraic sum of (a) the market value of rights exercised in consumption and (b) the change in value of the store of property rights between the beginning and end of the period in question”, while Hicks’ (1974) definition took income as the “maximum amount of money which the individual can spend this week, and still be able to spend the same amount in real terms in each ensuing week”. James further submits that the definition that seems to be increasingly accepted is that of total accretion. That is, the accrual of wealth, which includes as income an individual’s spending in a given period, plus any changes in his net wealth. Many types of capital gains may be considered as income. This definition includes inheritances, gifts, winnings from gambling and any ‘windfall’ gains.

1.3.2. Capital gain

A capital gain arises when the proceeds of the disposal of an asset are greater than the base cost or purchase price plus management costs of an asset. A portion of the gain is added to the taxpayer’s taxable income and is subject to normal tax (income tax) using progressive tax rates for individuals and companies. A person’s capital gain for a year of assessment, in respect of the disposal of an asset, during that year, is equal to the amount by which the proceeds received or accrued in consequence of that disposal exceed the base cost of that asset. The following example illustrates this:

Proceeds received or accrued in consequence

<i>of the disposal of an asset</i>	<i>R2000</i>
<i>less: The base cost of the asset</i>	<i>(R1500)</i>
<i>Capital gain</i>	<i>R 500</i>

(Huxham et al, 2002:587).

1.3.3. Capital loss

Capital loss arises when an asset is sold for less than the cost, or purchase price plus management costs. A person's capital loss for a year of assessment in respect of the disposal of an asset, during that year, is equal to the amount by which the base cost of that asset exceeds the proceeds received or accrued in consequence of that disposal. The following example illustrates this:

<i>Base cost</i>	<i>(R1500)</i>
<i>Reduced by proceeds received or accrued</i>	<i><u>R1000</u></i>
<i>Capital loss</i>	<i>(R 500)</i>

(Huxham et al, 2002: 587).

1.3.4. Asset

Chidell (2004:21) submits in the case of the U K jurisdiction that all forms of properties are assets whether situated in the United Kingdom or not.

The Taxation Laws Amendment Act of 2001 defines asset as a property of whatever nature, whether movable or immovable, corporeal or incorporeal, excluding any currency, but including any coin made mainly from gold or silver or platinum; and a right or interest of whatever nature to or in such property. Currency is excluded from the definition of asset.

1.3.5. Wasting Assets

Chidell (2004:25) propounds that as far as the definition of an asset is concerned, the universal rule is that there is no chargeable gain on the disposal of an interest, on an asset which is tangible movable property and which is a wasting asset. He further states that the UK legislation defines a "wasting asset" as an asset with a predictable life not exceeding fifty years, a motor vehicle can be given as an example.

1.4. OBJECTIVES OF THE STUDY

The objectives of this research study are:

- To establish whether capital gains tax was implemented for economic efficiency and growth. In this regard the question is what then is the impact of CGT on efficiency and economic growth? This study must articulate efficiency if any and empirically and analytically demonstrate growth or lack of it.
- To propound that the manner in which CGT was defined and identified before October 2001 was formulated on unsatisfactory bases.
- The reform ushered in by CGT was an overhaul of the South African tax system. This study seeks to establish to the extent to which CGT is rejected by taxpayers, and also if there is a serious problems with its management.
- CGT has been labelled as (costly) and a low yield (revenue collected will be insignificant) tax reform. This study seeks to know the extent to which CGT will affect the revenue collection process, in terms of growth (job creation etc), and government spending as well as income redistribution.
- South Africa is a developing country in need of direct foreign investment for job creation and poverty alleviation. This study seeks to determine to what extent has CGT encouraged offshore investments and discouraged foreign direct investment.
- The Apartheid regime deliberately created two classes in South Africa; the first rich and White and the second Black and poor. This study want to examine whether CGT seek to entrench equity among the taxpayers.

1.5. IMPORTANCE OF THE STUDY

- This study is done in the broadest sense for anyone who is interested in the economic impacts of capital income taxes. Those researchers interested primarily in non-technical issues of capital gains tax in South Africa in particular may find this study more useful as a starting point for locating the existing literature or as a reference source for data.
- The South African tax system, particularly the capital gains part of it still has incentives, which compromise the principles of fairness and equity. Because future tax reforms are inevitable; Legislators, Consultants, and Policy makers for any tax-reform will use this study as a reference document. They will be directed to further reference materials used in this study.
- The study will serve as an informative and reference text for Tax Scholars seeking greater insight into the Capital Gains Tax effects in developing countries with reference to South Africa.

1.6. SCOPE OF THE STUDY

Capital Gains Tax was implemented as part of a greater South African tax reform of 2001. The scope of the study is outlined in the following discussions:

- This study is anchored in the field of tax reform of 2001 but also focuses on the impact of Capital Gains Tax (CGT) to the Economy of South Africa. The impact will be measured in government spending, income redistribution, job creation and social securities.
- The study also looks into tax reforms of some developed and developing countries to assess whether South Africa is alone in the implementation of this most difficult type of tax reform. This will be done through literature review

about those tax jurisdictions, including literature and publications about South Africa before 2001, and after.

- This study is a quantitative survey employing secondary and primary data collection. The secondary data was obtained from South African Treasury Department, Statistics South Africa, South African Revenue Services (SARS), and The South African Reserve Bank. CGT implementation involves an Act of parliament and it is a complicated form of taxation, and cannot be easily understood by ordinary taxpayers. Therefore affluent and informed taxpayers were selected as a sample. The primary data collection involved telephonic interviews, the sample is not categorised but the population is represented by Union leaders, Lawyers, Accountants, and the media, randomly selected. In other words taxpayers who are well vested with the Taxation Laws before and after October 2001.

1.7. ORGANISATION OF THE STUDY



The survey is organised as follows:

- The first chapter comprises the introduction and background to the problem, objectives, scope, and importance of the study as well as the design and methodology.
- Chapter two depicts theoretical foundations and the literature review. The study of literature was undertaken with the objective of establishing, assembling and integrating theoretical data pertaining to Taxation reforms with special reference to CGT. The theoretical framework was based on information from Tax textbooks, journals articles, newspaper articles, magazines and the Internet.
- The statement of the problem is focused in chapter three. Commissions of inquiries into the introduction of CGT previously have not been in accord about CGT and its implementation in South Africa.

- Chapter four is dedicated to the reporting of the results from the empirical research as well as from the secondary data from existing statistics. It also focuses on research design and techniques used in the collection of data.
- Chapter five focuses on presentation, interpretations and analysis of data.
- In chapter six, the results of the research are discussed and conclusions drawn from the research presented, and the chapter closes with recommendations.

CHAPTER 2

LITERATURE REVIEW AND THEORETICAL FOUNDATION

2.1. INTRODUCTION

The aim of this work is to present a survey of the revenue collection system by way of Capital Gains Tax of South Africa, and the use thereof by the government, as it is embodied in Act 58 of 1962 before October 2001 and the period after the promulgation of Taxation Laws Amendment Act, 2001, which ushered Capital Gains Tax (CGT) as it stands defined to date. The work makes no pretensions to completeness. Nevertheless, it is hoped that it will articulate the impact CGT is going to make to the economy of a free South Africa.

Capital Gains Tax is a tax net. The impact it can have on the economy of South Africa can be two fold; a growing economy will depict a positive impact, whilst the opposite will indicate a negative impact. The administrative cost of this form of taxation can be one of the reasons for a negative impact. Sowetan (24 February. 2000) depicted Capital Gains Tax as one of the most significant of the taxes introduced, and also that its implementation was going to introduce the most far-reaching tax reform ever-undertaken in South Africa.

Government spending on infrastructure, health, education, Safety and Security among others contributes to the growth of the economy of a country. It is argued that, in order to achieve the basic tax policy objectives of equity and efficiency, a tax system should impose a direct tax on a broad income base. Such an income base, which must include all types of income, including the fruits of labour and returns on capital investment, is considered to be the best measure of a taxpayer's ability to pay. On the grounds of equity and efficiency, economic theorists have advanced strong arguments in favour of the taxation of capital gains (Coetzee, 1990:4).

2.2. CAPITAL GAINS TAX INTERNATIONAL PERSPECTIVES

2.2.1. IDENTIFICATION OF CAPITAL GAINS GENERALLY

Coetzee (1990:13) submits that the International Fiscal association addressed the problem of defining capital gains in various countries and reached the following conclusion: “It is almost impossible to provide a clear and simple definition of capital gains. This area of tax law is constantly in development and is one of the most interesting fields for study and research”.

In most countries, the concept of a *capital gain* is, inadequately defined in tax legislation. As a consequence of this common deficiency, the interpretation of the expression *capital gain* has been left to the courts. In the United Kingdom, for example, the legislation provides that all income from ‘trade’ is subject to ordinary income tax while income from non-trade is subject to capital gains tax. The Canadians define a capital gain in the negative, that is, a gain that arises from the disposition of capital property to the extent that the gain is not otherwise included in computing income. In South Africa ‘gross income’ excluded capital gains, which are defined as ‘receipts or accruals of a capital nature’ (Coetzee, 1990: 20).

In the three-mentioned jurisdiction the chief enquiry by the courts in the identification of a capital gain vary;

- **South Africa.** Has the relevant asset been dealt with, acquired, held or disposed of in pursuance of a scheme for profit-making?
- **United Kingdom.** Has the relevant asset been acquired with the intention to deal with it as part of the taxpayer’s trade?
- **Canada.** Has the relevant asset been acquired with the intention to deal with it as part of the taxpayer’s business?

It is concluded that the concept of capital gain in South Africa was interpreted in a narrow manner.

The inability to define capital gains in a more precise manner is inherent in the complexity of treatment of certain transaction at ordinary income tax rates and other at preferential tax rates. The absence of clear lines of differentiation between capital gains and ordinary income is not an intellectual frailty on the part of tax scholars in various institutions of learning, but somewhat a natural result of the inconsistency of treatment of almost identical types of gain (Coetzee, 1990:13).

2.2.2 Capital gains tax as a concept

Capital gains in most tax jurisdictions are taxed only upon realisation, rather than requiring taxpayers to annually value all their capital assets, which usually means when the asset is sold. Postponing the taxation of the gain until the time of sale, rather than when the asset appreciated, confers on the taxpayer the time value of money – it is always better to pay the bill later rather than sooner. It is as if the Revenue Service offers the asset holder an interest free loan equal to the tax due at the time the asset appreciates, from the time when the gain is made until the time the asset is sold.

This loan is more valuable the higher interest rates are and the longer an asset is held. This provides an incentive to hold onto appreciated assets longer than otherwise, a phenomenon known as the “lock-in effect”. The lock-in effect is greatly exasperated because of another feature of the current law – no tax at all due on capital gains if the asset is not sold during the holder’s lifetime (Slemrod et al, 2001:244).

Slemrod et al (2001:245) states that if an appreciated asset is bequeathed, the recipient can upon any subsequent sale treat it for tax purposes as if it were purchased at the value when inherited. Tax preferences according to capital gains also create an overwhelming incentive to repackage ordinary income into capital gains. Taxpayers who buy upper class houses take advantage of this feature, because their time and effort is not taxed as labour income. Instead, it is reflected in a higher sale price for their house, and hardly taxed at all due to open-handed rules about capital gains on owner-occupied housing.

Krishna (1983:1-2) argues that there is no simple answer to the question of what capital gains is. The Canadian tax law describes a capital gain as a gain that arises

from a disposition of capital property to the extent that the gain is not otherwise included in computing income. The Act defines a capital property as a property the disposition of which gives rise to capital gain. The test for distinguishing between capital gains and ordinary income is deceptively simple. The periodic yield of an investment is considered to be ordinary income; capital gains derive from realisation of the investment itself. Hence, the analogy that income is the fruit of a tree, whereas capital gains are the profits realised upon sale of the tree itself.

2.2.3. Global Characteristics of Capital Gains

James et al (1992:138-139) promulgate that most forms of capital gains have much the same characteristics as income. Several types of capital gains are really income in camouflage. Further he says the precise definition of income has been the subject of considerable debate the world over. Quoting Haig (1921) who for example, gave the following definition: "income is the money-value of the net accretion to economic power between two points of time". Another one is the somewhat comprehensive definition of income by Henry Simons (1938): "Personal income may be defined as the algebraic sum of: (a) the market value of rights exercised in consumption and (b) the change in value of the store of property rights between the beginning and end of the period in question", while Hicks' (1974) definition took income as the "maximum amount of money which the individual can spend this week, and still be able to spend the same amount in real terms in each ensuing week".

According to James et al (1992:138-139) the definition that seems to be increasingly accepted is that of total accretion, that is the accrual of wealth. This includes as income an individual's spending in a given period, plus any changes in his net wealth. Many more types of capital gains may be considered as income. This definition includes inheritances, gifts, winning from gambling and any 'windfall' gains. Taxing capital gains can be summarised under the headings of Equity and Efficiency. On Equity grounds, if capital gains are equivalent to income, they should equally be subject to tax. The equity argument is reinforced as capital gains accrue unevenly among the population. Gain can only accrue to owners of assets and, wealth is unevenly distributed. The efficiency argument has two main aspects. The first is that, as many types of income can be converted into capital gains to exempt the latter from

tax would encourage such conversion. This may involve economic costs for the individuals taking such action and economic costs for the Revenue Services in trying to prevent them. The second, and more important aspect, is that a tax on capital gains reduces the attraction of investment in 'non-productive' assets such as antiques, coins, paintings, precious stones and stamps, which are bought because of anticipated increases in their value, rather than for any productive purpose (James et al, 1992:139).

2.3. IMPACT OF TAX REFORMS

2.3.1. The Impact of Tax Reform on Individuals

In his discussion of personal tax reform, Carmichael (1988:3) quoting Courchene argues that the overall tax reform package passes the acid test of improving horizontal and vertical equity. Vertical equity is, enhanced by removing 800,000 low-income Canadians from tax rolls and by replacing personal tax deductions with tax credits. Horizontal equity is enhanced by substantially narrowing the differential tax treatment of personal income from different sources.

2.3.2. Labour Supply

It is agreed by most economists that taxes can play a major role in distorting the labour supply decisions of taxpayers. That is, taxes can affect both the amount and the intensity of effort that workers provide. In conventional economic analysis of the way in which these distortions work, individuals are thought of as having preferences both for goods and for leisure. By working taxpayers generate the income necessary to purchase goods. Taxes change the trade-off between working and leisure that taxpayers face by making consumables relatively more expensive. At the margin, a taxpayer will respond to a tax by substituting leisure for goods – that is, the taxpayer will work less hard. On the other hand, if the taxpayer's disposable income falls because of the tax, the taxpayer will work harder and take less leisure in order to overcome the loss in income.

Tax changes affect employment by affecting both the incentive to work and the incentive to employ labour. All taxes affect household labour supply to some extent. The effect of value added tax (VAT) on an individual who works and earned an income is to reduce the amount of goods that he can buy with his income and hence to affect his incentive to supply labour. Arising from the above statement, capital gains tax reduces the taxpayer's ability to invest in buying extra houses, caravans, and boats when as individuals or businesses their business is not on these properties (Mintz et al, 1989:5 – 6).

2.3.3. Impact of Tax Reform on Government Finances

During the 1980s, the size of the federal deficit was a major concern, as it increased Canada's vulnerability to external shocks and limited the flexibility of government to use fiscal policy to stabilise the economy. It is within this context that Ted Carmichael argues that tax reform and deficit reduction should be viewed as complementary instruments for meeting the economic challenges Canada faced. He argues that if tax reform is not accompanied by deficit reduction, a deteriorating fiscal position could offset the potential benefits from reform. Tax reform should be viewed as one element of a strategy to reduce the deficit in the fairest and least painful way. By strengthening the economy and broadening tax bases, tax reform could be a major part of the solution to the deficit reduction challenge (Carmichael, 1988:7).

2.3.4. Macroeconomic Impacts

How tax reform will affect macroeconomic variables such as employment, growth, inflation, and international trade and capital flows. Since tax reform is intended to be revenue-neutral, its macroeconomic impacts as Pierre Fortin suggests in his paper, will probably not be large (Mintz et al, 1989:18). Tax changes affect employment by affecting both the incentive to work and the incentive to employ labour.

Pierre Fortin (Mintz et al, 1989:18) suggests in his paper that since tax reform is mostly intended to be revenue neutral its impact on macroeconomic variables such as employment, growth, inflation, and international trade and capital flows will probably

not be large. It must be noted that growth in the economy depends on the availability of resources such as labour and capital.

2.3.5. The Impetus of Tax Reforms

“Lower rates, fairer system” Carmichael (Carmichael, 1988:12) submits was the statement, which the federal Government of Canada chose to sum up its approach to tax reform. But he further says one can go beyond this two-pronged approach, and postulate that the underlying thrust of the reform package appears to have three facts.

- To enhance horizontal equity that is, equal treatment of equals,
- To modify vertical equity in the direction of increasing progressiveness, particularly for lower-income group, and
- To enhance neutrality vis-à-vis the tax systems of Canada’s major trading partners, thereby serving to increase Canadian competitiveness.

2.3.6. Effect on Personal Income Tax



The ultimate effect of the reform proposals on personal income tax says Carmichael (1988:13) would be a substantial narrowing of the differential tax treatment of income, regardless of source:

- Capping the lifetime capital gains exemption
- Increasing the percentage of taxable capital gains that must be brought into income
- Eliminating or reducing various tax shelters.

Lowering marginal rates and broadening the tax base would, he further said, bring the Canadian system more in line with that of other Western Countries, thereby neutralising to some extent the impact of taxes on the international allocation of capital and labour.

2.3.7. Effects of Tax Avoidance and Evasion

Mintz (1989:127) propound that there has been a great deal of tax avoidance activity in the USA in the years before the tax reform of 1986, which he argues

was a problem the government brought upon itself. The main problem that such activities create for government, apart from the loss of revenue, is the perception of substantial unfairness. The public view has been that loopholes on tax systems are available only to the privileged few able to afford large professional fees. Most of the distortions to which Mintz refer are the result of deliberate policy choices. Choices based in many cases on political imperatives.

Slemrod et al (Slemrod et al, 2000:125) observed that if tax rates go up too much for your tastes, you might simply fail to report some of your income. These types of responses, called tax avoidance when the methods are legal and tax evasion when they are not, are key to understanding how taxes affect the economy. For one reason, they may mitigate the extent to which “real” economic decisions like labour supply are affected by taxation. You would almost always prefer to relabel your compensation as a fringe benefit than to make a real sacrifice such as earning less pay. Second, they can cloud the evidence about how taxes are affecting real economic decisions. For example, Slemrod further argues that if the taxable incomes of the rich go down significantly when their tax rates go up, it could mean that they have cut back on their labour supply, or it could mean that they are reporting less of their income and taking greater advantage of avoidance opportunities. Distinguishing among these kinds of responses is important because they have very different policy implications. In the example just mentioned, if we care about progressivity, then the appropriate policy response might be to limit opportunities for avoidance and evasion rather than to abandon a progressive tax structure.

Further that past experience has shown that individuals and firms are very willing to take advantage of opportunities for tax avoidance when they present themselves. The best example of this happened in 1986. The tax reform bill of that year was passed by both houses of Congress and signed into law by President Reagan on October 22 1986. According to the law, the tax on long-term capital gains realised by a top-bracket taxpayer was scheduled to increase from 20% to 28% as of January 1, 1987. Thus the tax rate was 20% for a limited time only. Understanding taxpayers took note, and the result was an unprecedented boom in capital gains realisations. Realisation of capital gains increased from \$167 billion in 1985 to \$322 billion in 1986, only to fall back to \$137.4 billion in 1987. Even more striking long-term capital gains on

corporate stock in December of 1986, the last month of the tax year, were nearly seven times their level in the same months of 1985 (Slemrod et al, 2000:126).

Another example of such a response occurred when the Tax Reform Act reduced the top marginal tax rate in the personal income tax below that in the corporate income tax for the first time in decades. This combined with the promise of avoiding double taxation of business income, made it much more attractive to organise a business as a partnership (known as S corporation), which are taxed solely under the personal code, instead of as a traditional C corporation, which is taxed under the corporation code (Slemrod et al, 2000:126).

The response was swift and dramatic. The number of S corporation, which had been rising at a 7.7% annual pace from 1965 to 1986, jumped by 17.5% a year from 1986 to 1990. The number of C corporations, which had been growing by an average of 3.5% per year from 1965 to 1986, dropped by 4.8% per year between 1986 and 1990; the biggest decline was among small C corporations, the ones that can more easily switch to S status. There were countless other examples of such responses to the tax changes of the 1980s. All in all, the evidence suggests that there is a hierarchy of behavioural responses to taxation. At the top of the hierarchy – the most clearly responsive to tax incentives – is the timing of certain economic transactions. The pattern of capital gains realisations before and after the 1986 tax reform is the best example. But there are many others, including foreign direct investment into the USA, which was \$16.3 billion in the forth quarter of 1986, more than double the rate of adjacent quarter, as investors raced to beat the expiration of tax rules favouring mergers and acquisitions (Slemrod et al, 2000:127).

Tax loopholes encourage taxpayers to illegally evade part of the taxes they owe. More important, they go to enormous trouble and expense rearranging their affairs legally to avoid taxes. Tax reform, it is submitted, holds out hope of improving compliance through two separate routes – reducing marginal tax rates and simplifying the system. Reducing the opportunities for tax avoidance hinges crucially on how income from capital is taxed.

2.3.8. Accruals and Capital Receipts – Planning for Avoidance/Evasion, encouraged by lack of stringent definition of concepts by Legislatures

Haupt (Haupt, 1992:115) state that revenue versus capital is a vast area in income tax law. Planning in the revenue/capital area can be divided into two broad types, that is:

- 1) Planning to be able to discharge the onus of showing that a capital receipt is such.
- 2) Planning to convert revenue receipts into capital receipts.

Haupt submits that planning for a capital receipts can be done, but one must remember that if a profit is sought, it is taxable, being derived in a scheme of profit-making, unless specifically exempted by the Act. Several problems arise in the revenue/capital area when the taxpayer is not able to show, on a balance of probabilities, that a genuine capital receipt is such. The dominant problem with demonstrating that a receipt is capital, from the taxpayer's point of view, is that the onus rests on him in terms of section 82 of the tax law, to do so. This is where adequate planning comes in.

How can the law cope with the full force of human ingenuity bend on converting ordinary income into capital gains?

2.3.9. Why? Tax Evasion is a Problem

Assuming there is currently \$195 billion of tax evasion, for argument sake. Why is it a problem? The answer appears to be obvious: if evasion vanished, then the surplus could be \$195 billion higher than otherwise. Alternatively we could spend \$195 billion more per year to finance health care, job training, childcare, infrastructure, and a host of other worthy projects. Or perhaps the most attractive option of all, federal income taxes could be cut by \$195 billion about 20%. There are two sets of reasons why some people may evade a great deal, while others engage in little or no evasion at all. The first are differences in personal characteristics, such as intrinsic honesty, willingness to gamble, and attitudes toward government and the tax system. The second are the opportunities and potential rewards for evasion. As long as people differ in these characteristics or opportunities, evasion can cause serious injustice and inefficiencies. Evasion creates horizontal inequity because people with equal abilities-

to-pay end up paying different amounts of tax. A lot of evidence suggests that the world is divided into evaders and non-evaders. According to IRS-sponsored study in 1979, 42% of all returns had some under-statement of taxable income (Slemrod et al, 2000:153).

2.3.10. Tax Fairness

The Tax Reform Act 1986 goes a long way toward making the USA tax system fairer and more equitable. The major accomplishment is the removal from the tax rolls of millions of taxpayers with income below the poverty line (Mintz, 1989:137). The Finance Department in the USA seemed to have concluded that the distinction between Capital Gains and ordinary income was no longer necessary, but it surprised Mintz, that the Department then lacked the political will to eliminate the distinction altogether (Mintz, 1989:186).

Fairness is the equal treatment of taxpayers in equal circumstances. If this condition is violated, taxpayers will be treated inequitably, and incentives will be created to base economic decisions on tax considerations rather than on true economic gain. We divide the issue of fairness into the following questions. What flows best measure ability to pay tax? Over what period should these flows be measured and taxed? Should taxes be levied only on actual transactions or also on accruals, that is on unrealised changes in asset values? How should the distorting effects of inflation be handled? And last, what system of taxation minimises distortions in saving?

The current capital gains tax gets poor marks from most tax jurisdictions for taxing improvements on owner occupied houses and the forgiveness of tax on capital gains held until death.

2.3.11. Criteria of a Well-designed Tax System

A well-formulated tax system should be simple and economical in administration. This means that a tax, which can be imposed in understandable language and collected with relative ease, for example the tobacco tax, has important advantages over one which requires elaborate provisions and administration. Also a well-

designed tax system should provide an adequate yield. To explain adequacy in this regard is that it is not merely a matter of mathematics, but involves dependability. The yield of the system should be reasonably dependable in bad as well as good times (Magill, 1943:7).

An adequately designed tax system should be fair to all taxpayers. This proposition of fairness, argues Magill (1943:8), is approved by all men in theory, and is not always approved by all men in fact. Abstract enquiry may look like practical discrimination when applied to the particular case. Humanity has a habit of defining equity in the concrete with a view to individual circumstances.

The individual's most immediate matter of concern propounds Magill (1943:8 –9) is the actual distribution of the tax load. This matter may simply entail the difference between success and failure in his business. His business finds it difficult to bear as he finds it difficult to accept as equitable and just a burden. He states that it is almost as evident that standards of fairness like standards of beauty are not susceptible of measurement with mathematical precision. Although mathematical standards of fairness are elusive, the general outlines of equity in tax systems have been more or less agreed upon, by economists, through a consideration of the basic problem of the relation of the taxpayer to the state, and the contribution, which he can be envisaged to make to it.

2.3.12. Taxation should be Proportional to benefits

There are two theories relative to the individual's relationship to the state problem, which have had the greatest currency Magill (1943: 9). These are:

- Taxation should be proportional to benefits received,
- Taxation should be proportional to ability to pay.

The subsidiary dogma to the above he adds, is that every citizen should make some contribution, however small to the state. The first theory of fairness is that taxation should be proportional to benefits received. The first assertion taken into consideration is that the state furnishes its citizens with certain benefits, such as roads,

public education, safety, and health among others: It evokes that the taxes a citizen pays are compensation for services the state renders to him.

The second theory of fairness is that taxation should be commensurate to the ability to pay. Wealthy and poor alike as members of a community have a common destiny. All may be called upon to contribute to a public fund for the welfare of all citizens. The wealthy should contribute more than the poor. The question is how much? In proportion to aggregate income, or aggregate wealth or at rates progressively higher as income or wealth increase? Economists seem to be agreed that income is sufficient as a single measure of ability to pay tax (Magill, 1943:11). Magill suggests that the tax system should be so designed that it would stimulate the economy to make the best use of its resources.

2.3.13. Long-term Impact on Economic Growth

Mintz (1989:418) posits that although the short and medium term impacts of tax reform will be dominated by demand-side factors, its long-term impact will be determined essentially by the reaction of aggregate supply, or “potential” income, through the lasting effects of the reform measures on labour supply, capital formation, factor productivity and efficiency, and foreign indebtedness. In the long run, when the effects of tax reform on the unemployment rate and the inflation rate have disappeared, there will remain a permanent effect on the levels of the growth paths of domestic production and national income.

2.3.14. Taxes and Economic Prosperity

Slemrod et al (2000:87) hold that the question of how taxes affect the economy has long been at the heart of the American political debate. At one end of the spectrum he says are those who argue that USA tax system is a serious drag on the economy and that radical changes could unleash a new era of unbridled growth and prosperity. He points out that Ronald Reagan made this a central theme of his presidential campaigns and rode to landslide victories as he promised and delivered lower income tax rates, with dramatic reductions concentrated at the top. Economists’ views of the impact of taxation and the potential benefits of reform tend to be considerably more circumspect

than those expressed by political advocates, but there is still a broad range of opinion he further establish.

2.3.15. Disputed Tax Issues at the Centre of the Public Debate

At the heart of public debate in the USA are some claims that play a big role over taxes. One such claim submit Slemrod et al (2000:127) is that tax cuts will increase economic growth so much that revenues will not fall much and may actually increase. A second is that the post 1986 surge in incomes that occurred at the very top of the income distribution reflected a dramatic response to the incentive effects of taxes.

2.3.16. Tax cuts affect Revenues

The assertion that across-the-board tax cut would lose no revenue is now associated with the economist Arthur Laffer, who claimed in the 1970s that high tax rates might be harming the economy enough and that tax cuts would provide more, rather than less, revenue. The free lunch promised by Laffer proved irresistible to politicians, and was one of the ideological underpinnings of the tax cuts in the Economic Recovery Tax Act of 1981. The massive increase in the budget deficit following that tax cut weakened support for such views, but some such support still persists today. For example, on the campaign trail in 1996, one of Steve Forbes's mantras was that tax cuts in the USA have always increased revenues (Slemrod et al, 2000:127).

2.3.17. Tax base

Carmichael (1988:1) submits that the general thrust of tax reform internationally has been to lower individual and corporate tax rates and to broaden tax bases. From a Canadian perspective according to him, this international trend culminated in the United States of America tax reform of 1986, which overhauled that country's income tax system – capital gains tax included – in a way that significantly lowered personal and corporate tax rates.

2.3.18. Choice of the Tax Base

The choice of the tax base, state Mintz et al (1989:24), is a central design issue, and one that has been a subject of considerable debate among economists. Two competing views have been given. The relevant one to this study is the view that comprehensive income is the appropriate measure of the taxpayer's well being, since it measures the individual's ability to pay for goods and services. He submits that comprehensive income is formally defined as the sum of labour income – salaries and wages – and capital income – dividends, interest, and capital gains. He argues that a proper measurement of comprehensive income necessitate that salaries and wages be measured net of human capital depreciation and that capital income be measured on an accrual basis, indexed for inflation and net of financial losses.

2.3.19. CGT affect mostly the affluent and high-income taxpayers

The treatment of capital gains is one of the most controversial and publicly debated issues about the income tax in the United States of America, with Republican Party – rich peoples' party – generally wanting to reduce rates on capital gains as much as possible and Democrats – poor people and workers party – wanting to keep them near rates on other income. It is a particularly divisive issue because realised capital gains are highly concentrated among high-income individuals. For example, in 1996, 67% of gains were received by households whose adjusted gross income (AGI) exceeded \$200,000 per annum, and capital gains constituted 21% of the AGI of these taxpayers. Because of this concentration, preferential tax treatment of capital gains is the archetypical example of "trickle-down economics", where the immediate benefits go to a small group of highly affluent people, and the extent of longer-term, more widely distributed benefits is hotly disputed (Slemrod et al, 2001:244).

2.3.20. Economic effects of tax reform

In the United States of America (USA) Aaron et al (1996:1) states that the 1986 tax act was a culmination of a decades-long effort to broaden the tax base and cut rates of the personal and corporation income taxes. They further say that in the decades before 1986, USA Congress enacted a succession of deductions, credits, allowances, and



exclusions, each intended to advance particular economic or social objectives. The provisions made the tax system more complicated, and they narrowed the tax base, thus requiring higher tax rates for income tax. As a result, efforts to shelter income also increased. As far as he was concerned, economists who urged sharp cuts in marginal tax rates financed by repeal of most of the base-narrowing tax provisions, until the mid-1980s their views had been treated as ivory tower speculations, since efforts to curtail deductions and shelters often failed in the face of impassioned opposition from powerful tax lobbies.

Against this backdrop, say Aaron et al (1996:2), the enactment of the Tax Reform act of 1986 became possible because of widening recognition of the general benefits of lower rates and base broadening. It disentangled tax filing for millions of filers by raising personal exemptions and the standard deduction. It lowered the maximum statutory individual rate from fifty percent to twenty eight percent and the maximum corporate rate from forty six percent to thirty four percent. Above all it reduced tax avoidance by eliminating shelters, ending the exclusion of half of long-term capital gains. The broad-minded applauded the more generous treatment of the poor and the closing of tax shelters, while conservatives valued the deduction in marginal tax rates.

2.3.21. Elements of Tax Reform

Intrinsic tax reform revolves around changes in three main features of the tax system. These are the tax base, allowable deductions from the base, and tax rates. It is clear that revenue needs constrain these choices. For instance, narrower bases and more generous deductions typically require higher tax rates to raise a given amount of revenue. Tax systems from tax jurisdiction to another differ in other important ways. For instance, how transparent the tax system is to the public, who sends the tax payments to the government, and how easy the tax system is to comply with and enforce.

2.4. THE TAX BURDEN AND THE ECONOMIC DECISIONS

Slemrod et al (2000:4) indicate that there is still a great deal of cheating on taxes. Although it is hard to measure such things accurately, the USA Inland Revenue Services (IRS) commissioner estimates that \$195 billion or more revenue is lost to non-compliance with the individual and corporate income taxes as well as employment taxes.

2.4.1. Income Redistribution

Arleen (1978:4) submits that the exact equality in effective rate would be the standard of fairness of the distribution of tax burdens. He argues that income redistribution is one step removed from the immediate objective tax policy, namely a fairer distribution of tax burdens. He further states that those in pursuit of a fairer distribution of tax burdens vociferously reject the strict proportionality of tax burdens to income, or wealth as the appropriate standard. He concluded that it is surely appropriate to infer, that behind the efforts to make the affluent pay more taxes and presumably the nonaffluent to pay less must lurk some notion of the desirability of greater equality in some relevant measure of economic status.

Tax scholars have for long relied on the proposition that income is the best measure of ability to pay taxes. If this proposition, argues Arleen, is addressed to the use of taxes to redistribute income, it implies either that income, as defined ideally for tax purposes, is a good proxy for economic status or that the proper objective of redistribution policies is not to equalise status – the ownership of stocks of claims to resources and output – but to equalise the flows thereupon (Arleen, 1978:5).

2.4.2. Taxes Affect Economic Decisions

Taxes affect the terms of almost every economic decision. They have an impact on the size of the rewards obtained from working hard, taking on second job, saving, and investing in training or education. The income tax changes how much it costs to contribute to charity or buy a home. Business decisions such as whether and how

much to invest in a new technology, or whether to locate a factory in the USA or Mexico, can all hinge on the tax consequences (Slemrod et al, 2000:4).

All taxes distort economic decisions. Some distortions arise from explicit efforts by the Legislature to influence economic and social behaviour.

2.4.3. Complaints about Tax burdens

Magill (1943:6) propounds that to pay the bill for government spending without serious injury to the economy, requires a tax structure devised with the greatest skill to be fair, adequate, and practical to administer. It is submitted that most tax systems are not simple and economical in administration.

Slemrod et al (2000:5) maintain that a wide variety of complaints have been levelled against the current income tax concerning its effects on the long-term prosperity of the economy. One charge is that high tax rates on the well-to-do discourage the hard work, innovation, and entrepreneurship necessary for a vibrant economy. A second claim is that the tax system is biased against saving and investment, which are essential for maintaining and improving the country's long-run standard of living, and that it is at least partly responsible for a USA national saving rate that is very low by both international and historical standards. Another grievance is that the preferences and penalties that are littered throughout the individual and corporate tax codes can significantly distort economic choices.

By erratically changing the relative costs and benefits of various activities and investments from what they would be in the free market, goes this argument, the tax system causes us to channel our resources to the wrong places, hampering the efficiency of the economy and shaking long-term growth prospects (Slemrod et al ,2000:5).

2.4.4 Income Tax is Unfair

What is it about income taxes that people think is unfair? Slemrod et al (2000:5) submit that there is disagreement certainly about how the burden should be shared

across families with different incomes. The current personal income tax is “progressive”, meaning that higher-income people typically pay a larger percentage of their incomes in taxes than those with lower incomes. This progressivity is achieved mainly by exempting the first several thousand dollars of income from taxation (\$17,900 for a family of four in 1998), and then imposing a set of “graduated” tax rates, which ranged from 15% to 39.6% in 1998, on successive brackets of income above that level. To some, a “fair” tax system means maintaining graduated rates and perhaps increasing the burden on those with high incomes. But others dismiss this as “soaking the rich” or “class warfare” and would prefer a less progressive system. Not surprisingly, people’s views about whether the tax system is fair are strongly influenced by how hard the tax system hits their own family.

2.5 THE BUSINESS CYCLE AND TAXES

The economy does not proceed steadily along a long-run trend, Slemrod (2000:89) indicated. Instead it experiences temporary ups and downs known as the business cycle. The downs, periods when the economy is sluggish and stuck significantly below its capacity, are known as recessions. Unemployment rates rise above their normal levels and industrial plant and equipment go under-utilised. Recoveries from recessions are periods of unusually rapid growth rates, as we make up lost ground and more fully utilise the capital and labour that are available. This kind of growth is fundamentally different from the kind of long-run growth that involves an expansion of the economy’s capacity or potential – more and better capital and technology, and more and better – skilled labour.

The function of taxes in the business cycle is more contentious among economists. It is true, Slemrod et al (2000:90) assert, that a tax cut puts more money in people’s pockets, and to the extent that people go out and spend some of it, this gives a boost to the economy. Slemrod further says that recent USA history reveals a number of episodes in which tax cuts have been explicitly used in an attempt to spur demand and jump-start a sluggish economy. The Kennedy – Johnson tax cut of 1964 is often cited as an example where a tax cut was intentionally and successfully used for this purpose. In other cases, stimulating demand is not a stated rationale for a tax cut, but it may have that effect anyway. For example, some argue that the recovery from the

1981 – 1982 recession was spurred in part by increased consumer demand induced by the Ronald Reagan tax cut.

Income taxes may help dampen recessions even in the absence of legislated changes by acting as an “automatic stabilizer”. Income tax revenues declined automatically in recessions because incomes are shrinking and people are slipping into lower tax brackets. This may help cushion the blow to consumer demand. For example, during the 1991 – 1992 recession, income tax revenues automatically declined and the deficit increased, and some economists believed this helped keep the recession from getting even worse than it did. For these reasons, when considering evidence about taxation’s impact on the long-run prosperity of the nation, it is very important to separate that issue from the short-term fluctuations in economic activity due to business cycle (Slemrod et al, 2000:91)

2.5.1 Budget Surpluses and Deficits

The budget surplus or deficit declare Slemrod et al (2000:92) is a second important issue that, in principle, is separate from the question of how our tax system should be designed. Just about any tax system could raise enough revenue so that there is neither a deficit nor a surplus, if its rates are set at the right levels. Moreover, people on all sides of the tax reform issue tend to agree, at least publicly, that the kinds of deficits the USA persistently experienced until recently are to be avoided.

The contention about the appropriate level of surplus or deficit, though, does get mixed into the tax reform debate when advocates of radical reform plans, argue that tax rates can safely be set much lower than what is conventionally considered “revenue neutral” on the grounds that the induced economic growth will make up the revenue short fall. This is one more reason why understanding the evidence on the economic impact of taxation is important. But it also means that we need to understand the case against deficits, so we know what is at risk if the extreme optimists are wrong (Slemrod et al, 2000:92).

The tax reform package is put together with finely balanced trade offs between economic rationality and political expediency, between the competitive need to bring

down personal and corporate tax rates and the obscene revenue requirements of the ever bulging government deficit, and between the differing interests of numerous pressure groups. Under the prevailing circumstances, a more constructive attitude is to view tax reform as one element of a strategy to reduce the deficit in the fairest and least painful way possible. By strengthening the economy and broadening tax bases, tax reform can be a major part of the solution to the deficit problem.

2.6 TAX REFORM AND WORLD ECONOMY

The fact that the level and structure of taxation affects several economic decisions the expeditious pace of tax reform the world over may well have significant and lasting effects on the world economy (Boskin et al, 1990:1).

2.6.1. International Trade



Boskin et al (1990:25) submits that as a country proceed from one set of circumstances to another, the model of its public finances conventionally changes. Therefore, there is a need for a country's tax policy to include considerations of international trade in goods and capital and features of tax rules that affect multinational organisations.

2.6.2. Reforming Taxation of Capital Income to Harmonised Tax Policies

Siebert (1990:1) states that in a world of highly integrated goods and capital markets like ours, countries are linked not only by the cross-border transactions of private agents, but also by their economic policies. The tax legislations and policies of one country affect economic activities and tax policies in other countries. With the world facing increased capital mobility in different directions and with the European Community in the process of completing its Internal Market, capital gains taxation especially has to be reconsidered and analysed extensively, empirically as well as theoretically. The impact of capital gains taxation on capital flows, is indicative of the importance for tax harmonisation and policy options for reforming the systems presently in existence. The deficient integration of corporate income taxes and individual taxpayer income taxes, at the same time with the faulty application of the

primary residence principle of taxation both at the corporate and at the individual taxpayer level, creates distortions in the international allocation of capital.

2.6.3. Taxation of Income from Capital

Taxation of income from capital tends irrevocably to reduce the size of a country's capital stock and hence to lower its level of actual salaries and wages. Stated generally, the welfare of any country, and of labour within that country, is best served by reducing the rate of capital income taxation. If one country fails to tax that capital income, the home-based country of a taxpayer will typically tax it. The country that reduced or eliminated its tax rate simply loses revenue (Boskin et al, 1990:26).

Multinational companies' capital income will be taxed in their home countries, some times in higher rates to the extent they are not taxed in the place where they have invested. The developing countries in this case should, therefore tax such capital income (Boskin et al, 1990:46).

2.7. EXPERIENCE IN DEVELOPED COUNTRIES

2.7.1. ISRAEL – PROPOSALS FOR BROADENING THE TAX BASE

Boskin et al (1990:100) established that a broadening of the income tax base in Israel would finance the proposed reductions in marginal tax rates. That is, income previously exempt from taxes such as capital gains or subject to favourable rates would be regarded on equal terms with income.

In Israel like in most countries, the tax system has become distorted and lost much of its efficiency because of excessive use of the tax benefits and exemptions that have been implemented over time. In each instant, there has been a specific activity or goal that seemed to the Legislature worthy of support. It was submitted that loss of revenue was stemming from tax benefits. The country had a tendency to perpetuate benefits and exemptions whose objectives had become obsolete or that had been shown to be ineffective or misused. Vested interests that withstand change become entrenched.

Capital gains are taxed in a number of developed countries, but only Austria has followed the USA in taxing them as ordinary income. Countries such as Sweden, Canada and the United Kingdom, tax capital gains realised from the sale of real estate but not capital gains realised from the sale of securities (Boskin et al, 1990:108).

2.7.2. DENMARK AND JAPAN – CAPITAL GAINS TAX

Denmark implemented a reform similar in nature to the one introduced in Israel. Capital Income is taxed separately at a flat rate on fifty percent regardless of the type or category of taxpayer. Full deduction of interest is done against capital income. In Japan a similar proposal to tax capital income at a flat rate was under discussion in 1990. In the Japanese tax system, capital gains from the sales of securities were completely exempted from taxation. Capital gains are taxed on realisation, and not accrual. The exemption of capital gains from securities was criticised as a preferential measure for the wealthy (Boskin et al, 1990:108-121).

2.7.3. SWEDEN – TAXATION OF CAPITAL INCOME

Sweden is regarded as a High-Tax environment. Boskin et al (1990:135) submit that the taxation of capital income presents special problems in a high-tax environment, first and foremost under inflationary conditions. The tax rates are exceedingly high. Capital income in Sweden is taxed under the personal income tax and is treated formally on a nominal basis. The taxpayer's primary residence is effectively taxed on a real basis.

2.7.4. UNITED KINGDOM – CAPITAL GAINS TAX

The experience derived from the UK is that some form of capital gains tax has been there long before 1965. In 1965 capital gains tax was introduced as a separate tax, on nominal gains, and it is imposed at income tax rates (Boskin et al, 1990:151-154).

2.7.4.1. Origin and Reasons for Capital Gains Tax

Whiteman et al (1973:1 – 3) establish that The Labour Government introduced CGT in 1965 to supplement the tax on short-term capital gains tax introduced in 1962. At the period, gains chargeable were excluded from the charge to capital gains tax. Estimations in 1965 were that the tax would in the long run yield £125 million per annum. According to Cooper in 1971/1972 the yield was £165 million. Whiteman et al further argue that capital gains tax is unlikely ever to constitute a major source of revenue, but it may well produce much more than its originators estimated. Whiteman et al (1973:4) quote the Labour Party's Chancellor Mr Callaghan in his Budget speech as follows:

“The failure to tax capital gains is widely regarded, outside as well as inside the Labour Party, as the greatest blot on our existing system of direct taxation. There is little dispute nowadays that capital gain confers much the same kind of benefit on the recipient as taxed earnings.... Yet earnings may tax in full while capital gains go free. This is unfair to the wage and salary earner.... It has in the past been one of the barriers to progress of an effective income policy,..... This new tax will provide a background of equity and fair play.....”

“Moreover, there is no doubt that the present immunity from tax of capital gains has given a powerful incentive to the skilful manipulator of which he has taken full advantage to avoid tax by various devices which turn what is really taxable income into tax-free capital gains.”

As a permanent feature of the British tax system CGT have to be judged mainly on grounds of “equity” and “social justice.” As the result and price of equity and social justice, the UK is now faced with a formidable body of legislation and a heavy administrative burden on civil servants, taxpayers and their skilled and professional advisers (Whiteman et al. 1973:4).

Whiteman et al (1973:4) quotes a relevant comment made by a Swedish tax Lawyer whose country has such a tax and who had studied the tax in both countries and elsewhere as follows:

“The capital gains tax is a fine example of a tax, the complications of which seem to be enormous, as soon as the tax is constructed to comply with high standards of justice. The complications can greatly be done away with, if the equity standard is lowered. But there is room for considerable doubt how far we can go in simplification without jeopardising the very idea behind the tax. This is not to collect money for the fisc (sic) – this could be done more simply – but to bring more equity into the tax system.... The UK solution is a heroic approach. Its success if there will be any, will be regarded not only as an enormous achievement of your administrative efficiency and your taxpayer’s morality, but as a guidelight (sic) for draftsmen of foreign tax laws.”

Pritchard (1987:1) states that before 1965 most types of capital gains were exempted from taxation apart from the isolated types which were brought within the charge of income tax either because they were defined by the courts as “adventures in the nature of trade” or by a specific legislation.

Bracewell-Milnes et al (1992:20-22) submits that British entrepreneurs would likely set up their first business in the UK. For their second business, when they are financially strong to choose where to live, capital gains tax differentials often become an important deciding factor. Venture Capitalist who are successful entrepreneurs in the UK would choose to have their second business in the USA or France or Germany, driven offshore by capital gains tax. Personal Equity Plans are one of the indications that the UK government accepts that capital gains tax rates affect investment decisions. So far the common feature of capital gains tax is that gains are taxed when they are realised, and not as they accrue in all countries.

2.7.5. USA – CAPITAL GAINS TAX

Boskin et al (1990:155-181) propounds that when the USA introduced its tax reform in 1986, its effects were felt in Britain and other trading partners. In 1988 the taxpayer’s capital gains tax rates were the same as the marginal income tax rates. Prior to this, there was a flat-rate capital gains tax at thirty percent. The Legislative process that ushered in the 1986 Tax Reform Act began in 1984 with the initial goal

of designing a tax system that would promote economic neutrality and efficiency, economic growth, fairness, and simplicity. The legislature failed to index the definition of income for inflation. Inflation is a fact of life everywhere including the USA. Therefore the absence of indexation presents an enormous problem especially for capital gains. Nominal capital gains are not a reasonable approximation of real capital gain. Taxing only real gains and allowing full nominal interest deductibility opens enormous opportunities for arbitrage.

2.7.6. AUSTRALIA – IMPOSITION OF CAPITAL GAINS TAX

Cooper (1992:1) established that long before the implementation of capital gains tax there had been a fundamental distinction in Australian Income Tax Law between capital and income receipts.

2.7.6.1. Tax-free Capital Gain – The former object of Investors

Before the implementation of Capital Gains Tax in Australia, Investors were very conscious of the fact that a significant part of the return on various investments took the shape of a tax-free capital gain. The capital gain accrued over the period of ownership. Especially in view of the prevailing high rates of personal income tax, many Investors were ready to accept very low income returns, provided that significant capital appreciation could be expected which would be exempt from tax (Cooper. 1992:2).

2.7.6.2. Impact and Significance of Capital Gains Tax

The implementation of Capital Gains Tax may be accepted as the single most important structural reform to the Australian taxation system. It is stated as having had a far-reaching effect and its introduction has been felt by a huge number of taxpayers (Cooper. 1992:2).

Cooper (1992:3) quoting the Australia Treasurer when Capital Gains Tax was implemented as having stated that:

“Revenue in the early years will be small and will build up only gradually. It is estimated that the capital gains tax could generate tax liabilities of around \$25m in the fifth year of operation.”

Cooper submit that the Budget Papers revealed that in 1989/1990 capital gains tax raised \$578m and in 1990/1991 it raised \$631m. Further he states that during 1990/1991 164,275 taxpayers were subject to capital gains tax, of which 154,730 were individuals.

2.7.6.3. Australia – The Future of Capital Gains Tax

The opposition parties in Australia since the introduction of CGT have at various campaigns stated that they were going to abolish it. In the early 1990’s there were indications suggesting that they have changed their stance about CGT. Cooper quotes the latest “Fightback package” of the Liberal and National Parties as follows:

“The taxation of capital gains is an essential element of any taxation system which continues to rely on income as a taxation base.”

And:

“The Liberal and National Parties recognise that there is a legitimate place in the income taxation system for a tax on capital gains derived as income”

(Cooper.1992:5).

Cooper (1992:6) closed his argument about the future of capital gains tax saying that the cost in terms of the revenue forgone would make it a brave decision for any government to abolish CGT. More so the experience derived from the UK suggest that, once in power, the clamorous critics of capital gains tax restrict their efforts to meddling with it and introduce little more than superficial improvements.

2.7.7. INTERNATIONAL TAX LAWS FOR CAPITAL GAINS

SEPARATE TAX LAW ON CAPITAL GAINS	COMPREHENSIVE COVERAGE WITH PROVISIONS INCLUDED -LONG-TERM CAPITAL GAINS	SPECIAL PROVISIONS MAINLY RESTRICTED TO SHORT-TERM OR SPECULATIVE GAINS	NO SPECIAL PROVISIONS
Denmark Ireland Portugal Switzerland (Zurich) United Kingdom	Australia Canada Finland France Japan Luxembourg Norway Spain Sweden United States of America	Austria Belgium Germany Turkey	Greece Italy Netherlands New Zealand

Adopted from Bracewell-Milnes B et al. 1992:33.

2.8. EXPERIENCE IN DEVELOPING COUNTRIES

Rosengard's (1998:1) argument is that the principal strengths and weakness of property taxation in developing countries are not well understood. Consequently, governments venture to use property taxes to achieve unrealistic policy objectives. At the same time, they disregard favourable opportunities to exploit property taxation effectively. Governments endeavour to remedy a multiplicity of economic, political, and social imperfections through property tax reform, while they fail to optimise the financial potential of property taxation. Property taxes are commonly taken to be a dominant factor in investment and consumption decisions.

2.8.1. COLOMBIA – CAPITAL GAINS TAXATION

Boskin et al (1990:211-217) presenting Mclure C.E's presentation in his book submits that capital gains were not taxed before 1960. From 1960 gains on real estate accruing after that year were taxed but taxable gains were reduced by ten percent for each year assets had been held. In 1974 general taxation of capital gains – defined as gains on assets held more than two years – was also implemented. The ten percent exemption of gains for each year of ownership was repealed, except for the taxpayer's primary

residence. By 1983 only real capital gains were legally taxable. Complete inflation adjustment was provided for capital gains in 1986. Boskin et al (1990:225) has established that Colombia has one of the best income tax law, which includes capital gains in Latin America.

2.8.2. INDONESIA – CAPITAL GAINS TAX ISSUES

In Indonesia the property tax law applies at a single rate on all types of property, and it was not a major revenue source, because of the low rates. The objectives of the Indonesian tax reform which were grouped under four general heading are:

1. Revenue
2. Income distribution
3. Economic neutrality
4. Tax Administration and Compliance.

The tax's revenue was the maintenance of the then levels of tax revenues. During the cause of time the property taxation moved from revenue neutrality to revenue enhancement.

2.8.2.1. Income Distribution and Economic neutrality

Regarding this topic the Indonesian Property Tax law was aiming at reducing relative impoverishment and uneven distribution of income across income classes. This tendency of the government emphasised total alleviation of absolute impoverishment, in other words, the raising of the standards for the poorest sixty percent of society, particularly for the millions of poor rural families. In the light of Indonesian fiscal experience since 1966, and in view of such conclusions on fiscal incidence as were available, policy makers came to view the appropriate income distribution goal for tax reform as insuring that changes on taxation would not make the poor worse off, primarily by placing low-income families outside the tax net, to the extent possible. The Indonesian tax policy in the three decades before 1984 was intentionally nonneutral. The tax system is a useful tool for guiding private consumption, investment, and employment decisions, as well as a means of raising revenue and redistributing income, to goals sought by the state (Boskin et al, 1990:228-238).

2.8.3. MEXICO – CAPITAL GAINS TAX INTRODUCTION

Tax reform has taught the Mexicans that the earnest pursuit of a global personal income tax faces constraints such as capital and population movements, administrative limitations, and mixed practical considerations. The global movement of capital means that financial interest income cannot be taxed, apart to the extent interest is grossed up. A registered complication is that taxpayers in a truly global system will stand not to declare capital gains but to fully deduct capital losses. Capital gains are not properly measured, and not all potentially taxable items included in the tax base (Boskin et al. 1990:271-279).

2.8.4. LIBERIA – IMPLEMENTATION OF CAPITAL GAINS TAX

The definition of income provided in the Liberian income tax law is excellently comprehensive. Importantly is the inclusion of capital gains tax. Boskin et al submits that the best way to cope with the administrative problems is to design tax reforms for developing countries in full recognition of the severe limitations imposed by administrative realities. Administrative dimension is central, not peripheral, to tax reform. Without meaningful administrative alterations, the alleged tax benefits will not be achieved. Tax policy and tax administration cannot be separated. No policy exists until it is implemented, and it is the manner of its implementation, which really determines its impact. Reforms proposed and enacted in the USA would be appropriate for developing countries; particularly important is the fundamental approach of broadening the tax base in order to reduce marginal tax rates and more comprehensive taxation of fringe benefits, and elimination of exemptions of the tax benefits of owner-occupied housing (Boskin et al. 1990:295-380).

2.9. CAPITAL GAINS TAX SOUTH AFRICAN PERSPECTIVE

2.9.1. INTERNATIONAL INFLUENCE

Currently no economy is an island apart from the world markets. This is particularly true of the Republic of South Africa, whose markets in goods (gold, platinum, iron among others) and services, and financial capital are relatively open to international flows. The country's markets are especially open to the USA, the EU and Canada our largest trading partners and creditors. Thus the issue of tax reform in the country should not and indeed cannot be evaluated without regard to its global implications. Two implications in particular are worth considering.

First, events outside the RSA economy, notably the steep reductions in personal and corporate income tax rates embodied in the tax systems of the country's trading partners must play a role in instigating the country to reduce personal and corporate income tax rate. This must be expected if the RSA want to remain internationally competitive.

Secondly, the degree to which South African markets are integrated with international markets will partially determine the impact of the different tax reform measures on the RSA economy and hence, the relative desirability of the present reforms for the country.

The three central macroeconomic questions in the RSA that need to be answered about the current tax reform are exactly those that the Economic Council of Canada under John Deutsch started asking several years ago about the tax reform and economic policy:

- Will it help to create jobs?
- Will it hold inflation in check?
- Will it enhance growth? (Mintz, 1989:403).

2.9.2. Canons of Taxation

In the year or around 1776, Adam Smith in his *Wealth of Nations* recognised that the levy of taxation should comply with certain basic norms or criteria and propounded the following four principles of taxation (Huaham et al, 2000:1):

- **Equity** – the subjects of every State ought to contribute towards the support of the government, in proportion to their respective abilities. The expense of a government to the individuals of a nation is like the expense of management to the joint tenants of a great estate, who are all obliged to contribute in proportion to their respective interests in the estate.
- **Certainty** – the tax which each individual is bound to pay ought to be certain, and not arbitrary. The manner of payment, the quantity to be paid, the time of payment, ought all to be clear and plain to the taxpayer.
- **Convenience** – every tax ought to be levied in a manner, or time in which it is most likely to be convenient for the taxpayer to pay it.
- **Economy** – every tax ought to be so contrived as both to take out, and keep out, of the pockets of the taxpayers as little as possible over and above what it brings into the public treasury of the State.

Some of the above maxims, which were formulated in the 1770's are still relevant in modern tax law. To achieve the basic tax policy objective of efficiency and equity, a tax system should impose a direct tax on a broad income base. Such an income base, which must include all types of income, including the fruits of labour and returns on capital investment, is considered to be the best measure of a taxpayer's ability to pay. Taxes have been described as "compulsory levies on private units for general government purposes". Another view is that taxes are contributions to the state for the ultimate benefit of all who enjoy the privileges and protection offered by the state. In addition to being the principal source of government revenue, taxes constitute a major instrument of national economic policy.

2.9.3. The Relevance of these maxims in modern times

Modern times tax systems recognise Adam Smith's first point on the ability to pay, and South Africa is not an exception. That is why our tax system is so structured that the wealthier person carries a greater burden in funding the state and paying more tax than the less affluent. This is the reason why South Africa's tax tables are progressive, which entails that the more a person earns, the more he pays on his income. Certainty in contemporary tax law is a very important principle. In South Africa certainty is achieved because the manner, method, time and quantity of taxation is clearly stipulated, except that in as far as capital gains tax collection was concerned there was uncertainty before October 2001, which will be discussed later. Tax in South Africa is convenient as "Pay as you earn" (PAYE), "Standard income tax on employees" (SITE), and Provisional Tax is a convenient method of collecting tax. The high cost of labour today has made collection of taxation uneconomical. South Africa's income tax Act is structured in such a way that persons with incomes below certain prescribed amounts are not required to submit tax returns. It is submitted that capital gains tax as implemented is not adding any burden to tax collection in South Africa, because it is linked to the present administrative procedures.

2.10. CAPITAL GAINS TAX LEGISLATION DEVELOPMENTS

2.10.1. Limited Capital Gains Tax in South Africa before October 2001

Meyerowitz report that in 1979 the South African Revenue Department put through an Act of Parliament providing for "a very limited and modest capital gains tax". In referring to the tax, the Minister of Finance observed: "Many misconceptions and even fears have arisen as to the form such a tax would take. Its inhibiting nature has been exaggerated out of all proportion, its place in the tax 'mixture' is not always appreciated, and sight is quite often lost of the fact that while normal earnings are fully taxed, capital gains which also do add to the wealth of the recipient, escape tax completely. This to me is not altogether fair. I feel we should seek a just balance" (Meyerowitz et al, 1979:61 – The Taxpayer volume 28. No. 4).

Meyerowitz's report on the above volume suggests that the capital gains tax, which has been implemented, was not conclusive all these years until October 2001.

2.10.2. Capital gain identification

The South African Courts placed importance on the purpose for which an asset was acquired, held and disposed of. When the courts for the purpose of testing the stated intention of the taxpayer, considered the surrounding circumstances of each case, numerous objective tests were employed. The chief enquiry by the courts in the identification of capital gain was;

- Has the relevant asset been dealt with, acquired, held or disposed of in pursuance of a "scheme for profit-making".

2.10.3 Tax Rates Before 2001

Tax rates raise several essential issues. The first concerns the effects of taxes on economic decisions. The higher the tax rate, the greater the distortion created by the tax system. The second issue concerns the effects of taxes on the distribution of tax burdens across the income distribution. In 1997 Stack et al (1997:578) states that the personal income tax in South Africa had nine rates: 17, 19, 21, 30, 41, 43, 44, 44, and 45 percent at successively higher taxable income. Taxpayers with taxable income over stipulated threshold lose portions of their personal exemptions and certain itemised deductions. Legislators use multiple positive rates in personal taxes to achieve a desired distribution of tax burdens among citizens or households. A zero rate under personal taxes for those with little income also unravel administration and compliance by vindicating households with few resources and little potential tax liability from the need to file returns. Multiple positive rates increase progressiveness but raise compliance and administrative costs.

The Tax law permitted many allowances, credits, exemptions, and deductions. Each provided tax relief that supporters believed improved equity or encouraged some meritorious activity such as the charitable contributions deduction. Most of these provisions of the tax law if eliminated; tax rates could have been reduced across the board. Repealing some of those provisions would also simplify compliance and

administration. Aaron et al (1996:5) argues that these provisions impose costs, and that the higher tax rates required to collect a given amount of revenue raise the distortions imposed by any tax system. He further submits that the provisions complicate record keeping and enforcement and add to complexity in a more subtle way since raising rates raises the return to tax avoidance.

2.10.4. The Franzsen Commission of Enquiry Report

Gird (1986:4) has established that there have been a number of commissions of enquiries, which have heard representations from the public for the introduction of CGT in South Africa, before the Margo Commission. The first commission published its findings in 1951 and its recommendation was that CGT should not be introduced. The Franzsen Commission of Enquiry published its findings in 1968, and recommended that CGT be introduced in a limited form.

2.10.5. The Margo Commission of Enquiry

The Commission of Enquiry Into Fiscal and Moneytory Policy in South Africa viewed the old tax system, and unlike its predecessor The Franzen Commission, recommended that Capital Gains Tax should not be subjected to tax. However, the Commission recommended that objective, instead of subjective criteria in dealing with “receipts or accruals of a capital nature” be used by the Courts, for the purpose of identifying a capital gain. The Commission also concluded that the tax system was complicated, unfair, and as interfering with economic choices, which ultimately affected economic growth.

The Commission has concluded that the optimum method of correcting the shortfalls of the tax system would be to substitute objective criteria for the then existing subjective criteria applied in distinguishing capital gains from those of an income nature. This arrangement, it is submitted, did not close the loopholes that existed, which were exploited by taxpayers, who by careful planning would be able to keep “receipts or accruals of a capital nature” outside the income tax net. The Commission stated that the constant necessity by the government to close the loopholes exploited by taxpayers has led to a complicated tax structure and has impaired the fairness and

economic neutrality of the tax system. They concluded by saying that the system lacked cohesion and manifests an absence of overall planning.

The Commission propounds that the situation had serious consequences, among them are: i). A decline in tax morality, which depends fundamentally upon a belief in the fairness of taxes; ii). A high incidence of tax avoidance and evasion; iii). The growth of a skilled tax avoidance industry, leading to both an eroded tax base and the use of resources and scarce skills in unproductive activities; iv). The proliferation of tax shelters.

The Commission states that they had a careful study of the tax systems from the following tax jurisdictions; United States of America, the United Kingdom, and Canada to mention but a few. The above-mentioned tax jurisdictions have long had capital gains tax in their tax codes. The question is why did the Commission recommend otherwise to the South African government? This need to be pursued but it is not within the scope of this study. I concur with the Commission on the following statement; “a normal, and healthy economy did not prevail in the Republic” of South Africa at the time, and therefore one concludes that they could not recommend a tax system that would infuriates the taxpayers (white minority electorates and businesses who owned properties). The Black majority at the time had no franchise and no significant properties that could be taxed under capital gains tax if implemented. The Commission recommended that;

- **Definition of Capital and Income:** A comprehensive statutory definition of capital and income should not be attempted.
- **Capital Gains Tax:** Capital Gains should not be subjected to tax.

2.10.6. The Tax Gap

The Tax Gap is described as the tax lost through both avoidance and evasion; the Margo Commission submits that it was a matter of concern in South Africa, although not unique to the country. Although the tax gap the Commission states cannot be quantified with precision, the indications state that in South Africa it was large and growing. This was supported by evidence from Inland Revenue, Customs and Excise and a number of other sources before the commission. In the light of that evidence the commission was of the view that South Africa was facing a serious problem regarding the tax gap, much of which was remediable by suitable measures.

The Commission further said that the taxpayer morality declines with resentment over what is regarded as unfair or unduly burdensome taxation. The Commission in this regard quotes the following relevant extract from a submission it received from the Tax Committee of the Association of Law Societies: “ There is, amongst professionals at least, a high and growing level of resentment at the unfairness of the taxation system. Practising attorneys resent the fact that there is widespread evasion of tax in commerce and industry, which appears to be perpetrated with impunity. Reasons identified are the following: dissatisfaction on the part of taxpayers with the tax system and more particularly, their conviction that the system is burdensome and unfair. Dissatisfaction with the system on the part of the taxpaying population is naturally a significant factor in the growth of evasion”.

In their first report published around 1994 the Katz Commission estimated that the “tax gap” was between R5 billion and R15 billion. Revenue, which could have been of good use to the country remained in the hands of taxpayers.

2.10.7. The Burden of Proof and Court decisions

The last component of the definition of “gross income” is the exclusion of receipts and accruals of a capital nature. Just like in the case of “source,” the Legislator has not attempted to define the term “of a capital nature” and in cases of uncertainty it was left to the courts to decide whether or not a receipt or accrual was of a capital nature. The onuses of prove is left to the taxpayer. Throughout the years this section of tax law has been, probably the subject of more case law than any other, which means that there is a substantial wealth of legal precedent on which to rely when making a decision as to the capital or revenue nature of income (Huxham et al, 1995:24).

Huxham et al (Huxham et al, 1995:7) submit that from time to time some sections of the Income Tax Act were not clear, and it might be necessary for the taxpayer to go to court to settle the matter.

2.10.8. Interpretation of the Law to resolve disputes

According to Davis (1933:10) the definition of gross income limited it to receipts from a source within the Union of South Africa– RSA as it was known then, and also excludes receipts or accruals of a capital nature. This definition was never corrected until The General Laws Amendment Act 2001, South Africa’s major Tax Reform act. The terms “capital” and “income” are mutually exclusive and each can only be defined with reference to the other according to the old tax law.

Davis (Davis, 1933:13) maintain that it is true that there is no definite test that can always be applied to determine into which category any particular receipt falls. One indication given is that the revenue or profit, which is derived from a thing without its changing hands, is rather to be considered as income than as capital. On the other hand, the profit, which is derived from a thing when it changes owners, is rather of the nature of capital, this is the conclusion of Judge J Wessels in the case of the Commissioner for Inland Revenue (CIR) versus Booysen’s Ltd (1918, Appellate Division at page 576).

2.10.9. Intention of the Taxpayer

The courts over the years have laid down various tests to be applied in deciding whether a receipt was of a capital or revenue nature. Intention among other tests has emerged as the dominant test. Intention was originally referred to in the case CIR versus Stott in the Appellate Division in 1928, where the court was called upon to decide whether the sale of certain land in Natal gave rise to a receipt of a capital or revenue nature. In his judgement Judge J A Wessels said: “It is unnecessary to go so far as to say that the intention with which an article or land is bought is conclusive as to whether the proceeds derived from a sale are taxable or not. It is sufficient to say that the intention is an important factor and unless some other factor intervenes to show that when the article was sold it was sold in pursuance of a scheme of profit making, it is conclusive in determining whether it is capital or gross income” (Huxham et al, 1995:25).

The rule as it was applied was firstly that the intention of the taxpayer at the date of acquisition must be established and secondly that it is possible to have a change of

intention in the intervening period prior to the sale of the asset. The intention, which the taxpayer may have at the time of acquisition, may be one of the following:

- **Investment**; to acquire and hold the asset as an income-producing machine that is as a source of future income. An asset, which, is acquired with this intention, is a capital asset and in the absence of a change of intention the disposal of such an asset will give rise to a receipt of a capital nature, which was not taxed.
- **Speculation**; for the purpose of making a gain by selling the asset in a scheme of profit making. In other words the intention was not to use the asset as an income-producing machine but rather to realise the profit inherent in the asset. The asset was therefore, acquired as trading stock with the intention of resale at a profit. The sale of such an asset will give rise to a receipt or accrual of a revenue nature.

It was necessary for the court to establish what the taxpayer's reason was in acquiring the asset in deciding whether or not the intention of the taxpayer was speculation. For many years the courts had adopted two tests for this purpose.

2.10.10. The Scheme of Profit-making Test

What is the meaning of a 'scheme for profit-making'? The South African Oxford Dictionary defines a scheme as a 'systematic plan for achieving a particular aim, a secret or underhand plan, a plot'. The Reader's Digest Oxford Complete Wordfinder defines scheme as an 'artful or deceitful plot, a plan of action, a design, a programme of action, system of action, a trick manoeuvre devised in order to attain some end'. Therefore it is deduced that 'a scheme for profit-making' is simply stated a plan of action in order to make a profit. It is submitted that in the absence of a definition of a 'scheme for profit-making', with respect, the expression was not clearly understood by the South African courts. In view of the narrow interpretation of the expression the courts have on occasions confused the meaning thereof with the expression 'trade' in the UK tax law, and 'business' in the Canadian tax law. The two words have been extended to include 'an adventure or concern in the nature of trade,' there is more

certainty as regards the identity of capital gain in those tax jurisdictions as compared to South Africa.

The 'scheme for profit-making' test, which had its origins in the California Copper Syndicate case, required that the taxpayer's intention must have been to deal in the asset as a business man would with a view to making a profit out of the acquisition and disposal of the asset. Where it was clear that the taxpayer's intention was one of "a scheme of profit-making" his intention was clearly revenue. What was not clear however was whether the converse was always true, namely if a taxpayer was not engaging in a scheme of profit making, was his intention capital? Some courts thought not and applied an alternative test of fixed versus floating capital (Huxham et al, 1995:25).

2.10.11. Intention of the Legislature on Capital Gains



Before October 2001, in South Africa, the UK, the USA, and in many European Countries 'revenue gains' as contrasted with 'capital gains' were subject to an income tax. The use of the word income in describing the tax reveals the intention of the Legislature to tax only income as opposed to capital. Income as it is comprehended in ordinary language normally originates from the carrying on of a trade or business. In most trading partners of South Africa for example the UK, the USA and Canada taxation on capital gains has long been introduced. The intention was to subject to a capital gains tax all gains flowing from non-trade or non-business activities, that is 'capital gains'. A capital gain originally in those tax jurisdiction was taxed at a rate that was lower than the rate applicable to income (Coetzee, 199:43).

Coetzee (1990:44) argues that the following question must be answered in the negative. What is meant by a scheme for profit-making? The extensive meaning given in judicial disputes to the expression has resulted in a *modus operandi* by the South African courts, which was not always consistent (the Berea West Estate (Pty) Ltd versus Secretary for Inland Revenue, 38 SATC 43). The Margo Commission in South Africa found that the basis upon which a capital gain was identified was unsatisfactory.

The concept of 'trade' and 'business' have broader meanings, therefore in the UK and Canada there has been certainty in the interpretation of a capital gain, compared to South Africa's 'receipts and accruals of a capital nature'. It is concluded that before October 2001 the Legislature in South Africa had failed to define a capital gain in a manner that would meet with one of the important canons of a good tax system, that is an acceptable level of certitude.

2.10.12. The Fixed versus Floating Capital Test

In some conclusions by Judges it was held that even if there was no profit motive the intention of the taxpayer was nevertheless revenue if the asset was acquired without an intention to hold it with some degree of permanence. These courts felt that intention was of a revenue nature in all cases where the taxpayer saw the asset as floating capital (acquired to hold for a short period) as opposed to fixed capital.

It is stated that the debate about the merits of these two tests was conclusively settled by the Appellate Division in *CIR versus Pick 'n Pay Employee Share Purchase Trust* in 1992. Judge A J A Nicholas in the dissenting judgement argued that the converse of the California Copper Syndicate test was not necessarily the only test and that one also had to establish whether or not the asset constituted fixed or floating capital. The majority of the court stuck steadfastly to the "scheme of profit-making test" as the only test, while Judge A J A Nicholas felt that it was not appropriate to use the converse of a positive test to establish a negative answer (Huxham et al, 1995:26).

A legal principle was created by the decision in this case, which eased the burden of proof placed on taxpayers by section 82 of the Act. Previously a taxpayer had to be sure that he could satisfy a court that;

1. he was not engaged in a scheme of profit-making, and
2. the asset was fixed and not floating capital.

He will now only have to satisfy a court that he was not engaged in a scheme of profit making in order to win his case. This meant that even in the case of an asset bought for the purpose of immediate resale the proceeds would be capital as long as there was no scheme of profit making (Huxham et al, 1995:26).

2.10.13. Intention of a natural person

A natural person's intentions are found to be his state of mind, therefore, not easily established. To overcome this problem the courts have used a number of subsidiary tests, which in them, are not conclusive enough but which in their entirety may give guidance as to the true intention of the taxpayer. Justice Miller in a special court case summarised it as follows; "the difficulty in these cases lies not so much in the formulation of approach but in the application of the principles which must necessarily guide the court. It is no difficult matter to say that an important factor is: what was the taxpayer's intention when he bought the property? It is often very difficult, however, to discover what his true intention was. It is necessary to bear in mind in that regard that the *ipse dixit* (what he says his intention is) of the taxpayer as to his intent and purpose should not lightly be regarded as decisive. It is the function of the court to determine on an objective review of all the relevant facts and circumstances what the motive, purpose and intention of the taxpayer were" (Huxham et al, 1995:27).

2.10.14. Intention of a company

Huxham et al (1995:27) indicate that it is easy to establish intention where the taxpayer is a company. The actions of a company are more formally regulated than those of an individual because of the requirements of the Companies Act 1973. The intentions of a company are determined by the acts of its directors as evidenced by minutes of directors' meetings, the memorandum of association, the articles of association, and the resolutions of the members. However caution should be exercised in placing too much reliance on the objects clause in the memorandum. The objects clause may give guidance but is not in itself conclusive.

2.10.15. Change of Intention

Stack et al (1987:55) argue that the intention at the time of acquisition of the property is not conclusive because an intention to hold as an investment may change, during the time the property is held, into an intention to engage in a profit making scheme, which is found in the case of CIR versus Richmond Estate (Pty) Ltd. A taxpayer may

buy a piece of land intending to farm on it. A marked improvement in land values in that area may encourage him to divide the property up into lots and embark on a property development venture. He has obviously changed his intention and entered into a business operation, and will be taxed on the proceeds of the sale of the land.

On the other hand the mere fact that the taxpayer decides to realise an asset is not proof of change of intention, nor the fact that he does so in such a way that he realises it to the best advantage. The example is found in the case of CIR versus Stott in 1928 Appellate Division page 252.

2.10.16. The Onus of Proof

Onus of proof in terms of section 82 of the Act regarding taxability of an amount lies with the person claiming non-liability for tax, that is the taxpayer. In discharging the onus created by section 82 of the Act, a taxpayer will have to show that the amount in question is of a capital, and not revenue nature. The court will decide, on a balance of probabilities, whether the amount is capital in the event of the dispute being referred to it. In reaching a decision the court will take account of the following factors:

- **The taxpayer's 'ipse dixit'**; the taxpayer's *ipse dixit* is what he says his intention is. The Appellate Division in the case of Malan versus CIR in 1983, the court held that, because of the burden placed on the taxpayer by Section 82, he would be at a considerable disadvantage if the court did not place heavy reliance on his *ipse dixit*. In handing down a judgement in favour of the taxpayer the court concluded that the lower court, in deciding against the taxpayer, had not placed sufficient reliance on his 'ipse dixit'. This is a very important principle because it means that, unless other factors discredit the taxpayer's 'ipse dixit', it will be conclusive.
- **Length of time asset held**; regard will be had in reaching a conclusion to the length of time that the asset was held. An asset, which has been held for a long period of time, is more likely to be regarded as capital than the one, which is held for a short time.
- **Frequency**; the frequency test will also be used by the courts as one of the means of establishing the taxpayer's real intention. If the asset in question is

regularly bought and sold by the taxpayer the presumption is that it is a revenue asset the hypothesis is that it is a revenue asset (Huxham et al, 1995:30).

2.10.17. Ways of avoiding Tax Legally by Exploitation of Loopholes

According to the Income Tax Law prior to the Taxation Amendment Act of 2001, the definition of gross income for the determination of taxable income, included all amounts, in cash or otherwise, received by or accrued to a taxpayer during the tax year from a source in the Republic of South Africa or deemed to be from a source within the Republic, excluding receipts or accruals of a capital nature. This means income was taxable, while capital income was not. One would ask what exactly was a capital receipt. The Act then did not define it. Taxpayers had to rely on common sense and where that failed them on Court decisions. In simple cases it was easy to tell the difference between capital and revenue. Considering a fruit tree. The tree is a permanent asset; its fruits represent the income that one derives from owning it. If one sells the tree, the proceeds would be of a capital nature. Similarly, if one bought a farm in order to raise cattle on it, the price of one's farm would be expenditure of a capital nature. If one sold the farm at a profit after a few years of farming, the money that one received would be a capital receipt, and one's profit would be a capital gain (Jordaan et al. 1989:13).



The above illustrates one main characteristic of a capital asset: it is something, which was bought or otherwise obtained with the intention of deriving income from it. One bought it to retain it as a source of income, not to resell it at a profit. It therefore follows that if the intention of acquiring the asset was to resell it at a profit, the asset was not a capital but a revenue asset in the taxpayer's hand. The money the taxpayer receives when one resold it would be income. The taxpayer's private car, house, furniture, jewellery, books and paintings are also capital assets. It is true that the diamond ring on the taxpayer's wife's finger, or the books on one's shelves were not bought with the intention of earning income from them. But, neither did the taxpayer buy them with the intention of selling them at a profit. As such they are capital assets. The land speculator buys and sells property. His overriding intention when he buys a property is to resell it at a profit. His properties are not permanent assets; they are floating assets, part of his stock-in-trade as a property dealer. His receipts from the

sale of land are revenue receipts as they form part of his gross income. The original intention at the time when a taxpayer acquires an asset is very important. If the taxpayer's original intention was something other than to resell it at a profit, the asset is of a capital nature. But intentions may change. To determine whether the proceeds from the sale of an asset are capital or revenue one must look at the seller's intention at the time of the sale to establish whether or not his intention had changed. Margo Commission recommended that objective instead of subjective criteria should be used in order to determine whether a particular receipt is of capital or revenue nature. It was often difficult to distinguish the difference between income and capital. The South African law reports are filled with cases fought to decide whether certain amount were income or capital. It is stated that about seventy percent (70%) of all court cases regarding tax were about this principle. In most cases the various decisions in those court cases were conflicting. Taxpayers where possible, would therefore plan their transactions carefully, so that their profits were obviously of a capital nature. By doing so they would avoid having to go to court for a decision in a tax area that bristles with uncertainties and difficulties (Jordaan et al. 1989:13-19).

2.11. INTRODUCTION OF CAPITAL GAINS TAX INTO THE INCOME TAX ACT

On the 23 February 2000 the Minister of Finance of the South African Government in his budget presentation announced that a capital gains tax would be introduced in South Africa with effect from April 2001. The proposal of Capital Gains Tax in Parliament was followed by an outcry of foul, by a sector of the public. A lot of energy was lost in trying to bar this new taxation reform, with statements from the media such as "it is going to be costly to implement", and "the revenue collected will be insignificant to make a difference". A year later in his budget review he extended the date to October 2001. He stated that, hitherto, the absence of capital gains tax in the country's tax code had encouraged taxpayers to convert income that would ordinarily be taxable into tax-free capital gains and that CGT would make the taxation system more equitable in that realised and not accrued capital gains are equivalent to income and can be used in the same manner. CGT therefore comprised an important backstop to personal and corporate income taxation (Williams. 2001:1).

The South African Taxation Laws Amendments Act, 2001 (Act No. 5 of 2001) amended the Income tax Act of 1962 (act 58 of 1962), among other things so as to

provide for the determination of taxable capital gains and assessed capital losses. This amendment was heralding the inclusion of taxable capital gains into taxable income.

The legislative provisions, which impose what is colloquially called “capital gains” are contained not in a separate, dedicated statute, but in a new Eighth Schedule to the Income Tax Act, Act 58 of 1962, read together with section 26A of that Act. “Capital gains tax” is called colloquial because the expression does not appear in the Act as promulgated. In order to accommodate and implement capital gains tax various provisions of the act have been introduced or amended. Capital gains tax therefore forms an integral part of the Income Tax code. The prevalent provisions of the Income Tax Act for among other things, those relating to tax returns, tax assessments, objections, appeals and the payment and recovery of tax, also apply to the CGT regime. The charging provision for CGT is section 26A of the Act, which states that a taxpayer’s taxable income for a year of assessment, shall include the “taxable capital gain” for that year of assessment, as determined under the provisions of the Eighth Schedule. The “taxable capital gain” is then taxed at the taxpayer’s marginal tax rate as stipulated in the Act. Capital gain tax is thus paid with income tax. Section 26A and the Eighth Schedule create a new tax in that they provide for the taxation of amounts that formerly were not taxed because they fell outside the charging provisions of the income tax Act. Section 26A read with the Eighth Schedule imposes a tax on all gains except those specifically excluded, which arise from the disposal of any asset, and do not postulate any inquiry into whether the gain was “of a capital nature”. CGT is in reality, a “catch-all” tax which sweeps up the gains from disposal of all assets, other than those specifically excluded and those which fall outside the extent of the terms “disposal” and “asset” (Williams, 2001:2).

The Eighth Schedule introduced as part of the Income Tax Act identifies and quantifies taxable capital gains and assessed capital losses. This is in other word similar to what was done when the Seventh Schedule was introduced for fringe benefits as part of the Income Tax Act to identify and quantify taxable fringe benefits. Section 26A stipulates that the taxable capital gain as determined in terms of the Eighth Schedule will be included in a taxpayer’s “taxable income”. It is essential to note that, since a taxable capital gain is embodied in “taxable income”, any reference in the Income Tax act to the “income” of a taxpayer will thus not take into account

any taxable capital gains. Capital gains do not increase the tax allowable contributions towards retirement annuity funds. The fact that a taxable capital gain is included in a taxpayer's "taxable income" will certainly affect natural taxpayers. Natural taxpayers do not pay tax at a flat rate, unlike corporations, which are taxed at a flat rate of say 30% irrespective of the amount of taxable income. In the case of a natural taxpayer, the higher the taxable income the higher the rate of tax, until the maximum rate of about 42%. Simply this means that if a natural taxpayer realises a capital gain in a tax year, this can cause that taxpayer to be subject to a higher rate of tax, if that taxpayer was not already paying income tax at the top rate say 42%. A capital gain does not increase the retirement lump sum. A capital gain will not be included in a taxpayer's "income", but only in "taxable income". Speculation in an asset attracts capital gain taxation. No tax is replaced by capital gain tax; it is an additional burden on taxpayers. A taxpayer on death is deemed to have disposed of his assets at market value for CGT purposes. CGT arise on disposal or deemed disposal of an asset, which has been held as a capital asset. CGT is an annual tax and not a transaction tax, like VAT or transfer duty (Geach. 2001:1–4).

The Taxpayer (The Taxpayer. 2001:Vol 50 No.4) states that it was decided by the Government to incorporate the CGT as an integral part of the Income Tax Act, as it is regarded as a tax on income and nothing more. This approach has administrative advantages as the existing provision and procedures of the Income Tax Act can be used for the administration of this tax as stated supra. Individuals, "special" trusts and deceased and insolvent estates will pay normal income tax on 25% of the capital gains of a disposal of an asset – that is capital profits- they make, whereas companies, close corporations, and ordinary trusts will pay normal income tax on 50% of the capital profits that they would make. The tax on capital gains will apply to any asset of a South African resident. This means that a South African resident is taxed on capital gains made on the disposal of assets which he owns anywhere in the world. For non-residents the following assets are covered by the capital gains tax provisions; disposal of immovable (fixed) property situated in South Africa, and disposal of assets of a South African permanent establishment (Huxham et al, 2002:580). Capital gains tax does not apply to owner occupied residential house, private motor vehicles, or personal belongings and effects commonly found in a home, including clothing,

art, and jewellery, but does apply to boats, caravans, aircraft, share certificates, and silver and gold coins.

Geach (2001:1) states that CGT was brought in as an integral part of the Income Tax Act, so that it should not be necessary to provide for a variety of matters such as capital gains tax returns, assessments, provisions for the payment of CGT and for the recovery of CGT. All of these issues, as well as provisions relating to objection and appeals, are already catered for in the Income Tax Act and will henceforth automatically apply to CGT.

2.11.1. Basic Framework of Capital Gains Tax

Section 26A of the income Tax Act requires that a person’s “taxable capital gain” as determined in terms of the Eight Schedule must be included in his/her taxable income. A taxpayer must have a gross income to be liable for capital gains tax. Starting from a taxpayer’s Gross Income, the above give us that the framework for the taxation of income and taxable capital gains is as follows (Huxham et al, 2002:581):

2.11.2 CGT basic framework;

TRANSACTION DETAIL	AMOUNT
GROSS INCOME (per section 1 of Income Tax Act)	R xxx
Less: EXEMPT INCOME (per section 10 & 10a)	<u>R(xxx)</u>
INCOME	R xxx
Less: DEDUCTIONS AND SET-OFFS (per section 11 to 37H)	<u>R(xxx)</u>
TOTAL	R xxx
Add: All amounts required to be included in taxable INCOME;	
• CAPITAL GAINS FOR THE YEAR	R xxx
• CAPITAL LOSSES OF THE YEAR	<u>R(xxx)</u>
TOTAL	R xxx
• ANNUAL EXCLUSION	<u>R(xxx)</u>
• AGGREGATE CAPITAL GAIN	R xxx
• ASSESSED CAPITAL LOSS from previous year of assessment	<u>R(xxx)</u>
• NET CAPITAL GAIN	<u>R XXX</u>

Huxham et al (2002:581)

2.11.3. CGT Rates Applicable to Different Types of Entities

Description	Companies & Close Corporations	Individuals and Special Trusts	Trusts
Capital gain	R50 000	R50 000	R50 000
Annual Exclusion	N/A	R10 000 pa	N/A
Net Gain	R50 000	R40 000	R50 000
Inclusion Rate Percentage	50%	25%	50%
Taxable gain	R25 000	R10 000	R25 000
Tax Rate	Fixed: 30%	Variable: Maximum 42%	32% to 42%
Effective tax rate	15%	Maximum 10,5%	16% to 21%
Further Tax	12,5% on any dividends or distributions	NIL	NIL

Exclusion for a natural taxpayer who dies during a year is R50 000 (Geach, 2001:17).

2.11.4. Residents

According to paragraph 2 of the 8th Schedule, the tax on capital gains will apply to any asset of a South African resident. This certainly indicates that a South African Resident is taxed on capital gains made on the disposal of assets which he/she owns anywhere in the world.

2.11.5. Non-residents

The capital gains tax provisions, as far as non-residents are concerned cover the following assets:

- 1) Fixed property situated in South Africa
- 2) Assets of a South African permanent establishment (if a Republic trade is carried on through it during the year of assessment).

2.11.6 Who? Is liable for capital gains tax in South Africa

South African residents are liable for Capital Gains Tax on their global assets. While non-South African residents are liable for Capital Gains Tax on immovable property situated in the Republic and on the assets of a permanent establishment in the Republic.

2.11.7 Disposal

Disposal as envisaged in the eighth schedule of the Taxation Laws Amendment Act among other things is; 1) Any event, act, forbearance or operation of law which results in the creation, variation, transfer, or extinction of an asset. 2). The sale of an asset. 3). The donation of an asset. 4). The expropriation, conversion, grant, cession, exchange of an asset. 5). The forfeiture of an asset. 6). The redemption, cancellation, surrender, discharge, relinquishment, release, waiver renunciation, expiry or abandonment of an asset. 7) The scraping, loss or destruction of an asset.

2.11.8 Exclusions

The prevalent principle is that any capital gain or capital loss made, which is subject to exclusion, must be disregarded when calculating the person's aggregate capital gain or aggregate capital loss for the year of assessment. The following are exclusions (Huxhm et al, 2002:616);

- The primary residence and personal-use assets
- Retired benefits and long-term assurance
- Debt defeasance and disposal of small business assets
- Compensation for personal injury, illness or defamation
- Gambling, games and competitions
- Unit trust funds – in respect of gains or losses for the fund itself
- Donations and bequests to public benefit organisations.

2.11.9 Primary Residence exclusion

In South Africa the general principle is that up to R1 million of the gain made on the disposal of the primary residence must be disregarded when calculating a natural person's aggregate capital gain. This exclusion also applies to a special trust. A Special trusts is a trust created exclusively for the benefit of a person who suffers from a mental illness or a serious physical disability to such an extent that they cannot maintain themselves financially or manage their own financial affairs.

2.12. CONCLUSION



South Africa like any government needs revenue in order to improve the living standards of every citizen. Revenue collection to meet the objectives of the state is done through tax collection. The tax on capital gain should be seen as part of a comprehensive tax reform in the Income Tax system. CGT is a tax net. CGT in most tax jurisdiction covered by this study is seen as a process of 'widening the tax base'.

According to the sources, CGT is a small contributor to any national revenue service, however it is an essential ingredient in a comprehensive tax system, which takes account all gains, no matter whether they are revenue or capital and based on the grounds of equity, certainty and ability to pay. Although revenue from the introduction of capital gains in all tax jurisdictions is not high, it seems there are some expected result of the taxation on capital gains. Would it be that taxpayers would not be attracted to invest in capital assets? Controversy over the taxing of capital gains, it is apparent is not peculiar to South Africa but has raised storming debates in almost every country that introduced CGT. The moral reason given for the taxation of capital gains is that the tax is based on the ability to pay and that all sources of income should be taxed.

Efforts have been undertaken to defines and identify capital gain before and after October 2001. Tax reforms literature in particular CGT in various tax jurisdictions relevant to this study have been studied. CGT has come out as very significant in any taxation system, and once implemented it cannot be repealed. The opponents

(opposition parties) of capital gains tax during implementation become proponents of CGT once in power.

CHAPTER 3

DEFINITION OF THE PROBLEM AND RESEARCH QUESTIONS

3.1. INTRODUCTION

Capital gains tax indeed will have a major impact on every South African asset and South African taxpayer, and particularly on business. For example, if a business is converted from a partnership to a trust, and an Electrician or a plumbing contractor operating as a sole trader bring in a partner among others. The rules of CGT are complex and mostly confusing to an ordinary taxpayer. Taxpayers may have to consult Tax Advisers on every major transaction. Taxpayers must plan their transactions in the outset so that unfavourable capital gains tax results should not occur, possibly many years later when planning would be impossible. Therefore it will be very critical for every business and every taxpayer to review the capital gains tax position on transactions such as:

- Share and securities strategies.
- Business rearrangement. (Sole trader to partnership or trust, trust to company, public company rearrangements)
- Non-residents establishing a business in South Africa or changing their residence to South Africa.
- Introduction of new shareholders, partners or trust beneficiaries into a partnership trust or company;
- Mergers and acquisition strategies.
- Investment decisions.
- Purchase of a new business.

3.2. THE RATIONALE TO THE PROBLEM

The reactions from the public media that followed the government's intention to introduce capital gains tax in April 2001, into the tax code of South Africa was echoed through out the world with the result that the issue was on the media for

several months and a lot of paper used. In my lifetime the only other Act that attracted such an attention was the introduction of the Immorality Act in South Africa resulting in books written about it. The captains of industry were at war with the government about this form of taxation, with statements such as “it discourages investment” and it will not have “significant” contribution to the country’s revenues in order to improve the living standards of the people. Before 1994 property ownership in South Africa was in the hands of a minority like in most developing countries.

Capital gains tax in developed countries like the United States of America, the United Kingdom, Canada and Australia to state but a few, has enforcement, compliance and transitional problems in those tax jurisdictions. It is also known as a low yield revenue collection method, which affects the affluent and wealthy property owners, a rather small percentage of any community. South Africa is a developing country, which has been struggling with the definition of capital gains for years, resulting in several court cases between the Receiver and taxpayers and a loss of billions of Rand due to tax avoidance and sometimes evasion.

3.3. DEFINITION OF PROBLEMS

- **PRIMARY PROBLEM:**

The RSA government went ahead to introduce Capital Gains Tax, an unpopular low yield form of taxation particularly in developing countries. This is evidenced by the strident and vehement public rejection when it was proposed in parliament.

3.4. FORMULATION OF RESEARCH QUESTIONS

- The South African taxpayers vigorously opposed Capital Gains Tax, because its implementation was thought to be bringing in taxes of great magnitude, which would typically increase substantially the taxes that some individuals and businesses were going to pay. The question is; will capital gains tax increase the burden of tax to the taxpayers.

- Adam Smith has stated that every tax ought to be so contriving as both to take out, and keep out, of the pockets of the taxpayers as little as possible over and above what it brings into the public treasury of the state, the question is; Whether CGT as introduced in South Africa will yield significant revenue to the country for Infrastructural developments and economic growth?
- Did the government of South Africa implement CGT for revenue enhancement in order to improve the living standards of the poor?
- Was it for equity that the South African government introduced CGT into the tax code?
- Will CGT be a deterrent to investments in properties?
- Will CGT deter foreign direct investments?
- Was CGT introduced to solve the problems of economic growth?

3.5 CONCLUSION

In this chapter the primary and secondary problems have been thoroughly explained and defined. Substantial Tax Reforms like capital gains tax in every tax jurisdictions, are perceived to be controversial by taxpayers as well as tax scholars, a lot of energy is used to vehemently oppose them. Whether it is in developed or developing countries the reactions are the same against the reforms. The research questions about the impact capital gains tax will have to the economy of South Africa will be recorded and verified in the following chapters of this study.

CHAPTER 4

RESEARCH DESIGN AND ANALYSIS

4.1. INTRODUCTION

In this study multiple research methods have been used because of the nature of the problems. Capital Gains Tax is a legislative framework. Baker (Baker, 1999:328-329) suggests that a research on among other things law can be best tackled by using evaluation research, which needs a comparative baseline for determining the success or failure of what is being evaluated. Programme evaluations are often case studies. Unfortunately evaluation or content analysis cannot come up with conclusive answers to the problems under review.

The multiple research methods selected are Qualitative and Quantitative methods. Primary and Secondary data will be collected and used. The Primary research design will involve generating original data to be collected by using questionnaires directed to a population of taxpayers as shall be explained later. This data will be strengthened by carrying secondary analysis of already existing statistics. The Secondary data will be the existing statistical data collected from government departments and other sources. Statistical data is going to be used as supporting data in the study.

4.1.1. Using Multiple Methods to Strengthen a Research Design

Baker (1999:297) quotes Brewer and Hunter (1989) as suggesting that the multimethod approach be applied to all stages of the research design. The two authors maintain that the multimethod strategy is “to attack a research problem with an arsenal of methods that have nonoverlapping weakness in addition to their complementary strengths”. They note the advantage of using more than one major research method. For example survey research and existing data is that the researcher can more thoroughly test the theories underlying the research. Using more than one method to research can strengthen a theory. Another argument posed on strengthening

the case for multiple methods is that often the ideal method for studying a problem cannot be employed for strategic, economic, or ethical reasons.

4.2. POPULATION

Although the population should be all South African taxpayers, the population is the aggregation of study elements, which include Lawyers, Accountants, Media representatives and Trade Unions in all the nine provinces of the country, from which the sample was drawn. The South African Tax Law categorise taxpayers as individuals, corporate companies, small business, partnerships, special trusts and ordinary trusts. A sample taken according to these categories was going to be problematic and would not solve the research problems. The main problem would be individuals, who had to be further categorised by race and also by variables of rich or poor, illiterate or educated among others. It is concluded that Trade Unions represent the majority of the working class, while Lawyers and Accountants best represent business generally. The sample is of elements that are well vested about the Tax Law, and therefore are taken as appropriate to solve the problems at hand.

4.3. SAMPLING TECHNIQUES

The sampling strategy used was non-probability sampling. Non-probability samples do not use random sampling. Their weaknesses can to some extent be mitigated by using knowledge, expertise, and care in selecting samples and by replicating studies with different samples. The use of this type of strategy indicates that there is no means of estimating the probability of units being included in the sample. Opportunistic sampling was used. The field researcher collected data from primary sources by means of telephonic interviews. One of the limitations of non-probability sampling is the fact that generalisation of the population is somewhat risky. The benefits of this method is that it is inexpensive and convenient, which outweigh the risk weakness in this instance. Opinion leaders as stated above in the area of taxation were selected on the basis of their availability to participate in the study, in addition to their knowledge and expertise in Capital Gains Tax.

The objective of the study guided the selection of the data collection and data analysis methods, which set out to outline the impact of capital gains tax.

4.4 SURVEY METHODS

The instrument used to collect primary data was by telephonic interviews. A mix of “open and closed ended” questions as per Annexure A were posed to all interviewees with the intentions of getting their view on the implementation of Capital Gains Tax. The main focus of the questions was to answer the research questions of this study. The secondary data for the support of the primary data was collected from government and other sources.

4.5 METHOD OF DATA ANALYSIS

Data was analysed by determining what was important to observe and thereafter the formulation of analytical conclusions on the basis of those observations. The findings in terms of the research questions, which were originally posed, were examined. The secondary data is qualitative so it will require processing the body of reports in such a manner that the central themes and meaning can be ascertained and pulled together (Baker, 1999:335).

4.6 CONCLUSION



Capital Gains Tax in South Africa may be a new name, but the concept has been in existence long enough to have a considerable expertise in the country. It was not difficult to find Lawyers and Accountants who were vested with this form of taxation. The Media from the on set was well schooled in the workings, advantages and disadvantages of capital gains tax. The respondents were conversant with the Act, and maximum input was secured. The interview for the primary data and records of the secondary data are presented in the next chapter, chapter 5.

CHAPTER 5

RESEARCH RESULTS

5.1. INTRODUCTION

The data collected in this study represent the perceptions thoughts and feelings of the respondents randomly selected as a sample from the population group as stated in the previous chapters. The data is supported by statistics obtained from sources from within South Africa also as stated in the previous chapters. These data, primary and secondary, depict the impact Capital Gains Tax has to the economy of South Africa.

Descriptive data and statistics were used to identify trends about how the respondents perceived the effects of CGT before and after October 2001 and are represented below in tabular form. The data is described in numbers and percentages.

5.2. DATA ANALYSIS

The following tables are the findings of data collected from the study.

Section 1: Capital Gains Tax before October 2001:

Table 5.2.1: The way CGT was defined and presented created uncertainty for liability for tax;

DETAILS	Number of Respondents	Percentage
Yes	142	71%
No	40	20%
Don't know	18	9%
Total	200	100%

Certainty for liability to pay tax is one of the main cannons for taxation as stated in chapter two. CGT as defined before October 2001 created uncertainty as 71% of the respondent in table 5.2.1 indicated in the study.

Table 5.2.2: Was taxation of CGT as it was levied with the exclusion of the “receipts or accruals of a capital nature” fair?

Number of Respondents	Percentage	DETAILS
20	10%	Yes
151	75.5%	No
29	14.5%	Don’t know
200	100%	Total

A tax system is fair when it taxes equals equally as evidenced in chapter two. The exclusion of “receipts or accruals” of a capital nature in the tax code of South Africa created unfairness in that those taxpayers who had expertise to have revenue transactions converted to “receipts and accruals” of a capital nature paid no tax while those without expertise paid tax for the same transactions. 75.5% of the respondents in table 5.2.2 say that the tax system was unfair.

Table 5.2.3: The interpretation of “Taxable Income” with the exclusion of “receipts or accruals” of a capital nature created loopholes for tax avoidance or evasion.

Details	Number of Respondents	Percentage
Agree	20	10%
Strongly Agree	162	81%
Didsagree	13	6.5%
Strongly disagree	5	2.5%
Total	200	100%

A great majority, 91% in table 5.2.3 of which 81% of the respondents strongly agree that the interpretation of “Taxable income” with the exclusion of receipts or accruals of a capital nature created loopholes for tax avoidance or evasion.

Table 5.2.4: The exclusion of “receipts or accruals” of a capital nature encouraged local investment or foreign direct investment in properties.

Details	Number of Respondents	Percentage
Agree	155	77.5%
Strongly agree	25	12.5%
Disagree	11	5.5%
Strongly disagree	9	4.5%
Total	200	100%

The lack of proper implementation of CGT encourages investments, local or foreign direct investment. In table 5.2.4, 77.5% of the respondents agree with the statement that the exclusion of “receipts or accruals of a capital nature” encouraged investment in properties from locals or foreigners.

Table 5.2.5: The exclusion of “receipts or accruals” of a capital nature encouraged economic growth resulting to job creation and eradication of poverty.

Details	Number of Respondents	Percentage
Agree	10	5%
Disagree	15	7.5%
Strongly disagree	170	85%
Don't know	5	2.5%
Total	200	100%

On the issue of economic growth resulting to job creation and eradication of poverty because of the absence of CGT in table 5.2.5, 85% of the respondents strongly disagree that lack of CGT encouraged economic growth, and it did not eradicate poverty.

Table 5.2.6: Was revenue collection before October 2001 good?

Details	Number of Respondents	
Good	15	7.5%
Very Good	10	5%
Poor	165	82.5%
Very poor	10	5%
Total	200	100%

Even without CGT the revenue collection was poor as table 5.2.6 shows, 82.5% of the respondents said it was poor.

Section 2: Capital Gains Tax after October 2001:

Table 5.2.7: The way taxable income and CGT are defined creates certainty for liability for tax.

Details	Number of Respondents	Percentage
Correct	176	88%
Incorrect	18	9%
Don't know	6	3%
Total	200	100%

The majority of the respondents 88% in table 5.2.7, agree that after October 2001 the way taxable income and CGT are defined created certainty for liability for tax.

Table 5.2.8: Do you consider the taxation of CGT after October 2001 fair?

Details	Number of Respondents	Percentage
Agree	80	40%
Strongly agree	109	54.5%
Disagree	6	3%
Strongly disagree	5	2.5%
Total	200	100%

In terms of the data collected it is clear that the introduction of CGT is a fair proposition of the tax system of South Africa. This is shown in table 5.2.8 with 54.5% strongly agreeing and 40% agreeing, the positive attitude of almost 95% in table 5.2.8.

Table 5.2.9: The inclusion of CGT has broadened the tax base this will impact positively towards economic growth by increasing government spending.

Details	Number of Respondents	Percentage
Agree	50	25%
Strongly agree	110	55%
Disagree	26	13%
Strongly disagree	14	7%
Total	200	100%

The broadening of the tax base increases revenue collection in most tax jurisdictions. In table 5.2.9 of this study, 80% of the respondents agree, of which 55% strongly agree.

Table 5.2.10: The introduction of CGT will lessen the burden of taxation to all taxpayers

Details	Number of Respondents	Percentage
Agree	90	45%
Strongly agree	70	35%
Disagree	28	14%
Strongly disagree	12	6%
Total	200	100%

The respondents who agree that the implementation of CGT has lessened the burden of taxation to all taxpayers in table 5.2.10 are 80% of which 45% agree and 35% strongly agree.

Table 5.2.11: CGT is known to be a low yield form of taxation; therefore its impact on revenue collection will be insignificant.

Details	Number of Respondents	Percentage
Agree	85	42.5%
Strongly agree	25	12.5%
Disagree	60	30%
Strongly disagree	30	15%
Total	200	100%



The introduction of CGT in South Africa like in most tax jurisdictions will not improve revenue collections. In table 5.2.11, the respondents who agree that CGT revenue collection will be insignificant are in the majority with 55%, comprising 42.5% agreeing and 12.5% strongly agreeing.

Table 5.2.12: The tax burden will be increased to the extent that the affluent who own properties pay more taxes.

Details	Number of Respondents	Percentage
Agree	24	12%
Strongly agree	16	8%
Disagree	150	75%
Strongly disagree	10	5%
Total	200	100%

When CGT was introduced the outcry from the media was that the affluent are going to be over taxed. In table 5.2.12, 80% of the respondents disagree, of which 5% strongly do so.

Table 5.2.13: CGT will be a deterrent to investments; local and foreign direct investment;

DETAILS	Number of Respondents	Percentage
Agree	120	60%
Strongly Agree	30	15%
Disagree	30	15%
Strongly Disagree	20	10%
Total	200	100%

It is a perception of some Tax Scholars who have written extensively that CGT discourages investments in properties. In table 5.2.13, 75% of the respondents agree, of which 15% strongly agree. According to them CGT is a deterrent to investments.

Table 5.2.14: CGT has introduced a tax system, which is wealth distributive to all taxpayers

DETAILS	Number of Respondents	Percentage
Yes	150	75%
No	24	12%
Don't know	26	13%
Total	200	100%

A tax system, which reduces tax rates and allows the poor not to pay tax, is wealth distributive. In table 5.2.14, 75% of the respondents believe that CGT is wealth distributive.

Table 5.2.15 CGT will create difficulties for tax administration.

DETAILS	Number of Respondents	Percentage
Agree	92	46%
Strongly Agree	54	27%
Disagree	34	17%
Strongly Disagree	20	10%
Total	200	100%

In most tax jurisdiction the introductions of CGT creates administrative problems. In the South African context, in table 5.2.15, 73% agree of which 27% strongly agree that there will be no problem in the administration of CGT after October 2001.

5.3. CONCLUSION

In this chapter the design and methodology of this research project has been portrayed. Accountants, Lawyers, Media and Union Representatives form the target out of which a sample was taken to represent the taxpayers as a population for this study. Administrative arrangements, the presentation method and analysis of the results have been elucidated and the responses as well as the deductions based on

these have been depicted. This chapter furthermore reflects the respondents' actual impressions about what they perceived as the impact of CGT to the economy of South Africa. The reactions to questions reflect the respondents' comprehension of CGT as well as their attitudes towards it. This is shown in their perception of it before October 2001 and after.

CGT before October 2001 questions:

- Was not properly defined, which created uncertainty for liability for tax.
- The exclusion of the "receipts or accruals" of a capital nature was unfair.
- Interpretation of "Taxable Income" created loopholes for tax avoidance or evasion.
- The exclusion of "receipts or accruals" of a capital nature did not encourage investments, local or foreign.
- The exclusion of "receipts or accruals" of a capital nature did not encourage economic growth resulting to job creation and eradication of poverty.
- Revenue collection was not enhanced by the exclusion of CGT.

CGT after October 2001 questions:

- Taxable income and CGT was defined correctly, and creates certainty for tax liability for a portion of the profit made from a disposal of an asset.
- Taxation of CGT is now fair
- Government spending will increase resulting in economic growth.
- CGT will lessen the burden of taxation to all taxpayers.
- Will be insignificant for revenue collection even after October 2001.
- The affluent that own properties will not be paying more taxes.
- CGT will not be a deterrent to investment of whatever nature.
- CGT is not known to be a distributive tax system.
- CGT will create difficulties for tax administration.

CHAPTER 6

DISCUSSIONS, CONCLUSIONS AND RECOMMENDATIONS

6.1. INTRODUCTION

The study focused on the impact of Capital Gains Tax on the economy of South Africa. This chapter serves to encapsulate the discussions, conclusions and recommendations on Capital Gains Tax in South Africa. The study probed CGT before October 2001 and after, to find out how it was and is perceived in these periods of time in regard to revenue collection, poverty alleviation, investments, government spending and economic growth, tax compliance. The Government, Legislators, Lawyers and Accountants may use the findings in future tax reforms.

The data collection techniques used was largely through one-to-one telephonic interviews. Explicit questions with multiple-choice answers as per Annexure A were asked from two hundred respondents with the intention of getting their perception about CGT in South Africa. Secondary Data has been collected from government departments or organisations to support the empirical findings.

The outcomes of the study are fully discussed in this chapter, with cross-references to the underlying theoretical foundation propounded in chapter two. Based on the facts from the analysis of the collected data discussions, conclusions and recommendations follow.

6.2. DISCUSSIONS

- Capital Gains Tax before October 2001; the way it was defined and presented created uncertainty for liability for tax;

According to the canons of taxation certainty should not be compromised in a good tax system. In chapter two it has been demonstrated that the tax, which each

individual taxpayer is bound to pay, must be certain. The manner of payment, the quantity to be paid and the time of payment ought to be clear and plain to the taxpayer. Uncertainty creates tax loopholes, which encourages taxpayers to legally or illegally evade or avoid part of the taxes they owe. More important, they go to enormous trouble and expenses rearranging their affairs to avoid taxes. Tax invasion is a big problem for any government. It was demonstrated in the preceding chapters that the manner in which CGT was identified before October 2001 did not rest on satisfactory bases. In 1979 the South African Revenue Department put through an Act of Parliament providing for “a very limited and modest capital gains tax”.

The definition of gross income for the determination of taxable income, included all amounts, in cash or otherwise, received by or accrued to a taxpayer from a source in South Africa, excluding “receipts or accruals of a capital nature”. This meant that income was taxable, while capital income (profit) was not. Capital receipt was not defined. Taxpayers had to rely on common sense and where that failed tried them on Court decisions. It has been stated that about seventy percent (70%) of all court cases regarding tax were about this principle, and in most cases the various decisions in those court cases were conflicting. Taxpayers where possible, would therefore plan their transactions carefully, so that their profits were obviously of a capital nature. Taxpayers would avoid having to go to court for a decision by planning their transactions in a tax area that bristled with uncertainties. In his Budget Speech in February 2001 the Minister of Finance stated that, the absence of capital gains tax in the country’s tax code had encouraged taxpayers to convert income that would ordinarily be taxable into tax-free capital gains.

In table 5.2.1, 71% of the respondents indicated that the way CGT was defined and presented before October 2001 created uncertainty for liability for tax.

- Was taxation of CGT as it was levied with the exclusion of the “receipts or accruals of a capital nature” fair?

Fairness is equal treatment of taxpayers in equal circumstances. If this condition is violated, taxpayers will be treated inequitably, and incentives will be created to base economic decisions on tax considerations rather than on true economic gain. A system

that allowed many loopholes for tax avoidance or evasion like the South African system, before October 2001 cannot be accepted as fair. An adequately designed tax system should be fair to all taxpayers. Another theory of fairness is that taxation should be commensurate to the ability to pay. Affluent and poor alike as members of a community have a common destiny. All may be called upon to contribute to a public fund for the welfare of all citizens. The wealthy should contribute more than the poor, but the wealthy may not have been paying tax when they sold their assets. Realised capital gains are highly concentrated among high-income individuals.

The Margo Commission of Enquiry had recommended that a comprehensive statutory definition of capital and income should not be attempted in South Africa, and that capital gains should not be subjected to tax. However, the commission recommended that objective, instead of the then prevailing subjective criteria in dealing with “receipts or accruals of a capital nature” be used by the Courts, for the purpose of identifying a capital gain.

The exclusion of “receipts or accruals of a capital nature” in the tax code of South Africa created unfairness in that those taxpayers who had expertise to have revenue transactions converted to “receipts and accruals of a capital nature” paid no tax while those without expertise paid tax for the same transactions. The British Chancellor Mr Callaghan in his Budget speech stated that there was little dispute then that capital gain conferred much the same kind of benefit on the recipient as taxed earnings, yet earnings may be taxed in full while capital gains went free, and that this is unfair to the wage and salary earner. In table 5.2.2, 75.5% of the respondents say that the tax system was unfair. In table 5.2.3 on the question of the interpretation of the “Taxable Income” with the exclusion of the “receipts or accruals of a capital nature” 91% of the respondents agree that this created loopholes for tax avoidance or evasion. The Katz Commission estimated the “tax gap” (revenue lost due to avoidance or evasion) at between R5 billion and R15 billion (Budget Review 2000).

- The exclusion of “receipts or accruals of a capital nature” encouraged local investment or foreign direct investment in properties.

In chapter two it was demonstrated that tax on capital gains reduces the attraction of investment in 'non-productive' assets such as antiques, coins, paintings, precious stones and stamps, which are bought because of anticipated increases in their value, rather than for any productive purpose. Furthermore capital gains tax reduces the taxpayer's ability to invest in buying extra houses, caravans, and boats when as individuals or businesses their business is not on these properties. It has also been indicated that capital gains tax drives potential local investors offshore. In table 5.2.4, 90% of the respondents agree with the statement that the exclusion of "receipts or accruals of a capital nature" encouraged investment before October 2001 in properties from locals or foreigners.

- The exclusion of "receipts or accruals of a capital nature" encouraged economic growth resulting to job creation and eradication of poverty;

There is no evidence that the lack of CGT encouraged economic growth. However during this period in South Africa the tax system had high tax rates. And it was indicated that high tax rates on well-to-do discouraged the hard work, innovation, and entrepreneurship necessary for a vibrant economy. It was demonstrated that history reveals a number of episodes in which tax cuts have been explicitly used in an attempt to spur demand and jump-start a sluggish economy. In table 5.2.5, 85% of the respondents strongly disagree that lack of CGT encouraged economic growth.

- Was revenue collection before October 2001 good?



Before October 2001 revenue collection was very poor, but CGT was not implemented yet. Mr P Gordaham, Head of South African Revenue Services in reply to the negative reports from the media about CGT propounded that South Africa has lost millions of Rand in tax revenue, because some taxpayers were converting income that would normally be taxed into free capital gains. Individuals and companies tended to plough income into capital investment to avoid income tax. In table 5.2.6 the respondents' (87%) reaction to revenue collection is that it was poor.

- After October 2001 the way “Taxable Income” and CGT are defined creates certainty for liability for tax;.

Certainty in contemporary tax law is a very important principle. After October 2001 in South Africa certainty was achieved because the manner, method, time and quantity of taxation, CGT included is now clearly stipulated. The legislative provisions, which impose CGT are contained in a new Eight Schedule to the Income Tax Act, Act 58 of 1962, read together with new section 26A of the Act. The charging provision for CGT is section 26A of the Act, which states that a taxpayer’s taxable income for a year of assessment, shall include the “taxable capital gain” for that year of assessment, as determined under the provisions of the Eight Schedule. According to paragraph 2 of the 8th Schedule the tax on capital gains will apply to any asset of a South African resident. This certainty indicates that a South African Resident is taxed on capital gains made on the disposal of assets which he owns anywhere in the world. The majority of the respondents in table 5.2.7, 88% of them agree that the way taxable income and CGT are defined creates certainty for liability for tax.

- After October 2001 in the South Africa context the taxation of CGT is now fair;

In chapter two it has been stated that it is evident that standards of fairness like standards of beauty are not susceptible of measurement with mathematical precision. Although mathematical standards of fairness are elusive, the general outlines of equity in tax systems have been more or less agreed upon, by economists, through a consideration of the basic problem of the relation of the taxpayer to the state, and the contribution, which he can be envisaged to make to it. Firstly taxation should be proportional to benefits received, and secondly taxation should be proportional to ability to pay. Every citizen should make some contribution, however small to the state. People’s view about, whether the tax system is fair are strongly influenced by how hard the tax system hits their own family. Almost 95% of the respondents in table 5.2.8 submit that CGT has introduced a fair tax system.

- The inclusion of CGT has broadened the tax base this will impact positively towards economic growth by increasing government spending

It has been submitted in chapter two that Government spending on infrastructure, health, education, safety and security, among others, contribute to the growth of the economy of a country. It was argued that, in order to achieve the basic tax policy objectives of equity and efficiency, a tax system should impose a direct tax on a broad income base. Such an income base, which must include all types of income, include the fruits of labour and returns on capital investment, is considered to be the best measure of a taxpayer's ability to pay. To pay the bill for government spending without serious injury to the economy, require a tax structure devised with the greatest skill to be fair. The rates are lower because of the increase in the tax net. In table 5.2.9, 80% of the respondents agree that CGT will impact positively towards economic growth by increasing government spending. Statistics contained in Annexure B section 2 table 2.1, indicates a constant average annual economic growth of 3.1% for South Africa from 1996 to 2004, and table 2.2 a Summary of Gross Domestic Product by Region the figures show 2% for 1996/1997, 1% for 1997/1998, 1% for 1998/1999, 1.3% for 1999/2000, 1.5% for 2000/2001, 1.4% for 2001/2002, 1% for 2002/2003, and 1.3% for 2003/2004, these figures show an average growth of 1.3% for the period in question. Table 2.3 (graph) a growth of Real Final Consumption Expenditure by general government (government including provinces) from below R170 billions in 2000 to over R210 billions in 2005-second quarter an 8% growth. It is concluded that CGT did not hamper growth of the country, and the country has been growing at almost constant percentages throughout the years. If anything it may have contributed to a slight growth. According to the 2000 Budget review tax relief for personal income tax was R9,9 billion, this coming before the implementation of CGT. After the implementation of CGT tax relief for personal income tax in 2002 was R15 billion, in 2003 it was R13,3 billion, in 2004 R13 billion and in 2005/06 R13,5 billion. From 2002 to 2005 R54,5 billion was given back to the taxpayers by the government to spend and grow the economy. The personal income tax reduction primarily benefits lower and middle-income households.

- Will the introduction of CGT lessen the burden of taxation to all taxpayers?

The individual taxpayer's most immediate matter of concern is the actual distribution of the tax load. This matter may simply entail the difference between success and failure in the taxpayer's business. His business finds it difficult to bear as he finds it difficult to accept as equitable and just a burden. Taxation should be proportional to benefits received, and should also be proportional to the ability to pay. The affluent should contribute more than the poor. The question is how much? In proportion to aggregate income, or aggregate wealth or at rates progressively higher as income or wealth increase? Economists seem to be agreed that income is sufficient as a single measure of ability to pay tax. CGT is an income, and nothing more. It is submitted that across-the-board tax cut may lose no revenue, and that high tax rates might harm the economy enough, that tax cuts would provide more, rather than less, revenue. The distribution of tax load has been to lower individual and corporate tax rates and to broaden tax bases.

Intrinsic tax reform revolves around changes in three main features of the tax system being the tax base, allowable deductions from the base, and tax rates.

It is clear that revenue needs constrain these choices. For instance, narrower bases and more generous deductions typically require higher tax rates to raise a given amount of revenue. There is disagreement among tax scholars about how the burden of tax should be shared across families with different incomes. The current personal income tax is "progressive", meaning that higher-income taxpayers typically pay a larger percentage of their incomes in taxes than those with lower incomes.

Legislators use multiple positive rates in personal taxes to achieve a desired distribution of tax burdens among citizens or households. A zero rate under personal taxes for those with little income also unravels administration and compliance by vindicating households with few resources and little potential tax liability from the need to file returns. In table 5.2.10, 80% of the respondents believe that the introduction of CGT has lessened the burden of taxation to all taxpayers. Table 1.1, Income Tax Rates for 1997 year of assessment for natural persons show that where the taxable income does not exceed R15,00, 17% of each R1 was levied to tax, and for people whose taxable income exceeds R100,000 paid R34 200 plus 45% of the amount by which the taxable income exceeds R100,000. For companies taxable income exceeding R100 00 paid R36 250 plus 45% of the amount by which the

taxable income exceeds R100 00. The tax rates on table 1.1 for 1997 are very high compared to tax rates on tables 1.2, for 2003, 1.3 for 2004, 1.4 for 2005/6, and the Budget speeches for 2002, 2003 2004 already discussed supra.

- CGT is known to be a low yield form of taxation; therefore its impact on revenue collection will be insignificant;

In chapters one and two it has been indicated that Capital Gains Tax is a low yield form of taxation as “the revenue collected will be insignificant to make a difference”. Whiteman et al argues that capital gains tax is unlikely ever to constitute a major source of revenue, but it may well produce much more than its original estimate. It was also submitted that revenue in the early years will be small and will build up only gradually. In Australia Cooper states that during 1990/1991 tax year 164,275 taxpayers were subject to capital gains tax, of which 154,730 were individuals. In table 5.2.11, 55% of the respondents agree that revenue collection will be insignificant. Table 2.5 Budget Review Actual shows that the actual taxes collected on Income and Profits average 1% growth for the period under review.

- The tax burden will be increased to the extent that the affluent pay more taxes;

It has been indicated that because of improper definition of capital gains tax, the affluent have been avoiding taxation on income which they should have otherwise have paid, by expertly presenting income as capital gains, which was not taxed before October 2001. The interpretation of taxable income and capital gain tax presently in Act 58 of 1962 as amended with section 26A and the Eight Schedule warrant that every capital gains except the exclusions of a South African resident be taxed. The affluent are not being over taxed but taxed on income on which they have liability to pay tax, CGT is tax on income but nothing more. In table 5.2.12, 80% of the respondents agree that the affluent will not be over taxed.

- Will CGT be a deterrent to local and foreign direct investments?

In chapter two it is posited that taxes affect the terms of almost every economic decision. They have an impact on the size of the rewards obtained from working hard, taking on a second job, saving, and investing in training or education. The income tax changes how much it costs to contribute to charity or buy a home. Business decisions such as whether and how much to invest in a new technology, or whether to locate a factory outside the country, can all hinge on the tax consequences. Tax systems are biased against saving and investment, which are essential for maintaining and improving the country's long-run standard of living. In table 5.2.13, 75% of the respondents agree that CGT is a deterrent to investment. Table 2.4 of Foreign liabilities of South Africa shows that total direct investment for the period under review was indeed insignificant.

- CGT has introduced a tax system, which is wealth distributive to all taxpayers;

In the USA the major accomplishment of the tax reform, which included capital gains tax, was the removal from the tax rolls of millions of taxpayers with income below the poverty line. The 1986 USA tax act was a culmination of a decade-long effort to broaden the tax base and significantly cut rates of the personal and corporate income taxes. The South African tax rates have also removed millions of poor tax payers from the tax roll on tables 103 and 104.

Regarding this topic, the Indonesian Property Tax Law was aiming at reducing relative impoverishment and uneven distribution of income across income classes. This tendency of the government emphasised total alleviation of absolute impoverishment. In other words, the raising of the standards for the poorest sixty percent of society, particularly for the millions of poor rural families. Indonesian policy makers came to view the appropriate income distribution goal for tax reform as insuring that changes on taxation would not make the poor worse off, primarily by placing low-income families outside the tax net, to the extent possible. As Table 5.2.14 shows, 75% of the respondents believe that CGT has ushered in a wealth distributive tax system.

In Tables 1.1 the tax rates are high and therefore the government gave nothing to all categories of taxpayers, but in tables 1.2, 1.3 and 1.4 the government has been giving all categories of taxpayers millions back, to spend as they wish, as already discussed *supra*.

- CGT will create difficulties for tax administration

A well-formulated tax system should be simple and economical in administration. This means that a tax, which can be imposed in understandable language and collected with relative ease, has important advantages over one, which requires elaborate provisions and administration. It is submitted that most tax systems are not simple and economical in administration. The South African Tax system before October 2001 was not simple, hence the many dispute, which were settled by the Courts. For a developing country the best way to cope with the administrative problems is to design a tax system in full recognition of the severe limitations imposed by administrative realities. Administrative dimension is central, not peripheral, to a tax reform.

In the South African context CGT is contained not in a separate, dedicated statute, but in a new Eight Schedule to the Income Tax Act, read together with section 26A of that Act. CGT therefore forms an integral part of the Income Tax code. The prevalent provisions of the Income Tax Act for among other things, those relating to tax returns, tax assessments, objections, appeals and the payment and recovery of tax, also apply to CGT regime. In table 5.2.15, 73% of the respondents believe that CGT will create administrative problems, however from the sources this is not true, because CGT forms an integral part of the present taxation law.

6.3. CONCLUSIONS

From the interviews and discussions conducted in the preceding chapters, the following conclusions can be drawn;

In a world of highly integrated goods and capital markets, countries are linked not only by the cross-border transactions of private agents, but also by their economic

policies. The tax legislations and policies of one country affect economic activities in other countries. With the world facing increased capital mobility in different directions, capital gains taxation especially has to be reconsidered and analysed extensively, empirically as well as theoretically for the amendment of the South African statutes to adopt the American model, which has no exclusion. But also a system which will consider the effects of inflation on realised assets.

At the heart of public debate in most tax jurisdictions are some claims that play a big role over taxes. One such claim it is submitted, is that tax cuts will increase economic growth so much that revenues will not fall much and may actually increase. The assertion that tax cut would lose no revenue is associated with the claims by some economists that high tax rates might be harming the economy enough, that tax cuts would provide more, rather than less, revenue issues presented in Discussions.

In South Africa structural changes to the Income Tax to include Capital Gains Tax was necessary to ensure that The South African tax system keeps pace with globalisation and integration of the country with the world economy. The premise that the wealthy and affluent should carry a greater proportion of the burden of funding the State than the poor was met by the introduction of CGT. After October 2001 taxation in South Africa is proportional to ability to pay and benefits received. Removing several poor low-income South Africans from tax rolls has enhanced vertical equity, already discussed in *supra*.



Before October 2001 the RSA tax system was a serious drag on the economy and the radical CGT changes have unleashed a new era of unbridled growth and prosperity, as discussed *supra*. The general thrust of tax reform internationally has been to lower individual and corporate tax rates and to broaden tax bases, as discussed *supra*. The provisions of the tax law before October 2001 made the tax system more complicated, and the tax base was narrowed, thus requiring higher tax rates for income tax to raise the required revenue. As a result, efforts by taxpayers to shelter income also increased, tax avoidance and evasion increased hence the several disputes taken to court for settlements, as discussed in preceding chapters. The immunity from tax of CGT has given a powerful incentive to the skilful manipulators, which had taken full

advantage to avoid tax by various devices, turning what was really taxable income into tax-free capital gains.

The current personal income tax is “progressive”, meaning that higher-income people typically pay larger percentage of their incomes in taxes than those with lower incomes. This progressivity is achieved mainly by exempting the first several thousand Rand of income from taxation. Tax cuts put more money in people’s pockets, and to the extent that people go out and spend some of it, giving a boost to the economy.

Venture Capitalists who are successful entrepreneurs in South Africa may choose to have other businesses elsewhere driven offshore by capital gains tax. Capital gains tax rates affect investment decisions. Before October 2001 Investors were very conscious of the fact that a significant part of the returns on various investments took the shape of a tax-free capital gain.

Certainty in contemporary tax law is a very important principle. After October 2001 certainty was achieved because the manner, method, time and quantity of taxation was clearly stipulated. Before October 2001 the Legislator had not attempted to define the statement “of a capital nature” and in cases of uncertainty it was left to the courts to decide whether or not a “receipt or accrual” was of a capital nature.

6.4. RECOMMENDATIONS

The following are recommendations for future tax reforms, based on the study to meet future revenue collections, fairness, equity and other government objectives;

- The accumulation of exclusions and deductions credits designed to help particular groups or advance special purposes including the primary residence exclusion of capital gains and some personal-use assets should be fully taxed. Presently the primary residence is excluded up to about a million Rand. Capital gains is a profit like the fruits of a tree which are sold and taxed. The taxation of 25% and 50% of the profits in the disposal of an asset in respect of individuals and special trusts and in respect of corporation should be done

away with. If these profits are not taxed it means that the taxpayers gain 75% and 50% respectively of the sale of their assets. Taxing these profits is in agreement with the ability to pay, and benefits received. In the USA all capital gains are taxed as income. Increasing the percentage of taxable capital gains that must be brought into income, and also capping the lifetime capital gains exemption, and eliminating or reducing various tax shelters must be considered.

- CGT has introduced a complex tax system, which needs particular skills to handle. Lawyers and Accountants have started another industry lately that of being tax advisers or consultants to wealthy and affluent individuals and companies in general, for every asset acquired or disposed off. Research should be undertaken to see how simple and best these transactions can be handled by taxpayers. Otherwise CGT will remain a deterrent for investments.
- The government needs revenue to service the budget deficit as much as possible, and also for spending on infrastructure, health, education, Safety and Security among others. Broadening of the tax base to meet these demands should remain in the Legislature's programme. Many types of capital gains are still excluded in the tax net such as inheritances, gifts, winnings from gambling and any 'windfall' gains. In order to achieve the basic tax policy objectives of equity and efficiency, the RSA tax system should impose a direct tax on a broad income base, which must include all types of income, including the fruits of labour and returns on capital investment.
- Capital gains are taxed only upon realisation, rather than requiring taxpayers to annually value all their capital assets, which usually means when the asset is sold. Postponing the taxation of the gain until the time of sale, rather than when the asset appreciate, confers on the taxpayer the time value of money – it is always better to pay the bill later rather than sooner. It is as if the Revenue Service offers the asset holder as interest free loan equal to the tax due at the time the asset appreciates, from the time when the gain is made until the time the asset is sold. This loan is more valuable the higher the interest rates are and

the longer an asset is held. This provides an incentive to hold onto appreciated assets longer than otherwise, a phenomenon known as the “lock-in-effect”. The lock-in effect is greatly exasperated because of another feature of the current law – no tax at all due on capital gains if the asset is not sold during the holder’s lifetime (Slemrod et al, 2001:244).

- So far the common feature of capital gains tax is that gains are taxed when they are realised only. Studies must be undertaken with the aim of coming up with recommendations for taxing accruals also.
- Inflation is a fact of life everywhere including South Africa. The Legislature had failed to index the definition of income for inflation. Therefore the absence of indexation presents an enormous problem especially for capital gains. Nominal capital gains are not a reasonable approximation of real capital gain. Taxing only real gains and allowing full nominal interest deductibility opens enormous opportunities for arbitrage (Boskin et al, 1990:155-181).

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ANNEXURE A

Questions answering the research questions posed to the respondents about their attitude towards the impact of Capital Gains Tax to the economy of South Africa:

1. Capital Gains Tax before October 2001;

1.1. The way Capital Gains Tax was defined and presented created uncertainty for liability for tax:

YES	NO	DON'T KNOW
1	2	3

1.2. Was taxation of CGT as it was done with the exclusion of the “receipts and accruals” of a capital nature fair?

YES	NO	DON'T KNOW
1	2	3

1.3. The interpretation of “Taxable Income” with the exclusion of “receipts or accruals” of a capital nature created loopholes for tax avoidance or evasion;

AGREE	STRONGLY AGREE	DISAGREE	STRONGLY DISAGREE
1	2	3	4

1.4. The exclusion of “receipts or accruals” of a capital nature encouraged local investment or foreign direct investment in properties.

AGREE	STRONGLY AGREE	DISAGREE	STRONGLY DISAGREE
1	2	3	4

1.5. The exclusion of “receipts or accruals” of a capital nature encouraged economic growth resulting to job creation and eradication of poverty

AGREE	DISAGREE	STRONGLY DISAGREE	DON'T KNOW
1	2	3	4

1.6. Revenue collection before October 2001 was it good?

GOOD	VERY GOOD	POOR	VERY POOR
1	2	3	4

2. Capital Gains Tax after October 2001:

2.1. The way taxable income and CGT is defined creates certainty for liability for tax on a portion of the profit made on the disposal of an asset;

CORRECT	INCORRECT	DON'T KNOW
1	2	3

2.2. Do you consider the taxation of CGT after October 2001 fair?

FAIR	VERY FAIR	BAD	VERY BAD
1	2	3	4

2.3. The inclusion of CGT has broadened the tax net this will impact positively towards economic growth by increasing government spending;

AGREE	STRONGLY AGREE	DISAGREE	STRONGLY DISAGREE
1	2	3	4

2.4. The introduction of CGT will lessen the burden of taxation to all taxpayers;

AGREE	STRONGLY AGREE	DISAGREE	STRONGLY DISAGREE
1	2	3	4

2.5. CGT is known to be a low yield form of taxation; therefore its impact on revenue collection will be insignificant;

AGREE	STRONGLY AGREE	DISAGREE	STRONGLY DISAGREE
1	2	3	4

2.6. The tax burden will be increased to the extent that the affluent who owns properties pay more taxes

AGREE	STRONGLY AGREE	DISAGREE	STRONGLY DISAGREE
1	2	3	4

2.7. CGT will be a deterrent to investments; local and foreign direct investments,

AGREE	STRONGLY AGREE	DISAGREE	STRONGLY DISAGREE
1	2	3	4

2.8. CGT has introduced a tax system, which is wealth distributive to all taxpayers

YES	NO	DON'T KNOW

2.9. CGT will create difficulties for tax administration;

AGREE	STRONGLY AGREE	DISAGREE	STRONGLY DISAGREE
1	2	3	4

ANNEXURE B

Section 1

Table 1.1. Income Tax Rates: 1997 year of Assessment

Tax Rates before October 2001:

NATURAL PERSON

TAXABLE INCOME	Rates of Tax In Respect of Natural Persons
Where the taxable income- Does not exceed R15 000.....	R17 per cent of each R1 of the taxable income R2 550 plus 19 % of the amount by which the taxable income exceeds R15 000; R3 500 plus 21 % of the amount by which the taxable income exceeds R20 000; R5 600 plus 30% of the amount by which the taxable income exceeds R30 000; R8 600 plus 41% of the amount by which the taxable income exceeds R40 000' R16 800 plus 43% of the amount by which the taxable income Exceeds R60 000; R25 400 plus 44 % of the amount by which the taxable income exceeds R80 000; R34 200 plus 45% of the amount by which the taxable income exceeds R100 000;
Exceeds R15 000 but does not exceed R20 000	
“ R20 000 “ “ “ “ R30 000	
“ R30 000 “ “ “ “ R40 000	
“ R40 000 “ “ “ “ R60 000	
“ R60 000 “ “ “ “ R80 000	
“ R80 000 “ “ “ “ R100 000	
“ R100 000	

PERSONS OTHER THAN A NATURAL PERSON

TAXABLE INCOME	Rates of Tax in Respect of Persons other than Natural Persons
Where the taxable income – Does not exceed R5 000.....	R17 per cent of each R1 of the taxable income; R850 plus 19% of the amount by which the taxable income exceeds R5 00; R1 800 plus 21% of the amount by which the taxable income exceeds R10 000; R2 850 plus 24% of the amount by which the taxable income exceeds R15 000; R4 050 plus 28% of the amount by which the Taxable income exceeds R20 000; R6 850 plus 36% of the amount by which the Taxable income exceeds R30 000; R10 450 plus 41% of the amount by which the Taxable income exceeds R40 000; R14 550 plus 42% of the amount by which the Taxable income exceeds R50 000; R18 750 plus 43% of the amount by which the Taxable income exceeds R60 000; R23 050 plus 44% of the amount by which the Taxable income exceeds R70 000; R36 250 plus 45% of the amount by which the Taxable income exceeds R100 000;
Exceeds R 5 000 but does not exceed R10 000	
“ R10 000 “ “ “ “ R15 000	
“ R15 000 “ “ “ “ R20 000	
“ R20 000 “ “ “ “ R30 000	
“ R30 000 “ “ “ “ R40 000	
“ R40 000 “ “ “ “ R50 000	
“ R50 000 “ “ “ “ R60 000	
“ R60 000 “ “ “ “ R70 000	
“ R70 000 “ “ “ “ R100 000	
“ R100 000	

Tax Rates After October 2001:

Table 1.2: Statutory rates of tax applicable to individuals 2003

TAXABLE INCOME	RATES OF TAX
WHERE THE TAXABLE INCOME -	
Does not exceed R40 000	18% of each R1 of the taxable income
Exceeds R40 000 but does not exceed R80 000	R7 200 plus 25% of the amount by which the taxable income exceeds R40 000
Exceeds R80 000 but does not exceed R110 000	R17 200 plus 30 % of the amount by which the taxable income exceeds R80 000
Exceeds R110 000 but does not exceed R170 000	R26 200 plus 35% of the amount by which the taxable income exceeds R110 000
Exceeds R179 000 but does not exceed R240 000	R47 200 plus 38% of the amount by which the taxable income exceeds R170 000
Exceeds R240 000	R73 800 plus 40% of the amount by which the taxable income exceeds R240 000

SARS TAX RATES FOR 2003.

Table 1.3: Statutory rates of tax applicable to individuals 2004

TAXABLE INCOME	RATES OF TAX
WHERE THE TAXABLE INCOME -	
Does not exceed R70 000	18% of each R1 of taxable income
Exceeds R70 000 but does not exceed R110 000	R12 600 plus 25% of the amount by which the taxable income exceeds R70 000
Exceeds R110 000 but does not exceed R140 000	R22 600 plus 30% of the amount by which the taxable income exceeds R110 000
Exceeds R140 000 but does not exceed R180 000	R31 600 plus 35% of the amount by which the taxable income exceeds R140 000
Exceeds R180 000 but does not exceed R255 000	45 600 plus 38% of the amount by which the taxable income exceeds R180 000
Exceeds R255 000	R74 100 plus 40% of the amount by which the taxable income exceeds R255 000

SARS TAX RATES FOR 2004

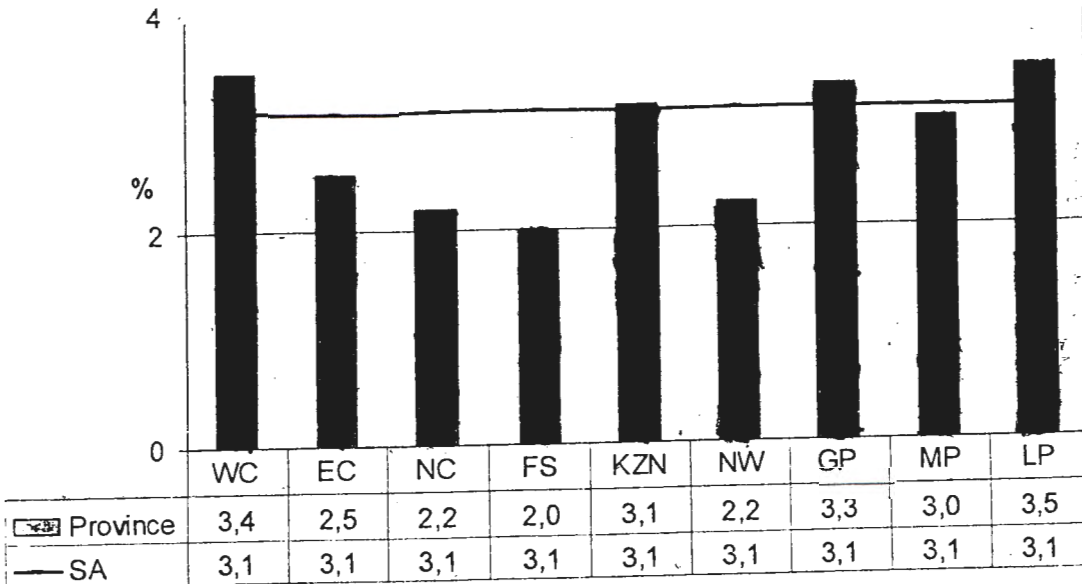
Table 1.4. Personal income tax rates for 2005/6

TAXABLE INCOME	RATES OF TAX
0 – R80 000	18% of each R1
R80 001 – R130 00	R14 400 plus 25% of the amount above R80 000
R130 001 – R180 000	R26 900 plus 30% of the amount above R130 000
R180 001 – R230 000	R41 900 plus 35% of the amount above R180 000
R230 001 – R300 000	R59 400 plus 38% of the amount above R230 000
R300 001 and above	R86 000 plus 40% of the amount above R300 000

SARS TAX RATES FOR 2005/6

Section 2

Table 2.1: Average annual economic growth: 1996 - 2004



Statistics South Africa

Table 2.2: Gross Domestic Product by Region: Summary

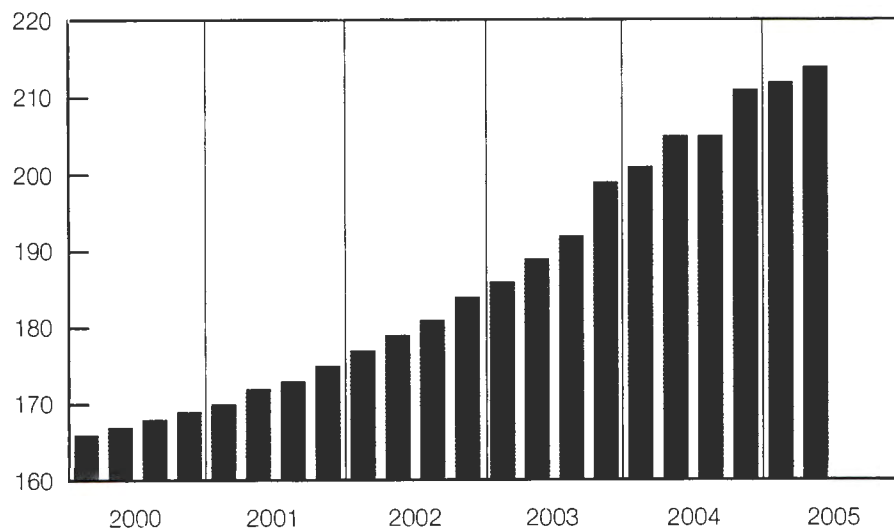
(Current prices –Rand million)

Province	1996	1997	1998	1999	2000	2001	2002	2003	2004
Western Cape	88363	98669	104908	116269	130983	144571	164886	181759	199412
Eastern Cape	51067	56501	60984	66853	75418	82403	90884	100747	112908
Northern Cape	12995	14258	15913	18325	21444	23507	25507	27850	30087
Free State	37102	40249	41168	45536	49649	54683	65551	68598	75827
KwaZulu-Natal	104081	114644	123882	132785	150912	168392	191289	207047	231616
North West	38730	42804	46844	51425	59898	67526	76646	79063	87127
Gauteng	207449	231223	250999	273164	311992	337443	382804	422066	462044
Mpumalanga	42830	47292	51292	56970	62901	73081	83020	86411	94450
Limpopo	34343	40091	46435	51755	58954	68290	78100	83484	93188
GDP at market prices	617959	685731	742424	813683	922151	1019898	1168777	1267026	1386658

Statistics South Africa – Gross Domestic Product – November 2005

Table 2.3: Real final consumption expenditure by general government

R billions at constant 200 prices



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Table 2.4: Foreign liabilities of South Africa

R millions

Direct investment	1997	1998	1999	2000	2001	2002	2003
Total direct investment	81 463	91 862	318 630	328 859	370 695	255 837	303 438

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Table 2.5: 2006 Budget Review

R million

Description	2000/01	2001/02	2002/3	2003/4	2004/05	2005/06
Taxes on income and profits	126146,1	147310,4	164565,9	171962,8	195219,1	228730,0
Taxes on property	3 978,8	4 628,3	5 084,6	6 707,5	9 012,6	11 120,0

RSA National Treasury Budget Review 2006 Actuals.